

EastBay

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ECONOMIC OUTLOOK



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The California Report: Three Things to Watch in 2007

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For most of 2006, our forecast for the California economy has been that the slowing housing markets would be a drag on growth – enough to slow the overall economy, but not enough to create a recession. While both building permits and construction employment have fallen faster than we predicted earlier in the year, other sectors have fared a little better than we expected, leaving the California economy as a whole growing slower than it has been, but slightly faster than we predicted.

So far, so good – but the end of the story is still in doubt. In our thinking, the outcome has always hinged on whether some other source of weakness would emerge to create a double whammy that would tip California into recession. With this in mind, this installment of the California Report looks at three California issues that we'll be watching closely in 2007. Two of these are potential candidates for that second source of weakness, and the last examines whether there are any "savior sectors" that will soften the impact of the real estate slowdown.

Issue #1: Retail Spending and the Housing Wealth Effect

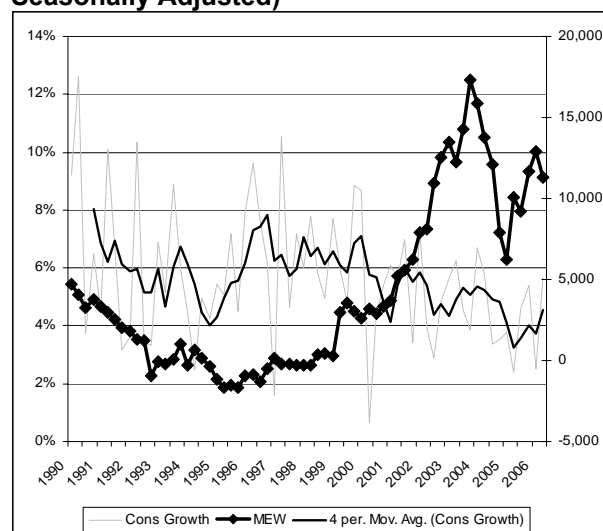
Just about everyone agrees that rapid appreciation of home prices played a major role in keeping consumption spending afloat in the wake of the 2001 recession, either directly through equity withdrawals or indirectly through the increased feeling of wealth derived from earning a 20% rate of return on your biggest asset. However, there is much less agreement on what happens to consumption now that home price appreciation has stopped: does it fall by a little or a lot, and how fast does this transition occur? Most of the ambiguity comes from an academic debate about whether consumers treat an increase in housing wealth differently than an increase in other types of wealth. A rough estimate of the wealth effect from financial assets is that an increase in wealth of \$100 will increase annual consumption by around \$4. However, several recent academic studies suggest that that a \$100 increase in housing wealth could increase consumption by as much as \$12 per year.¹ These estimates imply that

¹ Feeling brave? Some recent papers on this subject include "Comparing Wealth Effects: The Stock Market Versus The Housing Market" by Case, Shiller, and Quigely (2005), "Housing Wealth, Financial Wealth, and Consumption: New Evidence From Microdata", by Bostic, Gabriel and Painter (2006), and "How Large is the Housing Wealth Effect? A New

15% appreciation on a \$400,000 home could have added as much as \$7200 to annual consumption spending.

But in spite of these large estimates of the positive impact of home prices on consumption, there are reasons to think that a slowdown in home price appreciation may not bring consumption to a screeching halt. First, we have some international evidence on this question from the U.K. Home price appreciation hit a peak of 30% annualized growth in the summer of 2002, and mortgage equity withdrawals hit an all-time high at 9% of total disposable income in late 2003. In the next year and a half, both of these measures of the impact of housing wealth fell dramatically. Home price appreciation fell to zero by the middle of 2005, and the total volume of home equity withdrawals in the U.K. fell to only 3.1% of disposable income. Yet there is little evidence of a substantial effect on consumption spending. Growth slowed a little bit in 2005, but it is hard to distinguish the 2005 slowdown from the larger slowing trend that has prevailed since 2000. Thus, a middle-of-the-road interpretation of the British evidence suggests that while slowing appreciation may have had a small effect on consumption growth, it certainly wasn't enough to sink the overall economy.

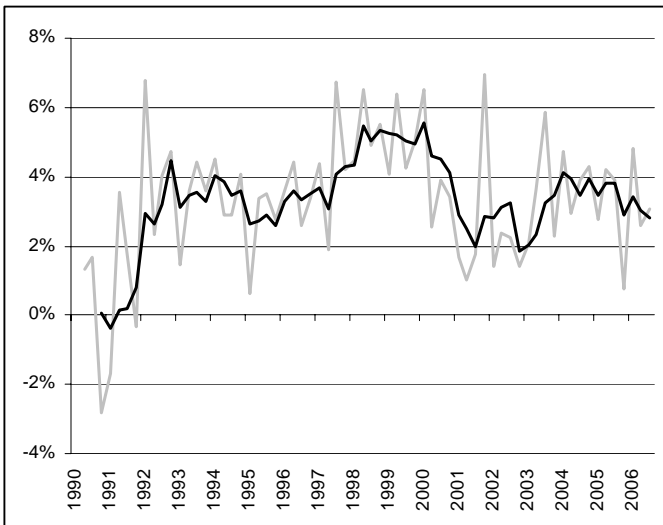
U.K. Growth in Final Consumption Spending (left, Seasonally Adjusted Annual Rate) and U.K. Mortgage Equity Withdrawals (right, mil. £, Seasonally Adjusted)



Approach", by Carroll, Otsuka, and Slacalek, (2006)

Second, we already have some preliminary evidence from the U.S. economy, as mortgage equity withdrawals have fallen significantly from the end of 2005. Estimates vary, but it appears that home equity withdrawals as a share of disposable income peaked in the 8-10% range in 2005Q3, and have fallen to somewhere between 3.3% to 6% in 2006Q2 – not quite as big as experienced in the U.K. over three quarters, but close. As in the U.K., we've seen some mild slowing in both consumption and retail sales in the U.S., but nothing that suggests that the decline in housing wealth will sink the U.S. economy.

U.S. Consumption Growth (Seasonally Adjusted Annual Rate, 4 qtr Moving Average in bold)

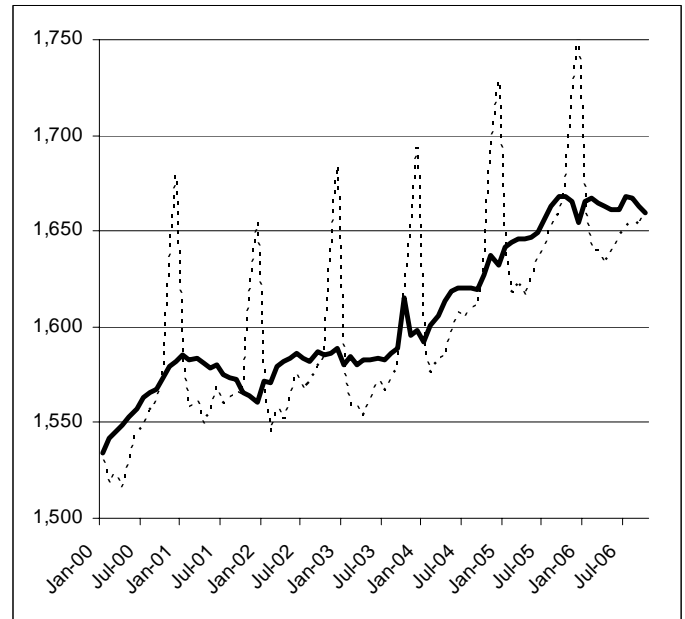


Has there been any evidence of a negative wealth effect from slowing appreciation in California? Taxable sales are our closest proxy for retail spending in California, but unfortunately the official estimates lag about one year behind. In the absence of direct data, some observers have pointed to two recent developments in the California economy as evidence of a negative wealth effect from housing: a significant slowdown in the year-over-year rate of job growth in Retail Trade; and a substantial drop in new car sales in California relative to last year (as measured by new Department of Motor Vehicle registrations). However, each of these trends has a simpler explanation than a negative wealth effect.

