

# ECONOMIC OUTLOOK

The cooling housing sector has continued to slow the national and California economies since the Governor's Budget forecast was constructed in November. A sharp drop in home building was instrumental in the national economy growing at its slowest pace in four years in the first quarter of 2007. In California, housing permits were 40 percent below the peak level reached in the third quarter of 2005. While the downturn in the housing sector will likely last longer than anticipated in the Governor's Budget forecast, encouraging signs are apparent. Home building was less of a drag on the national economy in the first quarter of 2007 than it was in the last two quarters of 2006, and California housing permits have been stable in the last six months. More importantly, there is little evidence that the weakness in the housing sector has spread to other parts of the national and California economies.

The most significant changes in the May Revision forecast are reduced estimates of California housing permits and personal income growth to reflect the faster-than-expected decline in the state's housing sector and its likely effects on personal income. For 2007, permits are projected to be where they averaged in the last six months at an annual rate, before increasing gradually in 2008 and 2009. The forecast for California personal income growth in 2007 has been lowered in the expectation that earnings will grow more slowly for construction workers, realtors, mortgage lenders, and other housing-related workers. Overall job growth in 2007, however, is slightly higher in the May Revision forecast, as other sectors of the state's economy are doing a good job of making up for jobs lost in the housing sector.

The outlook for the national economy is for slower growth in 2007 and improved growth in 2008 and 2009:

- Real GDP is projected to grow 2.2 percent in 2007, 3.1 percent in 2008, and 3.4 percent in 2009, as compared to 3.3 percent in 2006.

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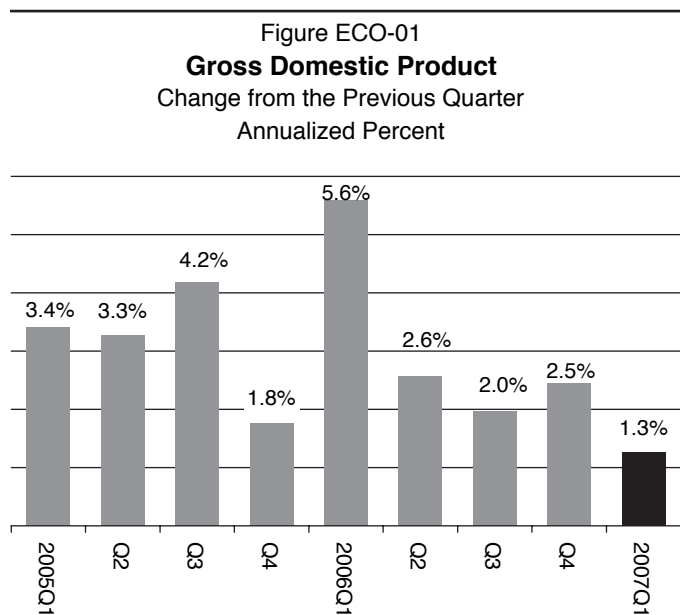
- Nonfarm payroll employment is forecast to increase 1.3 percent in 2007, 1.2 percent in 2008 and 1.6 percent in 2009, as compared to 1.9 percent in 2006.

The outlook for the California economy is also for slower growth in 2007 followed by improved growth in 2008 and 2009:

- Personal income is projected to grow 5.3 percent in 2007, 5.5 percent in 2008, and 5.8 percent in 2009, as compared to 6.1 percent in 2006.
- Nonfarm payroll employment is forecast to increase 1.3 percent in 2007, 1.5 percent in 2008 and 1.8 percent in 2009, as compared to 1.8 percent in 2006.

### THE NATION

Economic growth slowed considerably from the first quarter of 2006 to the first quarter of 2007 (Figure ECO-01). Recovery efforts after Hurricane Katrina boosted growth in the first quarter of 2006. Even after accounting for that, there remained a significant decline in output growth, much of it due to the downturn in the nation's housing sector. The fall in residential construction alone lopped more than one percentage point off of output growth in the third and fourth quarters of 2006 and one percentage point in the first quarter of 2007. Output of construction-related industries, such as housing finance and real estate brokerage and sales also fell or slowed. Statistics on home sales, housing starts, and residential construction show little evidence that the housing sector downturn is stabilizing. The sector will likely continue to be a major drag on the economy in the second quarter and perhaps the third quarter of 2007. Signs of growing stability should be evident by year-end.



