Economic Outlook

California, like the nation, is in the midst of an uneven economic recovery. Some sectors of the economy, including high technology and export markets, are doing well. Despite these areas of strength, economic conditions are still hamstrung by weak real estate markets, consumer confidence lingers at recessionary levels, and volatility in equity markets remains high.

Global and national events have created economic uncertainty and had an impact on the recovery. Most recently, congressional gridlock on budgetary issues, including the debt ceiling, has added to economic uncertainty and stock market volatility. Further, the European debt, banking, and budgetary crisis has adversely affected the California and national economies.

The Nation—Slow Economic Recovery Underway

A variety of fundamental economic indicators suggests that the national economy has experienced a slow, steady economic expansion over the past year, including a recovery from midyear weakness. In October 2011, the Index of Leading Indicators posted the largest monthly increase since November 2010, which suggests that the economy should continue to experience at least moderate growth well into 2012. After slowing sharply during May and June, nonfarm employment gains rebounded to over 100,000 jobs per month beginning in July. The unemployment rate dropped from 9.2 percent in June to 8.6 percent in November.

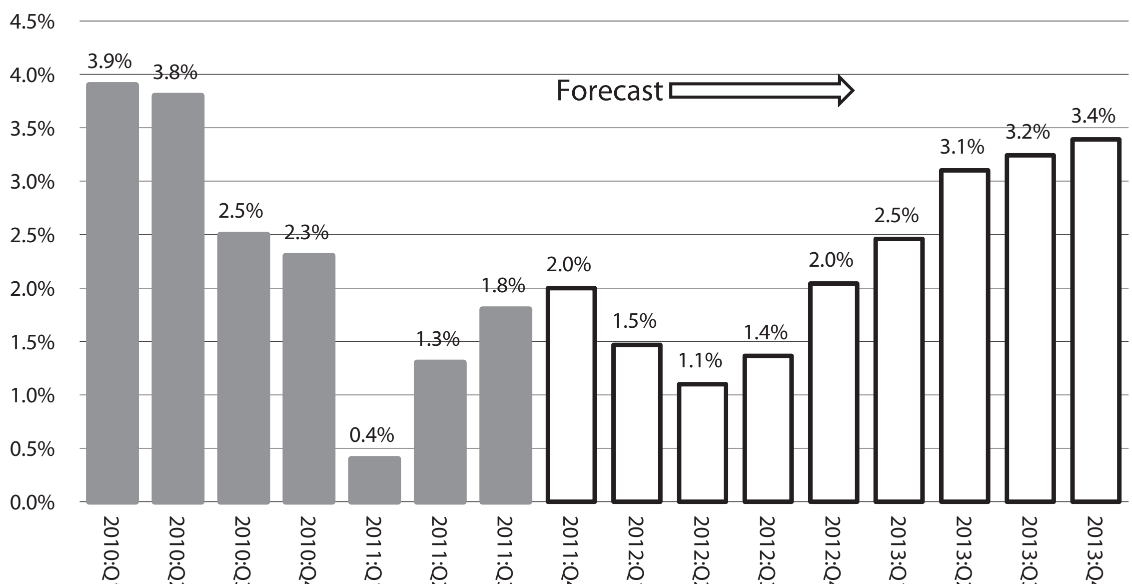
Consumer confidence also has improved steadily. The Conference Board Consumer Confidence Index rose in November, posting its largest monthly increase since April 2003. Even though indicators remain at recessionary levels, the improved confidence level has led to increased spending. Overall consumer spending in October was up 4.7 percent from a year earlier, led by a surge in motor vehicle sales, which in November reached their best level since June 2008 (excluding the August 2009 one-time Cash-for-Clunkers surge).

Businesses have remained cautious but boosted spending on equipment and software. Corporations with healthy profits invested in replacement needs neglected during the recession. Inventories remain low, which bodes well for future production growth.

After losing ground in August and September, industrial production accelerated in October and has continued to grow modestly. Construction spending also grew moderately in October, the third consecutive monthly gain.

In September, U.S. exports were up 16 percent over the year, led by industrial supplies and consumer goods. During the first three quarters of 2011, exports added 0.69 percentage point to Gross Domestic Product growth, trailing only the growth rates for household expenditures on services and business investment in equipment and software. (Figure ECO-01)

Figure ECO-01
U.S. Real Gross Domestic Product
Quarter-to-Quarter growth, annualized



Source: U.S. Bureau of Economic Analysis; CA Department of Finance Governor's Budget Forecast

Despite these indications that the economy was improving at the close of 2011, a number of factors will dampen economic growth in 2012.

