

California: A Bifurcated Recovery

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It has been three months since the last California report and California is growing again. But the landscape of the California economy is virtually unchanged. Employment is growing, albeit at very low rates, housing markets are continuing to stabilize, and exports through California's seaports and exports are continuing to grow. The state government remains embroiled in a budget crisis while state and local governments are continuing to shrink. The only significant event affecting the California economy over the last three months is the weakening growth in California's export economies.

Specifically, California will grow slower than the U.S. and a slow recovery in jobs will leave unemployment at 12.1% for the year. The latter of our forecast calls for the health care, professional and business services, export, construction and technology-related manufacturing sectors to generate a bit more robust growth in California. Even though the state will grow more rapidly in the following two years, job creation will not be fast enough to push the unemployment rate below double digits until 2012. Unlike other deep recessions, the rapidity of the recovery, at least on the employment front, will be muted.

Housing Markets and the East West Divide

The experience in California's housing markets from December 2008 to June 2009 was one of excess supply. Supply to the market was dominated by foreclosed properties and sales levels were over 50% higher by mid-year. In all coastal and inland markets home prices were falling. As more houses were foreclosed on inland, the intensity of housing market stress continued to be greater away from the coast, but this was a matter of degree rather than kind.¹ In the summer of 2009, three-and-a-half years after inflation-adjusted home prices began to fall, market conditions changed. In the coastal markets housing prices begin to rise. Even after one accounts for the subsidies driving demand in late 2009 and early 2010, the prices paid by new homeowners exceeded those paid the previous month. In addition, year-over-year increases in home sales occurred in all of the coastal markets except San Francisco. Thus, the market found a bottom, shifted from a supply-driven to a demand driven market.

For the inland cities, no such change occurred. Though some of the price data show an appreciation in a few inland cities, the appreciation is less than would be expected with the state and federal incentive programs. As the number of NOD's in the inland markets is still higher than those experienced in the coastal markets prior to those markets improving, there is no evidence that inland housing markets will find their bottom and change to a demand-driven markets anytime soon.

The implication of this analysis is straightforward. At a minimum, there is no reason for further contraction in residential construction on the coast. Indeed, new or restarted projects are being discussed up and down coastal California.² Once they begin construction, the recovery in residential construction jobs will begin. Inland, the implosion continues and will remain a drag on the inland economy through 2010.

¹ 57% of all California home sales in March 2009 were foreclosed homes, *DQNews.com*, April 16, 2009.

² John Wildermuth, "Park Merced Seeks To Triple The Number of Homes," *San Francisco Chronicle*, May 6, 2010.

Martha Groves, "Playa Vista Phase II Wins Final City Council Approval," *Los Angeles Times*, April 6, 2010.

Mark Mueller, "Lennar To Start Selling Central Park West Homes Again," *Orange County Business Journal*, May 28, 2010.

Private Sector Labor Markets: Where are the Jobs?

The past three months have confirmed our March analysis of California labor markets. There has been a steady net growth in jobs in 2010, but the increase has been quite small. From December 2009 to April 2010, California has added 63,900 private sector payroll jobs. While this is good news, it pales compared to the 1,349,000 private sector payroll jobs lost in the recession.³

Importantly, some of the recession job losses are permanent and will have to be replaced by the creation of different kinds of jobs. The 250,000 excess jobs in construction and 60,000 sub-prime mortgage processing jobs arrived as part of the housing bubble and have left with it. The geography of job increase mirrors somewhat the geography of the housing bubble. Manufacturing, health care and education have begun to grow along the coast at a rate that offsets weakness elsewhere in these regions. But the improved labor market conditions inland have not begun to generate net job gains.

Public Sector Employment: More Pain on the Way

One aspect of the California economy that has not changed in the past quarter is the budget shortfall, or more importantly the imbalance between government employment and the revenues which support it.⁴ Three years of revenue shortfalls imply a correction on the order of a reduction in public service employment of 130,000 jobs. Since the beginning of fiscal '08, state and local employment has contracted by 62,000 jobs and there are many more "full-time equivalent" jobs hiding in the government furloughs of the last year. The budget negotiations are currently being conducted in Sacramento and where the cuts will ultimately be made is still difficult to ascertain. With impending expiration of the temporary tax hikes designed to close part of the gap in fiscal '08 and '09, these cuts will need to be long lived.

The California Forecast

The current forecast differs from the previous one in as much as the demand for California goods from Europe is apt to be a bit less than before, and because the fall in the value of the Euro and the projected slower growth in Asia will impact California's exports to Asia. However, the impact of these recent events, while measurable, is not large. The net effect is a forecast which is not qualitatively different from our last two forecasts. Overall, the outlook for the balance of the year is for little to no growth. The economy will begin to pick up slightly in the beginning of 2011 and by the middle of 2011 begin to grow at more normal levels.

The recovery from this recession will be driven by education, health care, exports and technology and to some extent by growth in residential construction. The first four are more heavily centered in coastal California and are currently generating net job growth for these sub-regions. The latter will begin to generate jobs along the coast in the near term, but there will be little new activity inland until the housing markets turn. Thus, economic growth in California will be bifurcated with an early recovery along the coast coexisting with continued economic doldrums to the east.

On an annual basis our expectation is that total employment in California will contract by -1.1% in 2010. Once employment growth returns in 2011 employment will begin to grow faster than the labor force at a 2.0% rate and the unemployment rate will begin to fall. Real personal income growth is forecast to be 1.1% in 2010 and 2.9% and 4.1% in 2011 and 2012 respectively.

³ <http://www.labormarketinfo.edd.ca.gov>

⁴ A *shortfall* is defined here as the difference between planned expenditures prior to a budget resolution and forecast revenues. This is different from a *deficit* which ought to correspond to the difference between actual revenues from continuing sources and actual non-capital expenditures. The terms used to describe fiscal imbalances in public finance often confuse these two concepts.