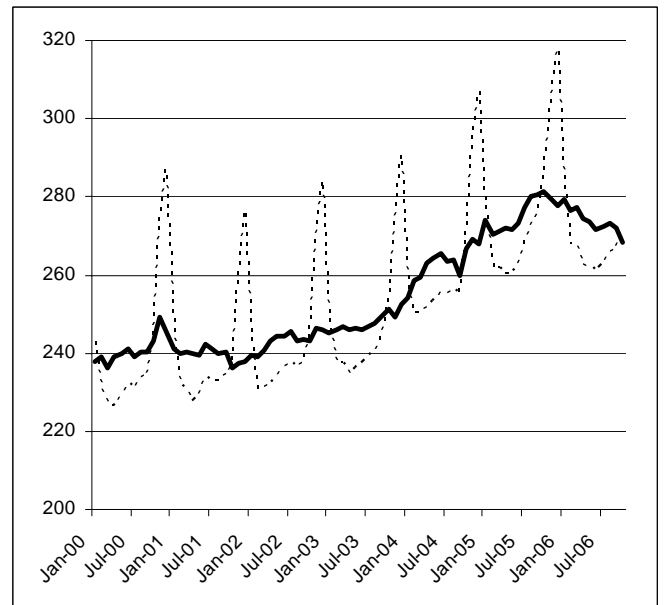
First, let's look more closely at Retail Trade employment, which has lost around 9,000 jobs since October 2005. Most of this weakness has come from the Department Stores category, which has lost just over 13,000 jobs over this period. While it's possible that some of this weakness stems from a housing-driven drop in demand, the more likely explanation is that most of these job losses stem from the Federated / May Company merger, which has resulted in the consolidation of Macy's and Robinson's May during 2006Q2-Q3. While it's a distant second, the Building Material and Garden Equipment category has also lost about 1,600 jobs since October of

2005. Of course, it's hard to categorize these losses as collateral damage from a negative wealth effect – they are just as much a direct consequence of a slump in the Construction sector.

CA Retail Employment (1,000s, Seasonally Adjusted in bold)



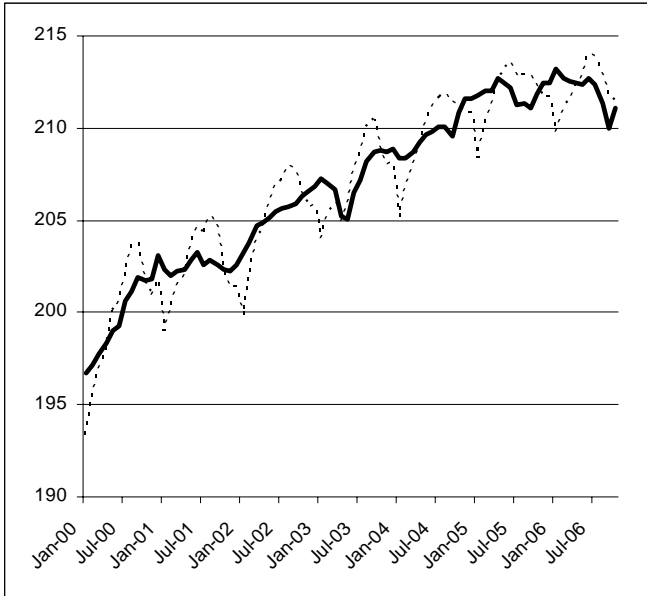
CA Dept. Store Employment (1,000s, Seasonally Adjusted in bold)



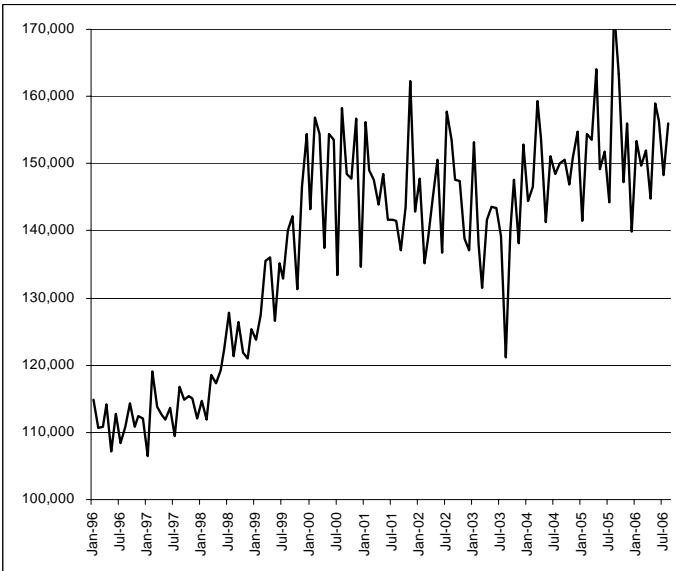
While the weakness in each of these previous retail industries is hard to tie to a negative wealth effect from housing, the recent weakness in the California auto market is harder to dismiss out of hand. Employment at motor vehicle dealerships in California fell by just under 1,000 jobs, and new car registrations fell 10% from the previous summer's levels. But even these trends have multiple explanations: is this the consequence of a

negative wealth effect from housing, or simply the fact that aggressive employee pricing programs in 2005 decreased demand from people who would have otherwise purchased a new car in 2006?

CA Car Dealership Employment (1,000s, Seasonally Adjusted in bold)



CA New Car Sales: New DMV Registrations (Seasonally Adjusted)



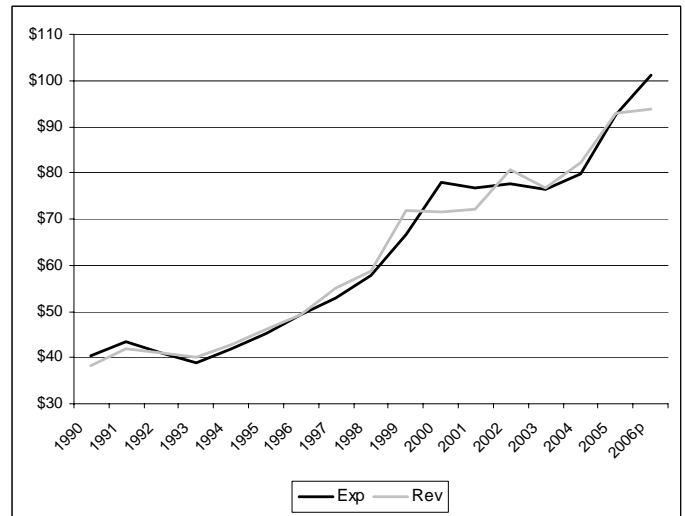
Looking backward, it's hard to find any unambiguous evidence of a negative wealth effect from housing in the U.K., U.S., or California data. However, since a slump in consumption and retail sales could potentially turn our housing-driven slowdown into a housing-driven recession, we'll be following the consumption and retail sales data closely, looking for further evidence of a negative wealth effect. But for now, our view is that we'll

believe it when we see it. We do not believe that a negative wealth effect from housing will be enough to tip the scales in 2007.