Since spending growth outpaced income gains, the boost from consumers may slow again. Much of the additional spending was financed by the greater use of credit and reduced savings. While the consumer debt-to-income ratio has declined steadily over the past six years as households reduced their debt loads, this trend bottomed out in May 2011 and debt ratios have increased since then. Outstanding non-revolving credit grew sharply in September and October, largely to finance motor vehicle sales. In October, the personal savings rate was down almost 2 percentage points from a year earlier.

Businesses also have been reluctant to expand payrolls too quickly and national economic growth has been extraordinarily dependent on exports, and thus more sensitive to global economic developments.

The failure of Congress to address the federal deficit leaves considerable uncertainty. One example of this is extending the 2-percent payroll tax cut and emergency unemployment insurance benefits only through February 2012.

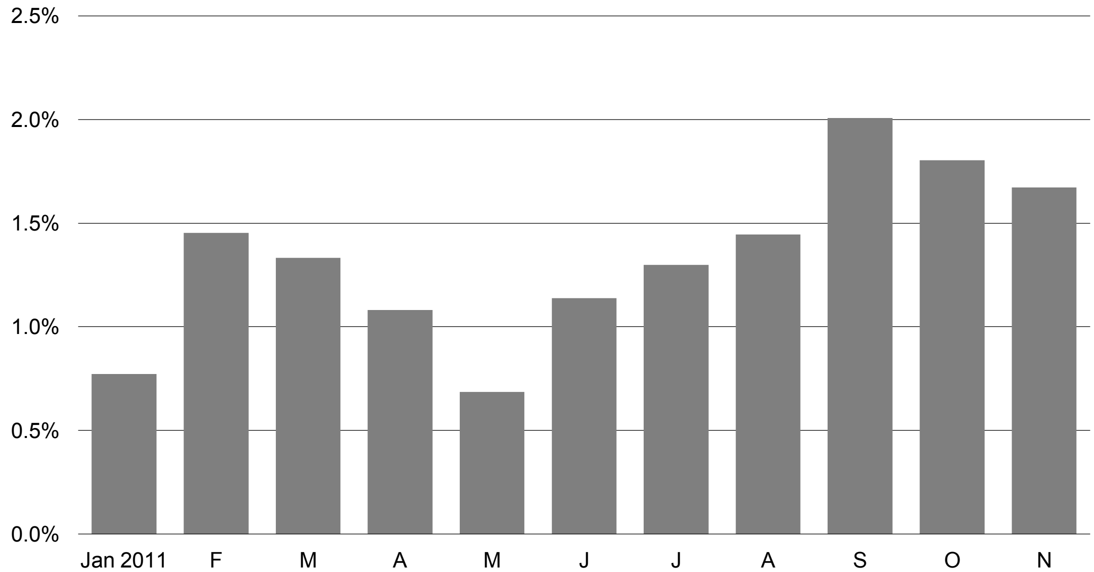
The European debt, banking and budgetary crisis also creates uncertainty and the lack of a solution could lead to a recession in Europe, thereby weakening the demand for U.S. exports, reducing corporate earnings, and strengthening the dollar. A full-blown financial collapse of the euro zone (those countries that use the euro as their currency) could drag the U.S. economy into recession.

California — An Uneven Recovery

Most of the indicators that affect the nation, both positive and negative, also affect California. In addition, California is affected by other positive and negative factors ranging from a robust high-technology sector to being one of the states hardest hit by the collapse of the housing market.

The state added 102,000 industry jobs in January and February, but only gained 4,700 jobs from March through July after the Japanese earthquake. The unemployment rate rose four-tenths of a percentage point between May and August. Nonfarm employment accelerated substantially from August through November and the unemployment rate dropped to 11.3 percent in November, the lowest rate since May 2009. Comparing November 2011 with a year earlier, 233,100 new jobs were created. (Figure ECO-02)

Figure ECO-02
California Nonfarm Employment
Year-Over-Year Percent Change



Source: California Employment Development Department

California wages also made substantial gains at the end of 2010 that continued into 2011. In the fourth quarter of 2010, California wages made their strongest quarter-to-quarter jump since the middle of 2000—the height of the dot-com bubble. Seven high-paying industries accounted for two-thirds of the overall wage gains in the fourth quarter of 2010, including computer and electronic manufacturing, finance and insurance, professional, scientific and technical services, mining, information (which includes motion pictures), management of companies, and health care and social assistance. In 2011, California personal income grew nearly $100 billion, the largest gain since 2006.

A disproportionately large share of the wage gain was driven by the state's high-technology and professional service sectors and by robust global demand for California exports. The surge reflected growing high-tech exports, booming Silicon Valley investment activity, strong stock market gains, and high oil prices. If these trends continue, it is expected that these sectors will expand their workforces.

Strong growth and rising profits among Silicon Valley companies and by booming investment activity likely led to wage gains in electronics manufacturing. In 2010, the

150 largest Silicon Valley corporations had their most profitable year in history. By the end of the first quarter of 2011, their combined stock market value rose over 11 percent from 2010.

