Economic Outlook

The national and California economies improved between the Governor's Budget and the May Revision. Output of the national economy grew for the third consecutive quarter in the first quarter of 2010, and California payroll employment grew in four of the six months ending in March. These were perhaps the most encouraging signs coming from the two economies in recent months but there were others. In fact, the good signs are coming at an increasing rate, especially in the national economy.

Because the recession was so deep, the recent monthly gains in payroll employment pale in comparison to the loss of payroll jobs since the beginning of the recession. The same is true for national economic output. The gains in the last three quarters were small compared to the loss in economic output since the recession began. And that is the case for almost every economic indicator that is showing gains.

In addition, some sectors of both economies have yet to show any positive signs —construction being a prime example. Unless the pace of the recovery picks up substantially, the recovery will be long.

Based on better-than-expected indicators that have been released since the Governor's Budget forecast, most notably GDP growth in the final quarter of 2009 that was much stronger than anticipated, the outlook for the national and state economies is more positive, but remains cautious. Historically, recessions sparked by financial crises and significant declines in asset prices, such as this one, are followed by long, gradual recoveries. The impact of the Federal Reserve actions taken and the federal fiscal stimulus package enacted in early 2009 that moderated the severity and length of the recession will be weakening. Consumer spending is likely to be hamstrung by modest income and job growth, a reduction in wealth, and limited credit availability.

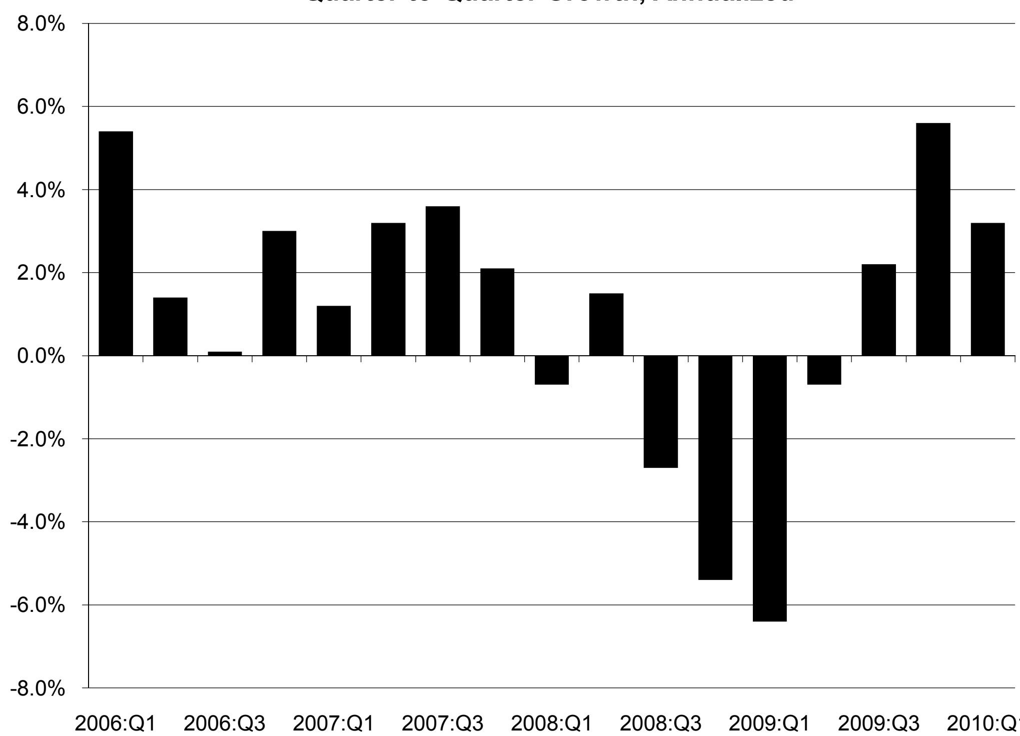
The Nation

The recession likely ended in the middle of 2009 after hitting its depths during the first half of the year. A wide range of stimulus measures turned the national economy around quickly. Real GDP fell by 6.4 percent on an annualized basis in the first quarter of 2009; in the fourth quarter of 2009, it grew by 5.6 percent. The advance estimate for the first quarter of 2010 was a more moderate and sustainable 3.2- percent annualized growth (Figure ECO-01).