Issue #2: Back to the Future? The State Budget and the Real Estate Slowdown

In the late 1990s, the dot.com frenzy yielded a double jackpot for state revenues -- the booming economy led to robust growth in both taxable sales and personal income, while the blizzard of stock options and IPOs led to a surge in non-wage income among the richest Californians, with a corresponding jump in capital gains revenue. Even as late as 1999, California found itself with \$5.4 billion more in revenues than expenditures. Unfortunately, the following year's budget took this jackpot for granted: state expenditures rose 17% in the 2000-1 budget, while realized revenues fell by 1%. Not surprisingly, this monstrous shortfall led to a budget crunch. Over the next two years, total state expenditures actually fell by a small amount, and state and local government employment lost jobs during 2003. When the California economy was already reeling from the collapse of the technology bubble, the resulting slowdown was deepened by a fiscal crunch in Sacramento.

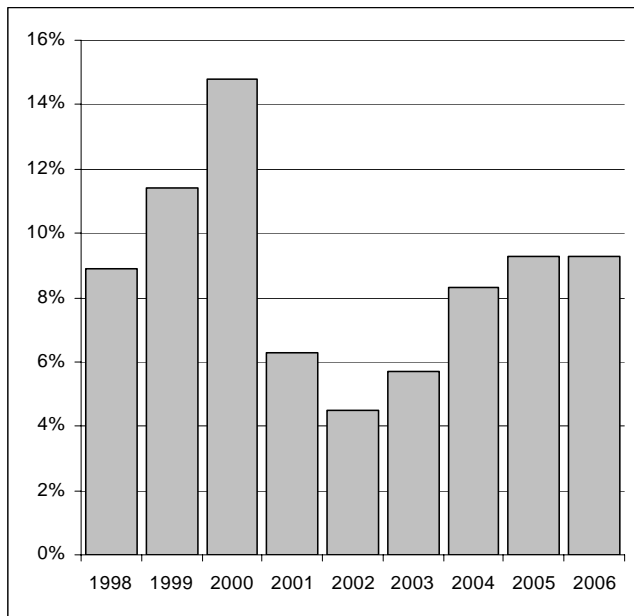
CA State Revenues vs. Expenditures (billion \$)



Six years later, our circumstances sound eerily familiar. The housing boom has created another temporary surge in revenues. The increased pace of new construction plus high turnover in the market for existing homes has caused the biggest five-year revenue increase since the passage of Proposition 13. Property tax revenues jumped by 58% between 2001 and 2006. Similarly, the capital gains on housing transactions have increased capital gains tax revenues to 9.3% of General Fund revenue – a significant increase, but not quite the highs established during the tech boom. Unfortunately, flat home prices and lower sales volumes suggest that these

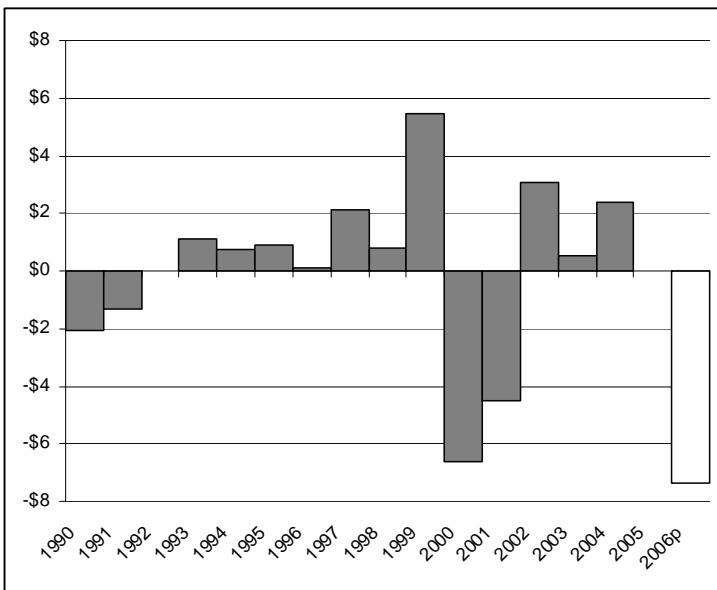
gains will disappear in the coming years, just like the revenue gains from the tech boom.

CA Share of General Fund Revenue from 9% Capital Gains Tax



Just as these sources of revenue growth look to be drying up, the Legislative Analyst’s Office estimates that the state general fund expenditures will exceed revenues by \$7.3 billion in the 2006-7 fiscal year – a bigger shortfall than the 2000-1 crunch-inducing budget. Without a significant change in taxation or spending policies, the LAO predicts that next year’s budget deficit will wipe out the last of the general fund reserve.

CA State Revenues minus Expenditures (billion \$)

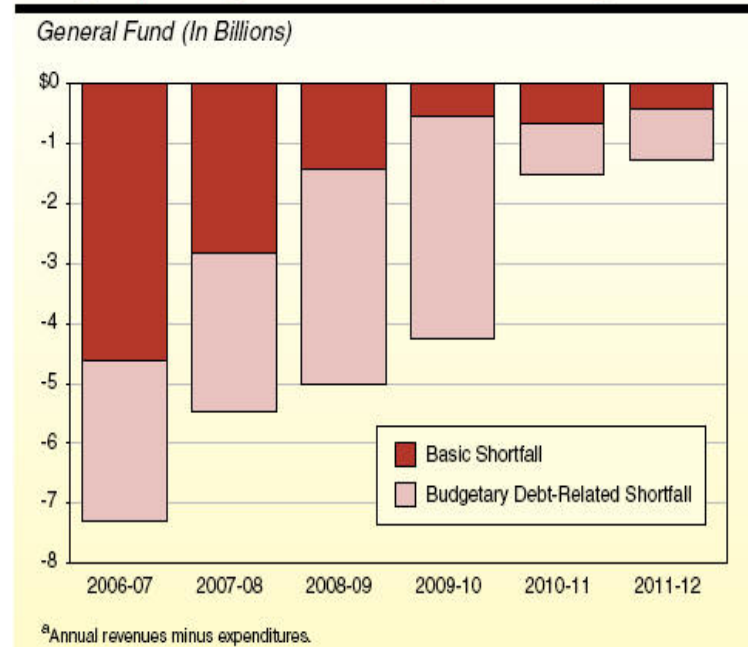


This raises the possibility that another round of spending and employment cutbacks in state government might be that second source of weakness that turns a housing slowdown into a housing recession. However, there’s at least one crucial difference this time around: nearly 70% of the shortfalls projected by the LAO from 2007-2010 arise from the deficit financing scheme passed in 2004. Under Proposition 58, between 1% and 3% of annual general fund revenue must be paid into a Budget Stabilization Account. Half of these annual payments are required by law to go to early payment of 2004’s deficit financing bonds (Prop. 57). The key word here is *early* – by making the minimum payments required, the Legislature and the Governor can close about half of these looming deficits. Of course, this still leaves a multi-billion dollar gap between “current law” spending and revenue that requires the type of tough political choices that Sacramento has proven itself unable to make in the past.