Residential construction was the only major industry with output falling in the last four quarters. Other sectors saw output growth slow, but remain positive. Spending by businesses on equipment and software was surprisingly slow, given the strong profits

corporations have enjoyed, the tight capacity in some industries, and the modest amount of this investment businesses have made in this expansion, by historical standards. This spending rebounded in the first quarter and in April after falling sharply in the fourth quarter of 2006. This rebound is expected to continue.

Exports grew strongly in 2006 before falling slightly in the first quarter of 2007. With the dollar falling in value against the Euro and other major currencies, and several major economies likely to grow more strongly than the U.S. economy in 2007, U.S. exports are expected to be strong again in 2007.

Even though economic output grew by less than 2 percent in the first quarter of 2007, consumer spending rose a brisk 3.8 percent. Spending on motor vehicles and parts, medical care, and energy goods and services was particularly healthy. Coming when other sectors of the economy have cooled, this strong performance makes it likely that the first quarter will be the low point of the year.

Job gains slowed in the first four months of 2007, averaging only 129,000 per month. In 2006, the average monthly gain was 189,000. The national unemployment rate has settled at about 4.5 percent. Tight labor markets have resulted in average weekly earnings gains of about 3.5 percent over a year ago.

Energy prices shot up in the first four months of 2007, with the average price for regular-grade gasoline reaching \$3 per gallon and crude oil prices pushing \$65 per barrel. These increases have boosted broad measures of inflation in the economy. Measures of inflation that exclude energy prices have eased somewhat but remain above the Federal Reserve's desired range of 1 to 2 percent. With economic growth slowing and inflation higher than it likes, the Federal Reserve policy is unlikely to change its policy.

#### **CALIFORNIA**

California began 2007 with a job loss in January, but February and March brought positive job gains. The annual benchmark revision of employment statistics in March revealed that considerably more jobs were created in the state during 2006 than were initially reported. The state added 275,000 jobs in 2006, the best gain since 2000. Nine out of the 11 major industry sectors saw employment grow in 2006. The state's unemployment rate averaged 4.9 percent in 2006 and was 4.8 percent in each of the first three months of 2007. An important development has been improved job growth in the San Francisco Bay Area. The region had the strongest percentage job growth of major California regional economies in 2006.

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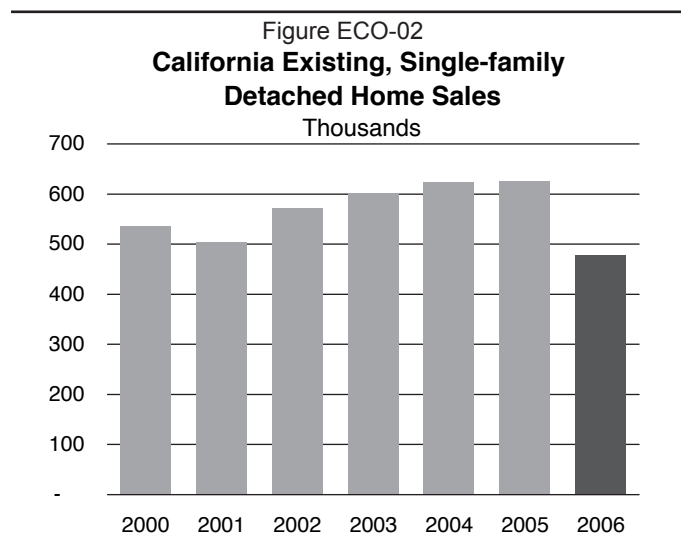
California personal income grew by an estimated 6.1 percent in 2006, somewhat stronger than in 2005. Taxable sales slowed considerably, however, in the second half of 2006. For the year as a whole, taxable sales increased 3.9 percent compared to 7.4 percent in 2005. New vehicle registrations fell in 2006 and likely played a role in the slowdown of taxable sales.

Made-in-California exports grew by 9.4 percent to a new-record level of \$127.7 billion in 2006. High-tech exports grew 6.7 percent in 2006. Exports of chemicals, miscellaneous manufactured products, and food and kindred products all grew at double-digit rates. Leading export destinations, in order, were Mexico, Canada, Japan, mainland China, South Korea, Taiwan, the United Kingdom, Hong Kong, Singapore, and Germany. Except for Hong Kong, state exports expanded to all of these markets.