Figure ECO-01

National Real GDP

Quarter-to-Quarter Growth, Annualized



Source: U.S. Bureau of Economic Analysis

The national economy has shown signs of improvement on many fronts. After plunging from July 2008 to March 2009, factory orders grew by 12 percent between March 2009 and February 2010.

Vehicle sales have stabilized and are beginning a modest but irregular rebound. During the six months ending with April 2010, motor vehicle sales averaged over 11 million units—somewhat better than their 2009 average, but still well below their 2008 level of 13 million units.

Exports and imports grew strongly in the second half of 2009 and the first quarter of 2010, indicating that the disruptions from the global economic recession and credit market turmoil have eased.

Retail sales surged in the first quarter of 2010, posting their strongest growth since the end of 2007. Consumers spent strongly at the beginning of the New Year despite high unemployment, sluggish income growth, and relatively tight credit.

Despite these positive developments, the recovery remains fragile. As would be expected, construction is the most significant drag on the recovery at this point. Residential construction dropped during the first quarter of 2010, which by itself subtracted 0.29 percentage point from the rate of GDP growth. Nonresidential construction remains on a declining trend because of rising vacancy rates, falling rents, and tight credit conditions, which reduced GDP growth by 0.44 percentage point in the fourth quarter of 2009.

On the bright side, there are signs that home prices have begun to stabilize and have improved in many regions. Existing home sales peaked during the summer of 2005 and fell steadily through November 2008. A robust recovery in sales took place between November 2008 and November 2009, as sales were boosted by the first-time homebuyers' tax credit. The credit's expiration, coupled with severe winter weather, caused home sales to fall again. Following the credit's extension, there was a moderate rebound in sales in March 2010. Nevertheless, home prices appear to have ended their 3-1/2 year slide, although any recovery in prices may be weak given the large number of distressed sales. The inventory of homes available for sale has fallen over the past year but there is likely a substantial "shadow" inventory that could come onto the market if home sales or prices were to rebound sharply.

Even though 2010 began with a return to sustained job growth, employment remains the biggest source of concern as it will take a long time to regain the nearly eight million jobs lost during the recession. After falling steadily between December 2007 and October 2009, industry employment increased in five of the six months ending in April 2010. Monthly job losses averaged 615,000 during the first six months of 2009 and only 175,000 during the last half of the year. Then, in concert with other improving indicators, over 570,000 jobs were gained during the first four months of 2010, or 143,000 per month on average. However, the unemployment rate is still elevated — 9.9 percent in April. Ongoing robust job growth will be needed to keep the recovery moving ahead.

The level of employment is still very low and it could take a long time to recover all of the lost jobs. Hiring usually lags behind output during the early stages of a recovery because firms tend to increase output first by boosting productivity and by raising the number of hours worked by existing employees. Hiring new employees tends to occur later. Moreover, the unemployment rate often remains high after employment begins to recover, because the perception of better labor market conditions encourages workers who had given up looking for work during the recession to reenter the labor force. According to the current outlook, the unemployment rate will improve gradually and may not reach “full employment” for several years.