CA LAO’s Projected Budget Shortfalls, 2006-2012

Figure 3

Large Operating Shortfalls Projected Through 2009-10^a



(Source: LAO Fiscal Outlook, 2006-07 to 2011-12)

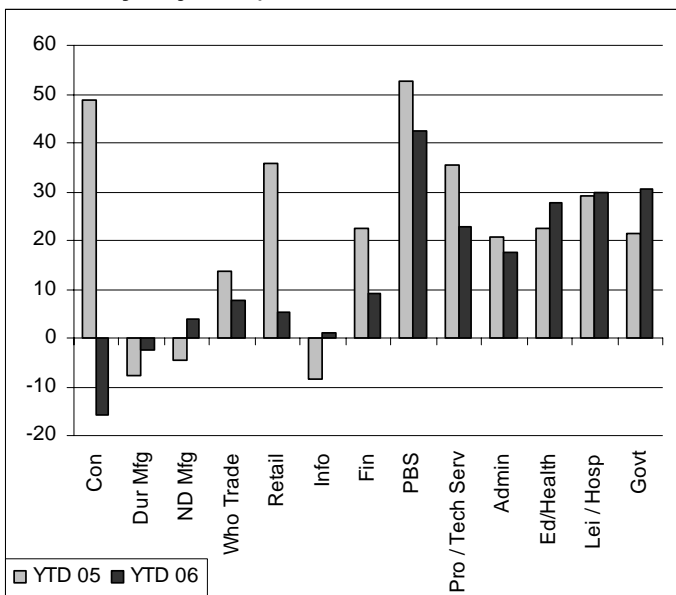
Bottom line? There’s some wiggle room in the substantial deficits projected by the LAO, since a significant chunk of projected spending is optional early payments on debt. But even if these payments are reduced to their legal minimums, the balance on the General Fund will still go negative within two years unless California can balance its spending and revenues. Since this rebalancing will almost certainly involve some combination of higher taxes and/or lower government spending, it will exert some drag on the California economy. Depending on the timing and the

severity, this budget crunch could be the second half of the double whammy that turns a California housing slowdown into a housing recession.

Issue #3: Are there any “savior sectors” that can pick up the slack?

The cooling housing market has already taken a heavy toll on job growth in California: weakness in real estate related sectors bringing January-October 2006 job creation in at 36% lower than January to October of 2005, with almost every sector experiencing slower job growth. Since 2007 will hold just as much if not more real estate related job weakness, one of the central questions for the California forecast is whether there are any sectors poised to offset this housing drag. Based on their external orientation and their current importance to total job growth, we think there are two possible candidates: the Professional/Business Service (PBS) sector, and Leisure and Hospitality (L/H).

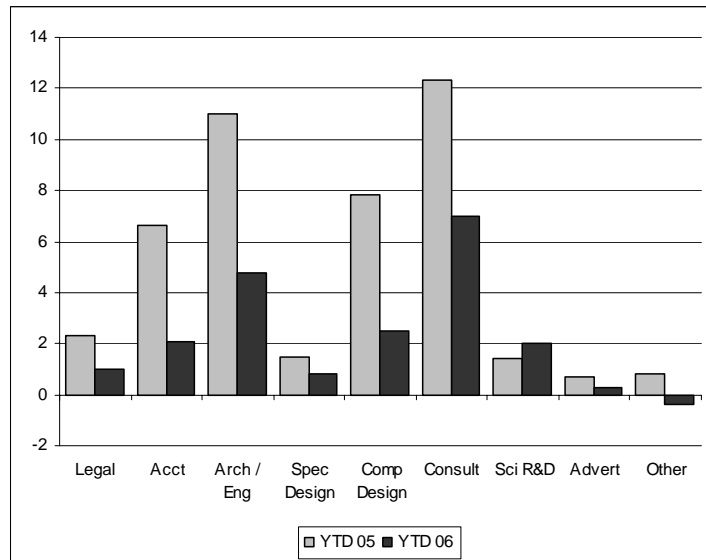
CA New Jobs by Sector, Year-to-Date (1,000s, Seasonally Adjusted)



These two industries have been a crucial part of the recovery from the 2001 recession. The period from October 2003 through October of 2006, our most recent data, roughly spans California’s climb back from the low point of total employment after the recession. During this period, California added 662,000 payroll jobs. On several occasions we have pointed out that this recovery was heavily reliant on the 108,000 jobs created in the Construction industry. However, the Construction industry was in fact only the third biggest source of new jobs in California, behind PBS (158,000 new jobs), and L/H (116,000 new jobs).

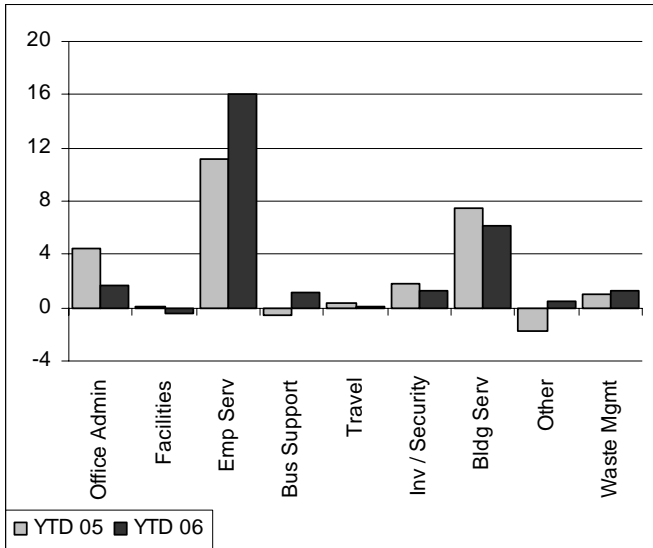
Although the PBS sector continued as the biggest source of new jobs in 2006, a change is in the wind. Growth during this three-year recovery period was fairly evenly split between the knowledge-intensive Professional/Technical Services (Pro/Tech) and Administrative Services categories, with a slight edge going to Pro/Tech. However, 2006 saw an across-the-board slowdown in Pro/Tech, with year-to-date job creation in 2006 down by over 50% compared to last year. Part of this is a real estate driven slowdown in Architecture and Engineering Services, but the consulting and computer design sectors have also slowed compared to similar data for 2005. Pro/Tech employment is still a slightly larger share of total employment than it was at the height of the tech boom, so this slowdown looks like a transition from a recovery period back to a slower long-run trend level of growth. In this light, an acceleration of job creation in Pro/Tech looks unlikely in 2007.

CA New Jobs in Professional / Technical Services, YTD (1,000s, Seasonally Adjusted)



Thus, any PBS help would have to come from the decidedly less exciting Administrative Services category. The murky realm of Employment Services, which includes temp workers of all stripes, from secretaries to engineers, makes up 45% of employment in this category. In fact, the top three occupations represented in this industry in 2004 might surprise you: Laborers and Freight, Stock, and Material Movers was #1 at 85,800 workers, Production Workers (i.e. manufacturing jobs) was #2 at 32,500, and Office Support Workers was #3 at 28,800. Employment in this industry was mostly flat through the early part of the PBS recovery, but saw significant growth in 2005 and even better growth in 2006. In fact, Employment Services has been the main engine of growth in Administrative services – most of the other components saw 2005’s moderate growth slow in 2006.