2010 was a banner year for California-made exports with the total value rising 19 percent from 2009. This boom was dominated by computers, electronics, and electronic machinery, which combined accounted for over 60 percent of California's 2010 export growth.

Similar to the nation, consumption spending in California rebounded in 2011 with growing vehicle sales playing a significant role. Taxable retail sales during the first three quarters of 2011 grew 8.5 percent from the same period in 2010. New motor vehicle registrations during the first nine months of 2011 were up over 11 percent from the same months of 2010.

California industries that are not connected to high technology and export markets, however, have not fared as well. In particular, the state's housing market, still burdened by high foreclosure rates, weakened considerably during the midyear slowdown. Existing home sales during the first 11 months of 2011 were up slightly from the same months of 2010. However, this came at the expense of falling prices. These trends are likely to continue into 2012 because more foreclosure actions are anticipated.

In contrast to the healthy wage gains noted above, wage rate growth in other industries, such as agriculture, construction, retail trade, and accommodation and food services, did not even keep pace with inflation. These sectors employ nearly half of the state's private sector workforce.

The Forecast

The prospects for the national and California economies are guardedly positive. The national recovery has regained momentum in the closing months of 2011. While disappointing, labor markets have improved slowly. Exports are making solid improvements over 2010. Manufacturing activity was growing, albeit sluggishly.

Another recession is not in the forecast. The forecast assumes the federal government will not add any more stimulus funding, that future federal budget actions will not result in a severe fiscal contraction, and that some combination of spending cuts and tax increases will most likely be phased in beginning in 2013. The outlook also assumes that the 2-percent payroll tax holiday and emergency unemployment insurance benefits will be extended though 2012 and that the temporary tax decreases implemented during the Bush Administration will continue beyond the January 1, 2013 expiration date.

The prospect of a European financial crisis is the biggest known risk at this point. It is still too early to know if protective measures of sufficient strength will be approved to minimize the economic fallout. At the very least, economic growth in Europe will slow in 2012, which will adversely affect U.S. exports.

As indicated in Figure ECO-03, it will be several years before the nation and the state return to a healthy, balanced economic growth. The national economy, slowed by weaker global demand, will expand at a slower pace in 2012. Barring a severe European recession, U.S. economic growth will accelerate to a more sustainable pace in 2013 and 2014.

Figure ECO-03

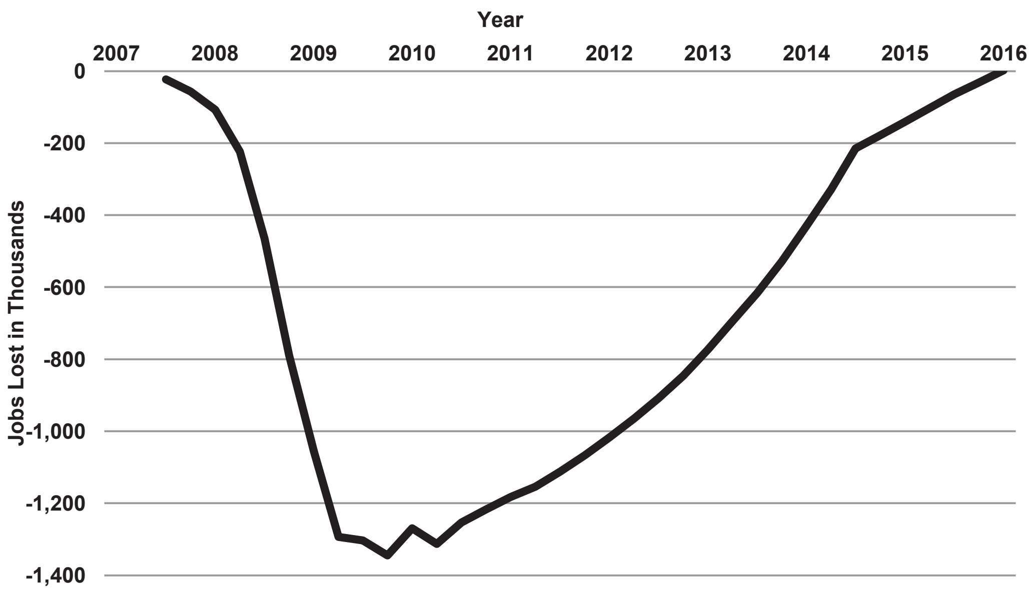
Selected Economic Data

		Projected				
	2011	**2012**	**2013**	**2014**	**2015**	**2016**
U.S. real gross domestic product (percent change)	1.8	1.7	2.5	3.5	3.1	2.7
California unemployment rate (percent)	12.0	12.0	11.7	10.9	9.9	9.3
California nonfarm wage & salary employment (thousands)	14,029.9	14,206.5	14,463.8	14,820.6	15,074.2	15,215.5
(percent change)	0.9	1.3	1.8	2.5	1.7	0.9
California personal income (billions)	1,681.6	1,746.2	1,818.0	1,916.0	2,013.6	2,107.2
(percent change)	5.7	3.8	4.1	5.4	5.1	4.6
California total taxable sales (billions)	519.4	537.9	572.9	619.7	660.4	693.3
(percent change)	8.7	3.6	6.5	8.2	6.6	5.0

Note: Percentage changes calculated from unrounded data.