California

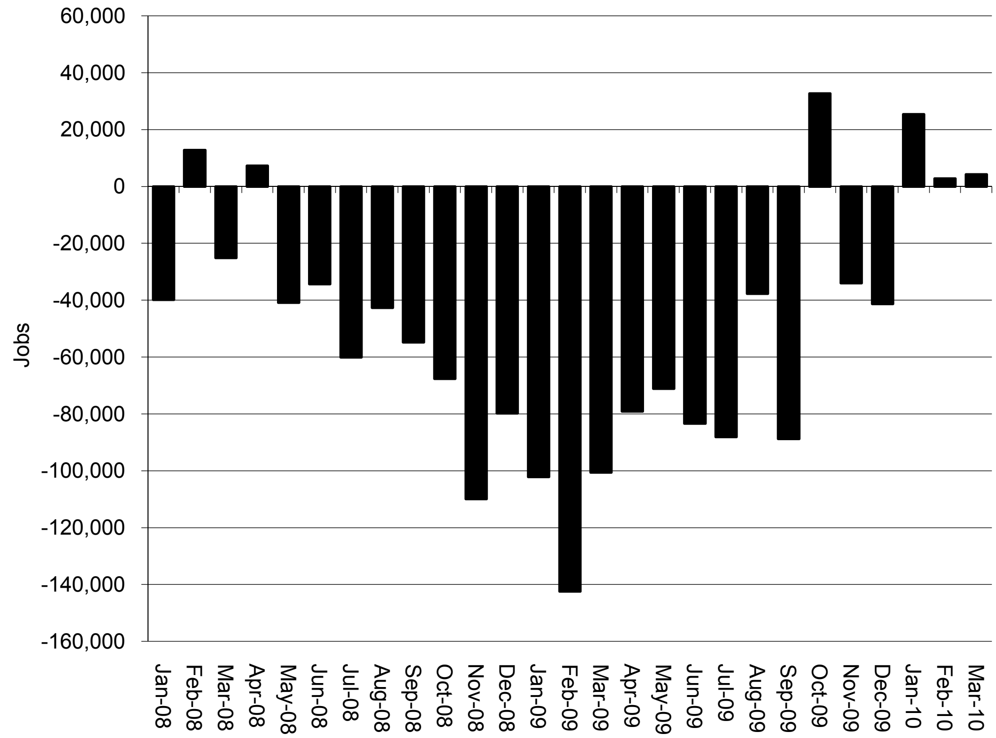
The state followed the nation’s path through the recession. California labor markets deteriorated dramatically during the latter half of 2008 and the first six months of 2009, suffering their worst losses on record (Figure ECO-02). Between June 2008 and June 2009, the state dropped nearly a million nonfarm jobs. These losses moderated as the year progressed and switched to very modest gains during each of the first three months of 2010. A return to positive job growth is a good sign, but as with the nation, it will take considerable time to recoup the losses.

California’s unemployment rate partially bucked the national trend by climbing through the early months of 2010. The national rate leveled off at 10 percent in November and December 2009 and slipped slightly during the first quarter of 2010. The state’s rate, in contrast, was still trending up through March 2010, reaching 12.6 percent. Since the recession began in December 2007, the ranks of California’s unemployed had grown by 1.3 million.

Given the large toll of lost jobs, it’s not surprising that California personal income declined in 2009 on a year-over-year basis for the first time since 1938. The decline began at the

Figure ECO-02

California Nonfarm Payroll Employment
Month-over-Month Change



Source: Employment Development Department, Labor Market Information Division

end of 2008 and continued through the end of 2009. The rate of decline eased up during the last quarter of 2009 when personal income fell 1.6 percent from a year earlier.

As with other economic measures, taxable sales slid dramatically in 2008, bottomed out early in 2009 and made meager gains during the rest of the year. Taxable sales in 2009 were down 15 percent from 2008 and despite their upward trend, the level of sales during the last half of 2009 were still down 20 percent from the peak reached in the second half of 2006.

Car sales in California reflect this same pattern. Sales ratcheted down harshly in 2008 as the housing crisis unfolded. New fee-paid automobile registrations at the end of 2008 were down over 40 percent from a year earlier. They continued slowing until bottoming out in the middle of 2009. A tentative recovery followed, spurred initially by the federal “Cash for Clunkers” incentive program. Registrations in December 2009 and January 2010 were up 16.7 percent on average from a year earlier. However, the level of registrations during these two months was still off more than 38 percent from the same months of 2006/2007.

Made-in-California exports plummeted in the second half of 2008 before bottoming out in the first quarter of 2009. For the year as a whole, California exports fell 17 percent in 2009. High-tech exports fell by nearly 16 percent. With global economic conditions easing up, California exports increased 19.4 percent year-over-year in the first quarter of 2010.