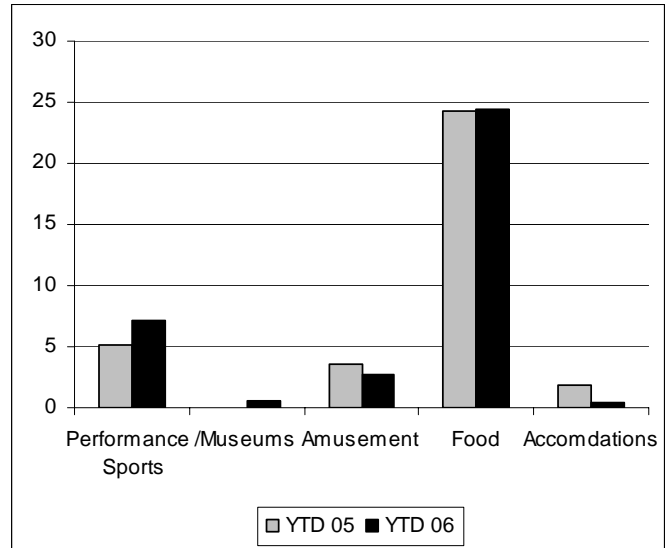
CA New Jobs in Administrative Services, YTD (1,000s, Seasonally Adjusted)



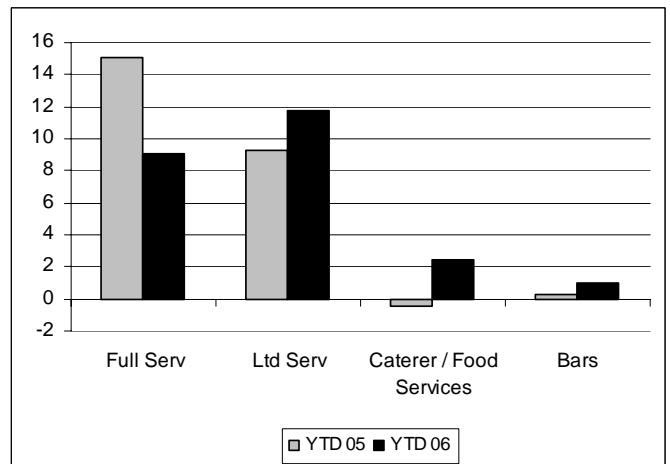
Based on what we see, it looks unlikely that PBS is in any position to pick up the slack from a slowing real estate sector. Job growth on the Pro/Tech side looks to be transitioning from a period of rapid growth in the aftermath of the tech bust to a period of slower “normal growth.” On the Administrative Services side, the only candidate for faster growth in 2007 would be Employment Services, but this seems improbable for two reasons. First, demand for temp workers has to come from somewhere else in the economy – this industry can’t pull itself along by the bootstraps. Second, any significant expansion of this industry at this point in the business cycle would more likely represent replacing permanent workers with temps, as opposed to filling new positions quickly with the intent of hiring full time later. While we will continue to watch developments in this important sector in 2007, at this point it looks like the best we can hope for from PBS is steady as she goes.

How about the Leisure and Hospitality industry – can California’s booming tourist industry offset housing weakness? L/H has seen strong and steady employment growth in the past two years, and is one of the few sectors to show no sign of slowing in 2006. However, the industrial distribution of this steady growth suggests that tourism is only part of the story. 69% of the L/H jobs added in 2006 have been in the restaurant industry, with limited service restaurants (i.e., fast food) as the biggest source of growth. While some of this growth can undoubtedly be linked to a healthy tourism sector, the boom in fast food employment suggests that some of this is the second wave of the residential building boom – as major new developments create new populations centers, restaurant and retail centers will surely follow.

CA New Jobs in Leisure/Hospitality, YTD (1,000s, Seasonally Adjusted)



CA New Jobs in Food Service (1,000s Seasonally Adjusted)



The importance of the restaurant industry to this sector’s growth over the past two years diminishes our hope that L/H could play the role of savior sector in 2007-8, since productivity in the Accommodation/Food Service industry is the lowest of any industry in California (\$36,494 of Gross State Product per worker in 2004). Imagine a scenario where 2007 has exactly the same level of overall job creation as 2006, but the bulk of those new jobs were in Accommodation and Food Service instead of in Construction. The lower productivity of workers in the Leisure and Hospitality sector means that even though total employment was unaffected, the overall economy ends up producing less. So even if the pace of job creation in this sector accelerates substantially next year, it would not be enough to counteract the slump in construction and real estate.

Forecast and Conclusions

The background for this California Report has been the forecast that we've maintained throughout 2006 – slowing housing markets will create a significant slowdown in the California economy, but will not create a recession without a secondary source of weakness. We've presented two candidates for potential sources of weakness (a negative wealth effect and a budget crunch), and two candidates for sectors that could soften our landing with accelerating growth (Professional/Business Services and Leisure/Hospitality).

In the end, none of these alternative scenarios look likely enough to cause us to alter our basic forecast. Currently, we don't have enough evidence to believe that the wealth effect will be big enough to dramatically alter the path of the California economy. A budget-related shock from Sacramento looks almost unavoidable, but with a significant portion of the projected shortfalls coming from discretionary pre-payment of debt, there may be some room to maneuver on the timing of this crunch. On the other side, neither of our candidates for savior sectors looks poised to generate enough growth to pick up the slack left by weakness in Construction and other housing sectors.

Thus, the central message of our forecast remains unchanged. The construction sector will continue to weaken, with total residential permit activity and construction employment hitting bottom in late 2007. This weakness will slow the California economy, but without a second source of weakness, it will not be enough to create a recession. Overall growth in non-farm payrolls will slow to 0.5%, with unemployment ticking up to 5.2% by the end of 2007; similarly, growth in real personal income and taxable sales will slow to 1.5%. 2008 will see a small recovery, but will still remain sluggish.

East Bay Forecast: The Real Estate Juggernaut Falts

In the second half of 2006, the East Bay remained the fastest growing economy in the Bay Area, with a year-over-year rate of job creation well above the state average during this period. However, the local economy showed some slight signs of slowing in the second half of the year, as the surprisingly resilient East Bay real estate market finally showed signs of fatigue. The pace of overall job creation in the East Bay slowed from 1570 new non-farm payroll jobs per month in the first half of 2006 to an average of 1380 new jobs per month from July to November, with unemployment essentially moving sideways over the same period.

Unemployment continues to fall in the East Bay, though not as fast as it did in 2005.

East Bay Unemployment Rate (Seasonally Adjusted)

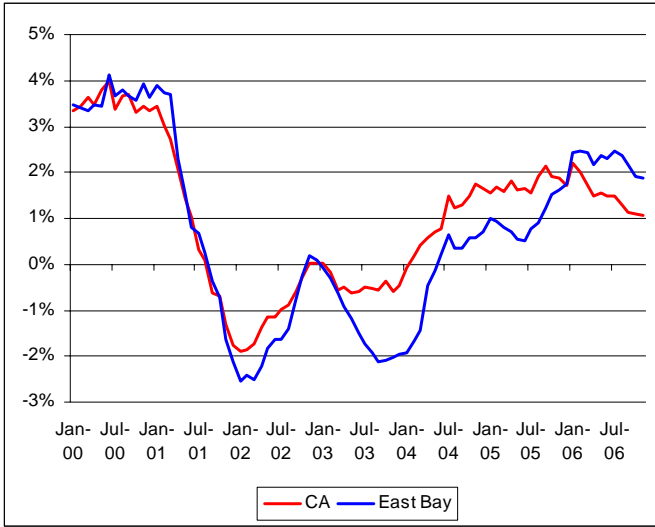


If anything, the East Bay has done surprisingly well in the second half of 2006 given the magnitude of the real estate slowdown, thanks to a surge in employment in several service sectors. Unfortunately, this lucky coincidence is unlikely to last into 2007. The experience of California counties with similar demographic and building trends suggests that the real estate slowdown has further to go in the East Bay – especially in Contra Costa County. At the same time, the surge in service sector growth that saved the day in the latter half of 2006 is almost surely temporary. So while some slowdown in 2007 looks unavoidable, the final outcome will likely be a tug of war between the general renaissance of the Bay Area technology economy and the specifics of a sluggish East Bay housing market.