California home building and residential real estate markets slowed considerably in 2006. The number of residential units permitted fell 22 percent, as compared to 15 percent for the nation; however, permits increased in the state in the first quarter of 2007. Existing, single-family detached home sales fell 24 percent in 2006, and home price appreciation slowed considerably (Figure ECO-02).

### THE FORECAST

The struggling housing sector will continue to weigh on the state and national economies during the rest of 2007 and, to a lesser extent, in 2008, but economic growth should steadily improve beginning in the third quarter of 2007 (Figure ECO-03 and Figure ECO-04).



Source: California Association of Realtors

Figure ECO-03  
**Selected U.S. Economic Indicators**

	<b>2006</b> <b>(Est.)</b>	<b>2007</b> <b>(Projected)</b>	<b>2008</b> <b>(Projected)</b>
Real gross domestic product, (2000 dollar) (Percent change)	3.3	2.2	3.1
Personal consumption expenditures	3.2	3.2	3.0
Gross private domestic investment	4.3	(4.8)	3.4
Government purchases of goods and services	2.1	2.5	1.7
GDP deflator (2000=100) (Percent change)	2.9	2.3	1.7
GDP, (Current dollar) (Percent change)	6.3	4.6	4.8
Federal funds rate (Percent)	5.0	5.2	5.0
Personal income (Percent change)	6.3	5.5	5.3
Corporate profits before taxes (Percent change)	19.2	3.4	2.8
Nonfarm wage and salary employment (Millions)	136.2	137.9	139.6
(Percent change)	1.9	1.3	1.2
Unemployment rate (Percent)	4.6	4.7	4.7
Housing starts (Millions)	1.8	1.4	1.6
(Percent change)	(12.4)	(21.3)	8.6
New car and light truck sales (Millions)	16.5	16.7	16.9
(Percent change)	(2.6)	1.0	1.5
Consumer price index (1982-84=100)	201.6	205.5	209.7
(Percent change)	3.2	2.0	2.0

*Forecast based on data available as of April 2007.  
Percent changes calculated from unrounded data.*

Figure ECO-04  
**Selected California Economic Indicators**

	2006	Percent change	Projected		2008	Percent change
			2007	Percent change		
Personal income (\$ billions)	1,416.6	6.1%	1,491.9	5.3%	1,573.4	5.5%
Nonfarm W&S employment (thousands)	15,064.9	1.8%	15,257.2	1.3%	15,485.1	1.5%
Natural resources and mining	25.1	6.7%	26.5	5.4%	27.0	2.1%
Construction	937.5	3.6%	920.6	-1.8%	921.0	0.0%
Manufacturing	1,502.7	-0.8%	1,497.6	-0.3%	1,501.4	0.3%
High technology	393.0	-0.8%	392.7	-0.1%	395.0	0.6%
Trade, transportation, & utilities	2,870.8	1.7%	2,916.7	1.6%	2,958.5	1.4%
Information	471.8	-0.4%	473.2	0.3%	482.0	1.9%
High technology	205.6	-0.5%	207.8	1.1%	212.2	2.1%
Financial activities	937.8	1.1%	939.5	0.2%	943.0	0.4%
Professional and business services	2,226.6	3.7%	2,292.2	2.9%	2,360.8	3.0%
High technology	285.5	5.2%	299.2	4.8%	313.4	4.7%
Educational and health services	1,618.5	2.0%	1,653.5	2.2%	1,685.5	1.9%
Leisure and hospitality	1,520.0	3.1%	1,555.0	2.3%	1,592.6	2.4%
Other services	506.6	0.2%	512.1	1.1%	521.3	1.8%
Government	2,447.4	1.3%	2,470.4	0.9%	2,491.9	0.9%
Unemployment rate	4.9%		5.0%		5.0%	
Housing permits (thousands of units)	162.9	-22.1%	132.8	-18.5%	143.4	7.9%
Consumer price index (1982-84=100)	210.4	3.9%	216.2	2.8%	221.8	2.6%

*Forecast based on data available as of April 2007.  
 Percent changes calculated from unrounded data.*