The worst of the housing slump that is at the heart of California's current economic troubles may be over. Home building permitting — which suffered a long, steady three-year decline starting in 2006 — bottomed out early in 2009 and was actually up on a year-over-year basis at the start of 2010. However, the number of permits issued was still off 78 percent from the peak output reached in mid-2005. Existing home markets are also faring better as home prices firmed up, inventories shrank, and the pace of sales stabilized at a sustainable rate. It remains to be seen however, how much of this recovery is owed to the federal tax credit and what impact the "shadow" inventory of existing homes will have on prices.

The Forecast

The longest and deepest recession in the post-Depression era is most likely over. Both the state and national economies appear poised to make modest comebacks. And many indicators released since the Governor's Budget forecast have been more encouraging than originally expected. The recovery, will probably be moderate and prolonged by historical standards. This means that the outlook for the near future is positive but sober. The national economy is forecast to return to modest growth rates in 2010 and beyond. The outlook for the California economy largely mirrors the national outlook, but with slightly less growth (Figure ECO-03 and Figure ECO-04).

Figure ECO-03
Selected U.S. Economic Indicators

	2009 (Est.)	2010 (Projected)	2011 (Projected)
Real gross domestic product, (2000 dollar) (Percent change)	-2.4	3.0	3.0
Personal consumption expenditures	-0.6	2.4	2.7
Gross private domestic investment	-23.2	11.4	13.2
Government purchases of goods and services	1.8	0.8	-0.8
GDP deflator (2000=100) (Percent change)	1.2	1.0	1.9
GDP, (Current dollar) (Percent change)	-1.3	4.0	5.0
Federal funds rate (Percent)	0.16	0.20	1.70
Personal income (Percent change)	-1.7	3.3	4.9
Corporate profits before taxes (Percent change)	-2.4	18.4	10.4
Nonfarm wage and salary employment (Millions)	130.9	130.2	132.6
(Percent change)	-4.3	-0.5	1.8
Unemployment rate (Percent)	9.3	9.6	9.0
Housing starts (Millions)	0.55	0.67	1.19
(Percent change)	-38.6	21.8	75.9
New car and light truck sales (Millions)	10.3	11.8	13.8
(Percent change)	-21.6	14.2	16.9
Consumer price index (1982-84=100)	214.5	219.3	224.6
(Percent change)	-0.4	2.2	2.4

Forecast based on data available as of April 2010.
Percent changes calculated from unrounded data.

Figure ECO-04

Selected California Economic Indicators

	2009	Percent change	Projected 2010	Percent change	2011	Percent change
Personal income ($ billions)	1,558.8	-2.8%	1,608.8	3.2%	1,681.6	4.5%
Nonfarm W&S employment (thousands)	14,089.0	-6.0%	13,984.5	-0.7%	14,228.8	1.7%
Natural resources and mining	25.9	-9.9%	25.4	-1.6%	25.8	1.4%
Construction	621.5	-21.2%	596.2	-4.1%	650.5	9.1%
Manufacturing	1,281.8	-10.1%	1,244.1	-2.9%	1,263.2	1.5%
High technology	350.7	-6.2%	346.9	-1.1%	355.1	2.4%
Trade, transportation, & utilities	2,640.1	-7.4%	2,616.0	-0.9%	2,662.3	1.8%
Information	444.4	-6.5%	446.9	0.6%	460.0	2.9%
Financial activities	797.0	-6.3%	780.6	-2.1%	784.2	0.5%
Professional and business services	2,055.3	-8.1%	2,075.5	1.0%	2,151.2	3.6%
High technology	307.7	-4.4%	309.1	0.5%	314.9	1.9%
Educational and health services	1,740.7	0.9%	1,775.6	2.0%	1,817.4	2.4%
Leisure and hospitality	1,498.5	-4.7%	1,471.8	-1.8%	1,487.7	1.1%
Other services	486.6	-4.8%	485.8	-0.2%	499.6	2.8%
Government	2,497.2	-0.9%	2,466.5	-1.2%	2,427.0	-1.6%
Unemployment rate	11.4%		11.9%		10.7%	
Housing permits (thousands of units)	36	-44.5%	64	75.4%	105	64.2%
Consumer price index (1982-84=100)	224.1	-0.3%	229.4	2.4%	235.5	2.7%

Forecast based on data available as of April 2010.
Percent changes calculated from unrounded data.