For California, job growth will improve through 2014. The state is forecast to recover the nonfarm jobs lost during the Great Recession in the second quarter of 2016, or approximately 84 months after the end of the recession. (Figure ECO-04) During the previous six recessions, full job recovery was achieved between 4 and 56 months.

Figure ECO-04
Jobs Lost During Recession Not Recovered Until 2016



The projection for wages and salaries in 2011 was boosted by upwardly revised historical information and better-than-expected growth at the end of 2010 and first half of 2011. Compared to the economic forecast developed for the May Revision, this outlook projects more restrained growth in 2012 due to a weaker national economic forecast and a lack of meaningful improvements in the state's real estate conditions.

Home construction also continued to slow during the last three quarters of 2011, rather than achieving the modest acceleration projected in the May Revision. Thus, employment and construction are weaker in the current forecast.

In contrast, new personal income data showed that California wages and salaries grew more strongly than originally indicated. Revised wage estimates for the first three quarters of 2010 (the latest data available at the time of the earlier forecast) raised the year-over-year growth in state wage income from 0.4 percent to 1.3 percent. In the fourth quarter of 2010, wages and salaries grew much stronger than forecast in the May Revision — 4.5 percent versus 1.9 percent. Wage growth during the first half of 2011 was also stronger than forecast in the May Revision. Overall, this boosted the outlook for 2011 personal income growth from 4.4 percent to 5.7 percent. On the other hand, the more subdued national outlook led to a more restrained projection for 2012—year-over-year wage growth dropped from 4.5 percent to 3.8 percent.

See Figure ECO-05 for highlights of the national and California forecasts.

Figure ECO-05

Selected Economic Data

United States	2011 (Est.)	2012 (Projected)	2013 (Projected)
Real gross domestic product (percent change)	1.8	1.7	2.5
Personal consumption expenditures	2.3	2.1	1.9
Gross private domestic investment	4.3	5.4	8.0
Government purchases of goods and services	-2.0	-2.7	-2.0
GDP deflator (percent change)	2.1	1.4	1.2
GDP (current dollar, percent change)	3.9	3.0	3.7
Federal funds rate (percent)	0.1	0.1	0.1
Personal income (percent change)	5.0	3.1	3.5
Corporate profits before taxes (percent change)	10.1	2.1	3.6
Nonfarm wage and salary employment (millions)	131.1	132.2	134.0
(percent change)	1.0	0.9	1.4
Unemployment rate (percent)	9.1	9.2	9.0
Housing starts (millions)	0.6	0.7	1.0
(percent change)	2.0	11.1	43.6
New car sales (millions)	6.2	6.9	7.9
(percent change)	7.9	12.2	13.5
Consumer price index (1982-84=100)	225.0	228.9	233.6
(percent change)	3.2	1.7	2.0
California			
Civilian labor force (thousands)	18,060.5	18,155.9	18,364.6
(percent change)	-0.6	0.5	1.1
Civilian employment (thousands)	15,893.8	15,975.8	16,207.0
(percent change)	-0.1	0.5	1.4
Unemployment (thousands)	2,166.7	2,180.0	2,157.7
(percent change)	-4.0	0.6	-1.0
Unemployment rate (percent)	12.0	12.0	11.7
Nonfarm wage and salary employment (thousands)	14,029.9	14,206.5	14,463.8
(percent change)	0.9	1.3	1.8
Personal income (billions)	1,681.6	1,746.2	1,818.0
(percent change)	5.7	3.8	4.1
Housing units authorized (thousands)	46.4	52.2	79.9
(percent change)	4.1	12.5	53.0
Corporate profits before taxes (billions)	165.0	170.6	179.7
(percent change)	7.7	3.4	5.3
New auto registrations (thousands)	1,221.8	1,364.3	1,431.4
(percent change)	4.1	11.7	4.9
Total taxable sales (billions)	519.4	537.9	572.9
(percent change)	8.7	3.6	6.5
Consumer price index (1982-84=100)	233.0	237.3	242.3
(percent change)	2.7	1.8	2.1

Note: Percentage changes calculated from unrounded data.