Economic Outlook

The California and national economies got off to fast starts in 2006, but declining housing sectors increasingly weighed on the economies as the year progressed. Economic data for October and November suggest that the fourth quarter will be the low point for national economic growth in 2006. While on the whole, 2006 was a better year than 2005 for the state and national economies, neither economy will be going into 2007 with much momentum.

Economic growth will likely be modest in the first half of 2007, and unemployment could increase slightly. The second half of the year should bring better growth as state and national housing sectors begin to pull out of their downturns. Both economies should improve further in 2008.

The major risks to this outlook are a longer, deeper housing slump and higher mortgage rates, either of which could test consumer confidence.

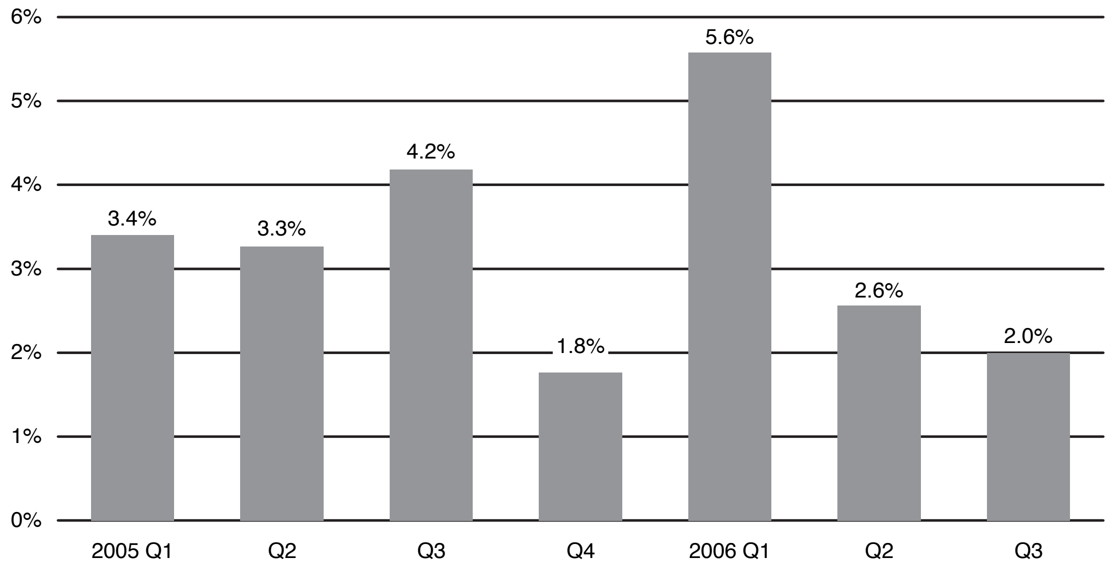
The Nation—Slowing Growth

The outlook for the national economy is slowing growth:

- Real GDP is projected to grow 2.4 percent in 2007 and 2.9 percent in 2008, as compared to 3.3 percent in 2006.
- Nonfarm payroll employment is forecast to increase 1.1 percent in 2007 and 1.2 percent in 2008, as compared to 1.4 percent in 2006.

Two sectors of the economy are primarily responsible for the expected slowdown in real GDP growth in 2007-the housing sector and light vehicle manufacturing. The downturn in the nation's housing sector is by far the more important. Declines in residential construction reduced real GDP growth by 0.7 percentage points in the second quarter of 2006 and 1.2 percentage points in the third quarter, pulling real GDP growth below 3 percent in both quarters (Figure ECO-01). Cuts in residential construction are expected to lop off about 1 to 1.2 percentage points in real GDP growth in the fourth quarter of 2006 and the first quarter of 2007. The drag of residential construction on real GDP growth is expected to diminish in the second quarter of 2007 and then contribute to real GDP growth in the second half of 2007 and in all of 2008.

Figure ECO-01
Real Gross Domestic Product
Change from the Previous Quarter
Annualized Percent



Source: U.S. Commerce Department, Bureau of Economic Analysis

The slowdown in the nation's housing sector is now evident in almost every measure of the sector. The value of new residential construction fell 10 percent from March 2006 to October 2006. Housing starts declined 28 percent from their peak in June 2005, and housing permits 31 percent from their October 2005 peak. New home sales fell 25 percent from October 2005 to October 2006 and existing home sales by 12 percent. The median price of existing homes sold fell about 4 percent over that period, while the median price of new homes, without adjustment for buyer incentives, rose about 6 percent. If buyer incentives were subtracted from the prices of new homes, the median new home price in October would likely be down from the year-ago price.

Light vehicle sales dropped sharply in October and November, and automakers responded by making production cuts, some of them extending through the first half of 2007.