Labor Market Update: Picking up the Slack

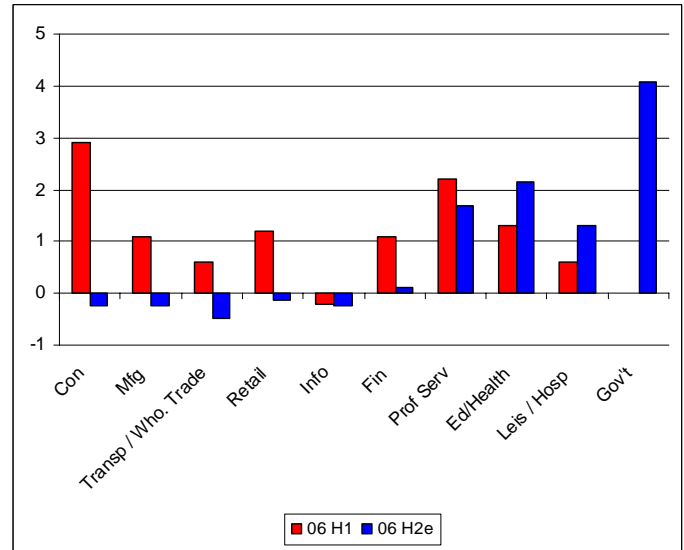
In percentage terms, the East Bay remains the fastest growing job market in the Bay Area; however, the combination of a slight slowdown in the East Bay and an acceleration of growth on the Peninsula has narrowed the gap significantly in recent months.

Year-over-Year Growth in Non-Farm Payroll Employment



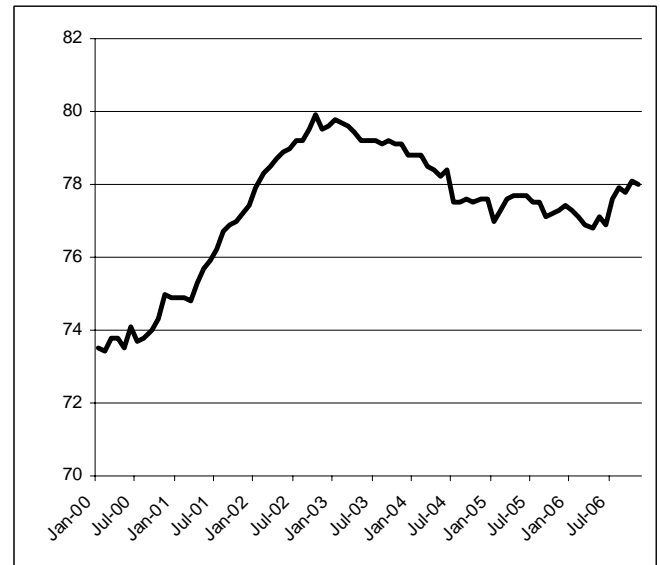
While the overall pace of job growth looks only slightly slower than the first half of 2006, this masks a substantial shift in the industry mix of those new jobs. Real estate was still the major engine of growth in the East Bay economy in the first half of 2006, with Construction and the Credit Intermediation (real estate lending) industries accounting for 37% of the new jobs created. However, from July to November, both of these sectors have experienced substantial slowdowns, with job losses in seasonally adjusted terms. Like many other regions in California, real estate has gone from pulling the economy forward to actually holding it back – it’s just taken a little longer to happen in the East Bay than in most other parts of the state. Unfortunately, this recent slowdown in real estate job creation has gone hand in hand with a similar reversal in retail employment. In the first half of 2006, Retail Trade added 1,200 new jobs, but has added no new jobs aside from the seasonal surge that we would normally expect to see in the fourth quarter.

New East Bay Payroll Jobs by Sector (1000s Seasonally Adjusted) (2nd half 2006 estimated from July-Nov data)



But in spite of this slowing, several service sectors have stepped up to keep overall job growth healthy in the second half of 2006. The Education/Health Care, Leisure/Hospitality, and Government sectors all saw more job creation in the second half of the year. Surprisingly, while Leisure/Hospitality has more than doubled its rate of job creation in the second half of the year, it was the addition of more than 3,400 new Government jobs that more than offset the loss of Construction-related growth.

East Bay Employment in State and Local Government, excluding Education (1000s, Seasonally Adjusted)

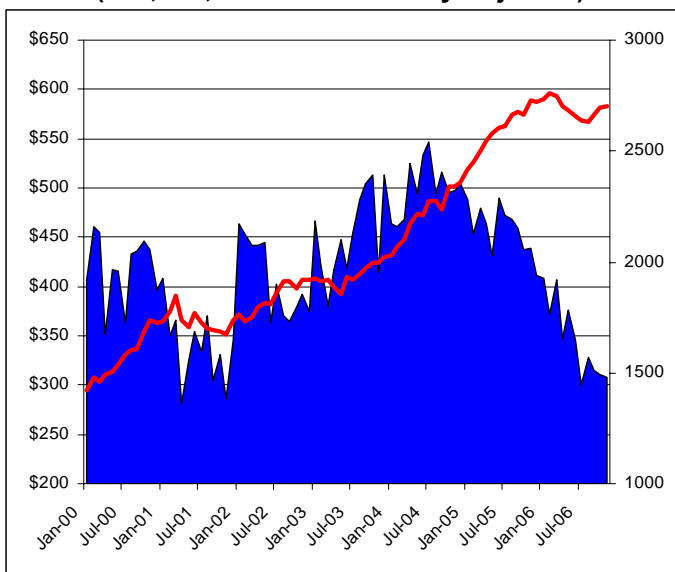


Thus, there are two key questions when looking forward at what to expect from East Bay job markets in 2007: how much more slowing will we see from the real estate side of the economy, and will these other service sectors continue to make up for that weakness? We'll consider the fate of the Construction sector in more detail in the next section, but we expect that real estate will continue to be a drag on the East Bay economy in 2007. We are also skeptical that the service sector will continue to buoy the economy as it has in the second half of 2006. In addition to the general reasons discussed in the California Report, it seems unlikely that any economy can long be sustained by local government as its primary source of growth.

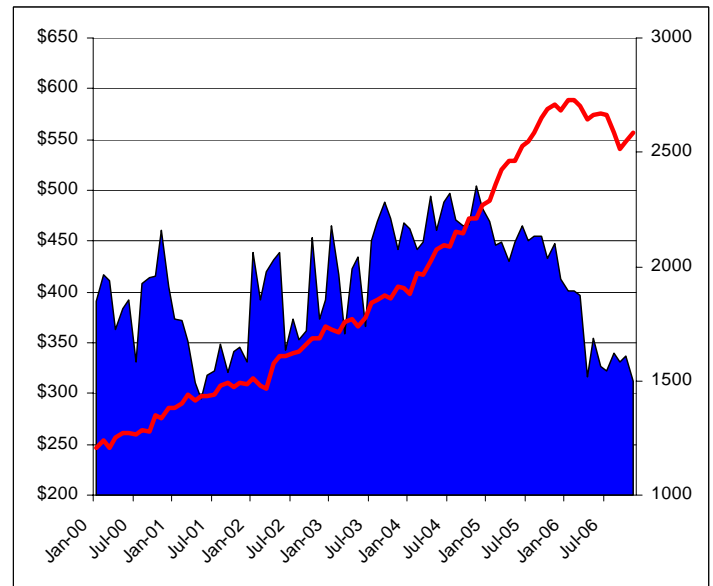
Population, Construction, and Home Prices

The last months of 2006 have seen more of the same from Bay Area housing markets – falling sales and flat prices continue to be the rule. Unfortunately, the East Bay has been on the bad side of this regional average: sales have fallen to levels last seen in the 2001 recession, and the median sales price for all homes has shown moderate declines in both East Bay counties. In Contra Costa County, the median sale price for all homes had fallen by over 8% from the record high set in early February before staging a small recovery in the last few months. Alameda County has experienced a less severe version of the same trend: from February to August, median sales prices fell just under 5% before staging a similar recovery in the fall months.

Alameda County: Total Home Sales (area, right, Seasonally Adjusted) and Median Sales Price of All Homes (line, left, \$1000s Seasonally Adjusted)

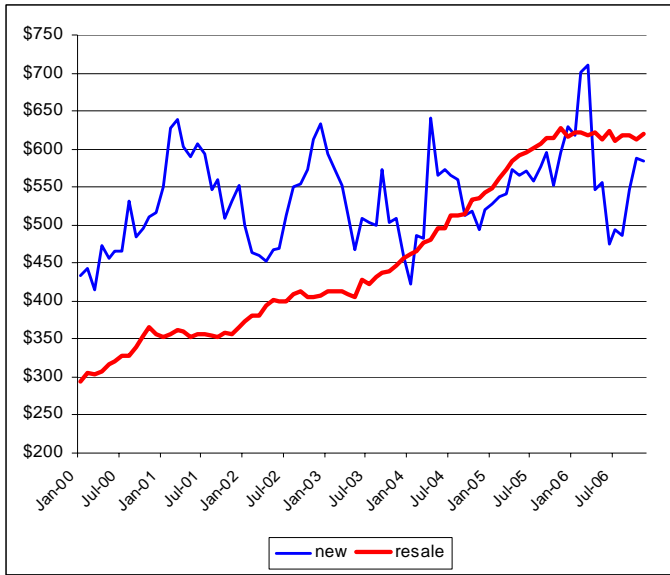


Contra Costa County: Total Home Sales (area, right, Seasonally Adjusted) and Median Sales Price of All Homes (line, left, \$1000s Seasonally Adjusted)

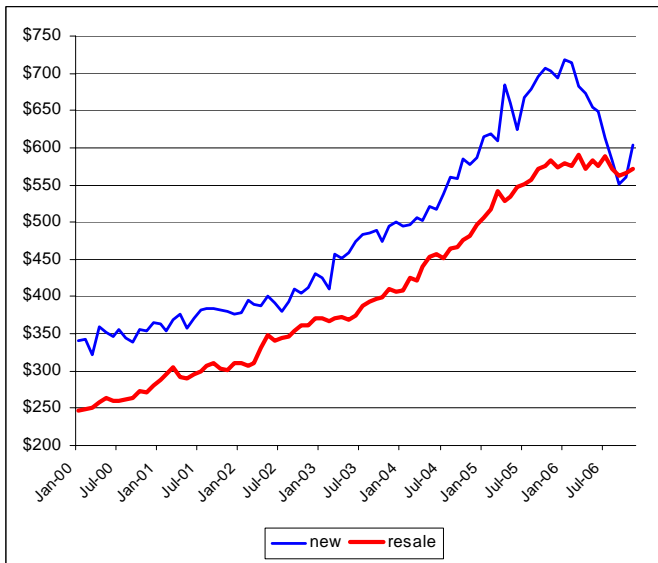


Our national and state forecasts have repeatedly stressed the idea that historically, significant home price declines only occur in the wake of recession. Thus, since we are not forecasting a recession, we have not included a significant decline in home prices. As we discussed at some length in last quarter's East Bay Forecast, the declines in median sales prices seen in the East Bay are not inconsistent with this story. Instead, the East Bay shares many of the same features that have led to similar price declines in San Diego and Sacramento – the price of new homes has fallen precipitously, and new homes make up an above average share of total sales in these markets. This pattern is nothing new: historically, the sellers of new homes have been much more willing to drop prices than sellers in the resale market.

Alameda County: Median Sales Price of New Home vs. Resale Home (\$1000s Seasonally Adjusted)



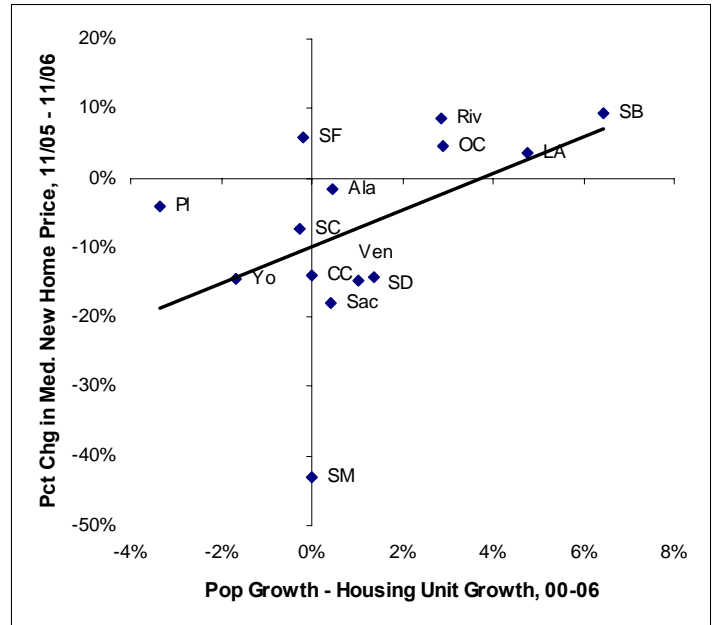
Contra Costa County: Median Sales Price of New Home vs. Resale Home (\$1000s Seasonally Adjusted)



But why has the price of new homes in the East Bay and these other markets fallen so dramatically, while new home prices are still rising in other counties? The common denominator in these unlucky counties is the relationship between growth in population and the number of new homes built in the county. In the graph below, the horizontal axis ranks the biggest counties in California by the difference in the growth rate of their populations and their housing stock from January 2000 to January 2006: counties where population growth has outstripped growth in the number of homes will appear further to the right. Similarly, the vertical axis ranks these same counties by percentage change in the price of a new home from November 2005 to November 2006.