Other sectors of the economy may experience some slowdown in growth, but most are expected to hold up quite well in 2007, the most important being consumer spending. Growth in consumer spending slowed in the second and third quarters of 2006. Some of this slowdown was directly due to the housing downturn: growth in spending on home furnishings and appliances fell sharply in the second and third quarters as home sales dropped, for example. But most of the housing sector's effect on consumer spending was indirect-the result of cutbacks in spending by workers in the housing sector and closely related industries whose incomes were reduced. Thus consumer spending is expected to continue growing at a rate somewhat higher than that of economic output. There is little evidence that consumers have cut back their spending because reduced home price gains or price declines have made them feel less well off.

Holiday sales are reported to be close to relatively modest expectations. Retailers are using discounts to entice shoppers, but most discounts were planned and not a sign of panic. Retailers are hoping that the procrastinators will come out in numbers on the weekend immediately preceding Christmas.

Two sectors are expected to grow considerably quicker than real GDP in 2007 and 2008: exports and investment in equipment and software by business. Exports will benefit from the declining dollar, and the improved economies of many of the nation's major trading partners. Investment in equipment and software will be boosted by the strong profit gains of recent years and growing capacity constraints in many industries.

Rising energy prices pushed up general inflation in 2006 but are expected to be more stable in 2007 and 2008, resulting in lower general inflation. The improvement in inflation and relatively modest output growth in 2007 will likely keep Federal Reserve inflation hawks at bay. In fact, the Federal Reserve is expected to cut short-term interest rates three times in 2007 to ensure that the slowdown in economic growth does not turn into something worse.

While the outlook is for slower, but still positive growth, the major risk for even slower growth would be if there is a longer and deeper decline in housing and higher mortgage rates.

California—Slowing Growth As Well

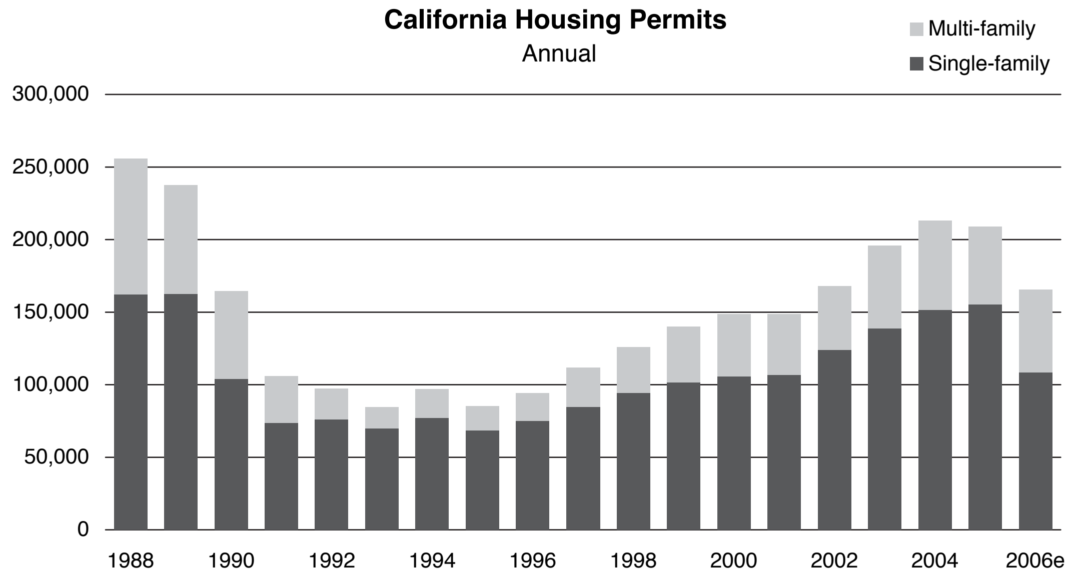
The outlook for the California economy is slowing growth:

- Personal income is projected to grow 5.7 percent in 2007 and 5.4 percent in 2008, as compared to 6.6 percent in 2006.
- Nonfarm payroll employment is forecast to increase 1.2 percent in 2007 and 1.6 percent in 2008, as compared to 1.8 percent in 2006.

As in the nation as a whole, a downturn in the state's housing sector is primarily behind the slowing of the California economy in the second half of 2006. A second, but considerably smaller, factor is reduced light vehicle sales.

The state's housing sector has turned down more sharply than has the national housing sector. The number of new permits issued in the first ten months of the year was 21 percent below the year-ago level (Figure ECO-02). Sales of existing single-family detached homes were down almost 30 percent in October from the year-ago level, and new home sales were down 21 percent. Price gains have moderated considerably, and some counties, including six of the nine Bay Area counties, have experienced year-over-year price declines. The number of foreclosures in the third quarter of 2006 was more than double the year-earlier level. Residential permits are projected to fall again in 2007 before rebounding in 2008.

Figure ECO-02
California Housing Permits
Annual



e: estimate based on the first ten months of 2006; Source: Construction Industry Research Board

California participated in the decline in auto sales in October and November. In fact, sales in the state were described as especially weak in news reports.

A number of measures of the California economy, while showing signs of slowing, are quite strong-personal income, taxable sales, private-sector nonresidential and public works construction, and state exports.

According to the U.S. Bureau of Economic Analysis, personal income-income received by California residents from all sources-was up 6.6 percent from a year earlier and wages and salaries 7.6 percent in the first three quarters of 2006. Both are growing considerably quicker than in 2005. Personal income posted a 5.4 percent gain in 2005 as a whole, for example. But, for both measures, the gain was strongest in the first quarter and then shrank as the year proceeded. This pattern is consistent with news reports that 2005 bonuses were large in financial services, some high-tech industries, and durable goods manufacturing. Personal income is expected to benefit in 2007 from large bonuses on work done in 2006, as well as increased equity-related compensation.

Statewide taxable sales were more than 7 percent above their year-ago level in the first half of 2006, consistent with the strong gain in wages and salaries in that period.

Private-sector nonresidential construction was strong again in 2006 with large gains in office, hotel and motel, and parking garage construction and alterations and additions. Work on the new Bay Bridge helped public works construction surge by over 20 percent in 2006. Private sector nonresidential construction is expected to post high single-digit percentage gains and public works construction, mid-to high single-digit percentage gains in 2007 and 2008.

Made-in-California merchandise exports were almost 11 percent higher than a year earlier in the first three quarters of 2006 and should easily set a new record in 2006. Gains in exports to mainland China and Mexico dwarfed those to other destinations. High-tech exports grew, but not as quickly as total exports.

For the first 10 months of 2006, job growth was about the same as in 2005. Smaller job gains in retail trade, construction, and financial activities were offset by bigger job gains in leisure and hospitality, government, and professional and business services.

The state's unemployment rate dropped from an average of 5.8 percent in the first ten months of 2005 to 5.1 percent in the first ten months of 2006, as the number of unemployed persons fell below 900,000 for the first time in five years.

While the outlook is for slower, but still positive growth, the major risk for even slower growth would be if there is a longer and deeper decline in housing and higher mortgage rates. California's economy, like those of other states with expensive housing, is particularly sensitive to changes in interest rates. A jump in mortgage rates would raise payments for home owners with adjustable rate mortgages and come at the same time as the first wave of refinancing of the various five-year balloon mortgages.

As the fifth year of economic expansion comes to a close, the national and California economies are facing increased risks. Slower growth, stable energy prices, moderating inflation, and stable to lower interest rates might be the best possible outcome in the near-term.

Figure ECO-03 provides additional economic data and forecasts for 2006, 2007, and 2008.

Figure ECO-03

Selected Economic Data for 2006, 2007, and 2008

United States	2006 (Est.)	2007 (Projected)	2008 (Projected)
Real gross domestic product (2000 CW* $, percent change)	3.3	2.4	2.9
Personal consumption expenditures	3.2	2.8	2.6
Gross private domestic investment	4.8	(1.4)	2.6
Government purchases of goods and services (percent change)	2.0	1.9	1.5
GDP deflator (2000=100, percent change)	2.9	2.3	1.9
GDP (current dollar, percent change)	6.3	4.7	4.9
Federal funds rate (percent)	4.96	4.86	4.49
Personal income (percent change)	7.2	5.4	5.3
Corporate profits before taxes (percent change)	15.9	1.5	2.4
Nonfarm wage and salary employment (millions)	135.3	136.8	138.5
(percent change)	1.4	1.1	1.2
Unemployment rate (percent)	4.6	4.8	4.9
Housing starts (millions)	1.8	1.6	1.6
(percent change)	(11.0)	(14.0)	2.1
New car sales (millions)	7.8	7.6	7.4
(percent change)	1.1	(1.5)	(3.1)
Consumer price index (1982-84=100)	201.6	205.5	209.9
(percent change)	3.2	2.0	2.1
California			
Civilian labor force (thousands)	17,741.8	17,980.5	18,257.1
(percent change)	0.3	1.3	1.5
Civilian employment (thousands)	16,880.4	17,091.0	17,330.0
(percent change)	0.8	1.2	1.4
Unemployment (thousands)	858.5	889.5	927.2
(percent change)	(9.5)	3.6	4.2
Unemployment rate (percent)	4.8	4.9	5.1
Nonfarm wage and salary employment (thousands)	15,057.0	15,242.0	15,489.7
(percent change)	1.8	1.2	1.6
Personal income (billions)	1,421.2	1,502.5	1,583.4
(percent change)	6.6	5.7	5.4
Housing units authorized (thousands)	167.6	151.6	164.8
(percent change)	(19.8)	(9.5)	8.7
Corporate profits before taxes (billions)	184.6	192.6	201.2
(percent change)	1.8	4.3	4.5
New auto registrations (thousands)	1,879.0	1,916.0	1,918.0
(percent change)	2.1	1.9	0.1
Total taxable sales (billions)	561.0	578.6	610.1
(percent change)	4.5	3.1	5.4
Consumer price index (1982-84=100)	210.5	216.0	221.2
(percent change)	3.9	2.6	2.4

* CW: Chain Weighted

Note: Percentage changes calculated from unrounded data.