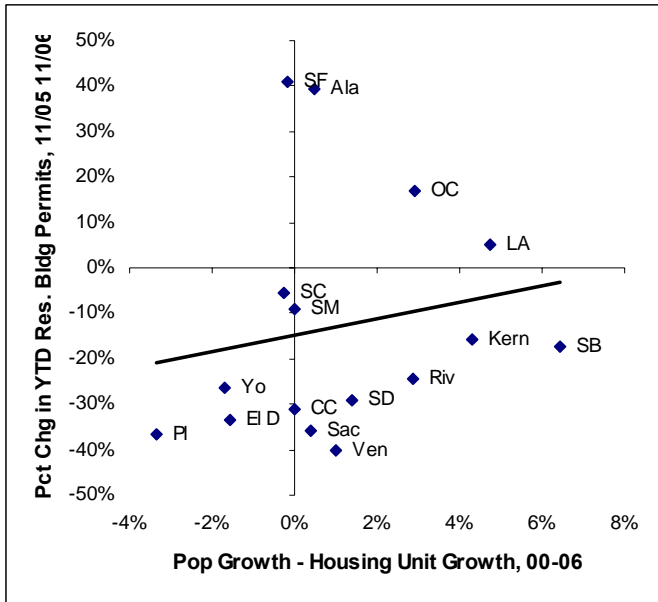
Not surprisingly, there is a positive relationship: the counties where the pace of building over the past five years has kept close to population growth tend to be the counties that have seen the biggest declines in new home prices this year.

Change in New Home Prices vs. Building Pace for Major CA Counties



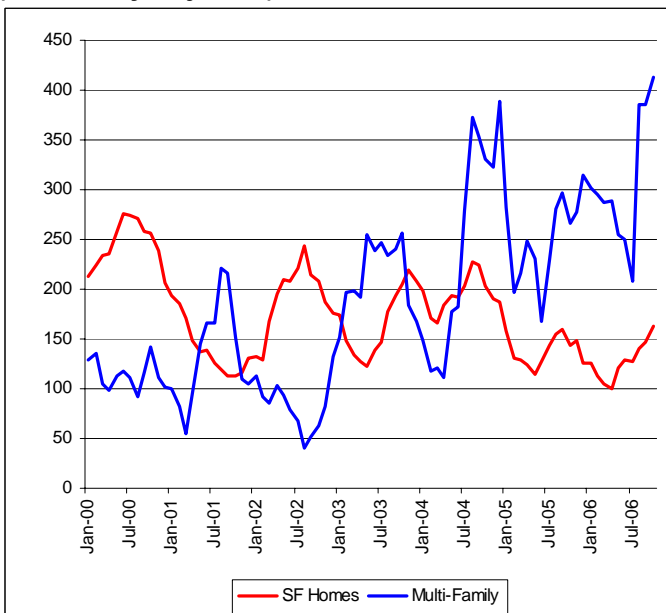
This relationship suggests two kinds of housing markets in California right now. At one extreme, counties like those surrounding Sacramento have actually seen the housing stock grow faster than population, and new homes are a significant portion of the overall market. Not surprisingly, they have seen some of the biggest year-over-year declines in the median sales price of a new home in 2006. At the other extreme, markets like L.A. County have seen population growth significantly exceed the pace of building, and new homes are a tiny fraction of the overall market. In these circumstances, new homes prices have shown more staying power. The East Bay's experience has been somewhere in the middle: the building boom has essentially kept up with population growth over the past five years, implying a middle of the road decline in the price of a new home. Of course, the fate of the new home market is intimately connected to the prospects of the local construction industry. The graph below has the same horizontal axis as the last graph: counties with a big positive difference between population growth and growth in the housing stock are further to the right. However, this time the vertical axis shows the percentage change in total number of building permits issued between January and November 2005 versus 2006.

Change in YTD Building Permits vs. Building Pace for Major CA Counties

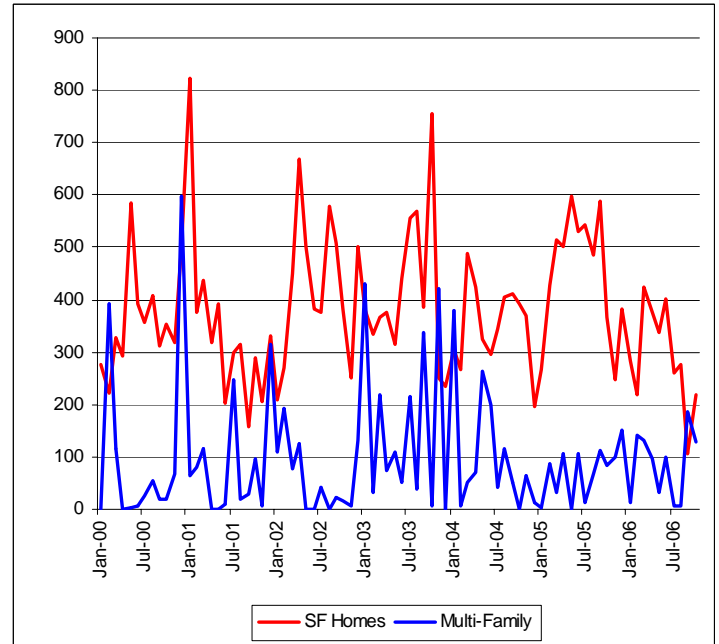


Again, we see a positive relationship: counties where building has kept pace with population growth are also the counties that have seen the biggest drop in permit activity – no surprise given the trend in new home prices in these counties. However, this time there is a substantial difference between the East Bay counties. While the housing stock has grown roughly as fast as population growth in both counties, Contra Costa County has seen the predicted drop in residential building permits, while Alameda County is a significant outlier, with one of the biggest percentage *increases* in permits seen anywhere in California.

Alameda County: Building Permits by Type (Seasonally Adjusted)



Contra Costa County: Building Permits by Type (Seasonally Adjusted)



The difference between these counties is the type of building. Contra Costa County's building boom was primarily in single family homes, which in recent months have fallen back to lows seen during the 2001 recession. In contrast, Alameda County's building has focused more on multi-family construction, which is still healthy even today. This is the classic choice between building denser and closer in versus building further out (similar to the dynamic between Sacramento County and the surrounding counties): as the larger building boom runs out of steam, the pendulum swings away from higher cost single family units further out and begins to favor lower cost units in the more densely populated areas.

Conclusions

Circling back now to the implication that these relationships have for the Construction industry and the overall East Bay economy, it looks again like a tale of two counties. With residential permit activity hitting a recession-level low and no influx of migration on the horizon, Contra Costa County looks poised for more Construction related job loss in 2007. Alameda County may fare a little better given the recent strength in multi-family permits in late 2006, but since Contra Costa County has been the center of gravity for the building boom, this suggests that we've only seen the beginning of the East Bay real estate slowdown.

How much will this increasing drag from the real estate sector slow the wider economy? While another surge in internally-oriented services like Local Government and Health Care could provide a temporary boost similar to what we've seen in the second half of 2006, it seems unlikely that these sectors could replace real estate as an engine of growth. But while some slowing seems

unavoidable in 2007, the Bay Area may have one advantage that the rest of California lacks. The Bay Area technology economy has seen a renewal in 2006, both on the service side of the economy and to a lesser extent in manufacturing. If this strength continues in 2007, it may prove to be the externally-oriented sector that can pick up some of the slack from real estate. This is an ironic sort of economic karma: the Bay Area may avoid the full impact of the real estate slowdown in 2007 precisely because its major industries took so long to recover from the 2001 recession. While the East Bay will likely bear most of the brunt of the real estate slowdown, exactly how severe this slowdown becomes will hinge on how much steam is left in the tech renaissance.