

ECONOMIC OUTLOOK

Two years into the housing slump, the national and California economies began to face additional headwinds—falling home prices, tight credit conditions, dysfunctional financial markets, and soaring food and energy prices. These headwinds took a toll: The housing downturn worsened. Labor markets weakened. And, at the end of 2007, consumers began to lose confidence in the economy.

In the mid-2000s, low interest rates, easy credit, and questionable lending practices sharply increased the demand for housing, leading to accelerating home prices, increased home building, and strong consumer spending. But this sizable economic stimulus depended on rising home prices, and when declining home affordability put a cap on home prices, the stimulus evaporated. Uncertainty about how far home values would decline depressed home sales and building. Consumers were pinched as their home equity fell.

Declining home prices and jumps in subprime mortgage rates have led to record mortgage delinquencies and home foreclosures in California. Home values may decrease further before real estate markets and home building return to normal. Until then, the housing sector will be a significant drag on economic growth in the state.

The most significant differences between the May Revision forecast and the Governor's Budget forecast are lower real GDP growth, weaker California job growth, and smaller gains in California personal income in 2008 and 2009.

ECONOMIC OUTLOOK

The outlook for the national economy is for slow growth in 2008, moderate growth in 2009, and near-trend growth in 2010:

- Real GDP is projected to grow 1.2 percent in 2008, 1.7 percent in 2009, and 3 percent in 2010, as compared to 2.2 percent in 2007.
- Nonfarm payroll employment is forecast to increase 0.2 percent in 2008, 0.4 percent in 2009, and 1.2 percent in 2010, as compared to 1.1 percent in 2007.

The outlook for the California economy is for little growth in 2008 followed by slow growth in 2009 and moderate growth in 2010:

- Personal income is projected to grow 4.5 percent in 2008, 4.1 percent in 2009, and 5.1 percent in 2010, as compared to 5.9 percent in 2007.
- Nonfarm payroll employment is forecast to fall 0.2 percent in 2008, and then grow by 0.6 percent in 2009 and 1.4 percent in 2010, as compared to 0.7 percent in 2007.

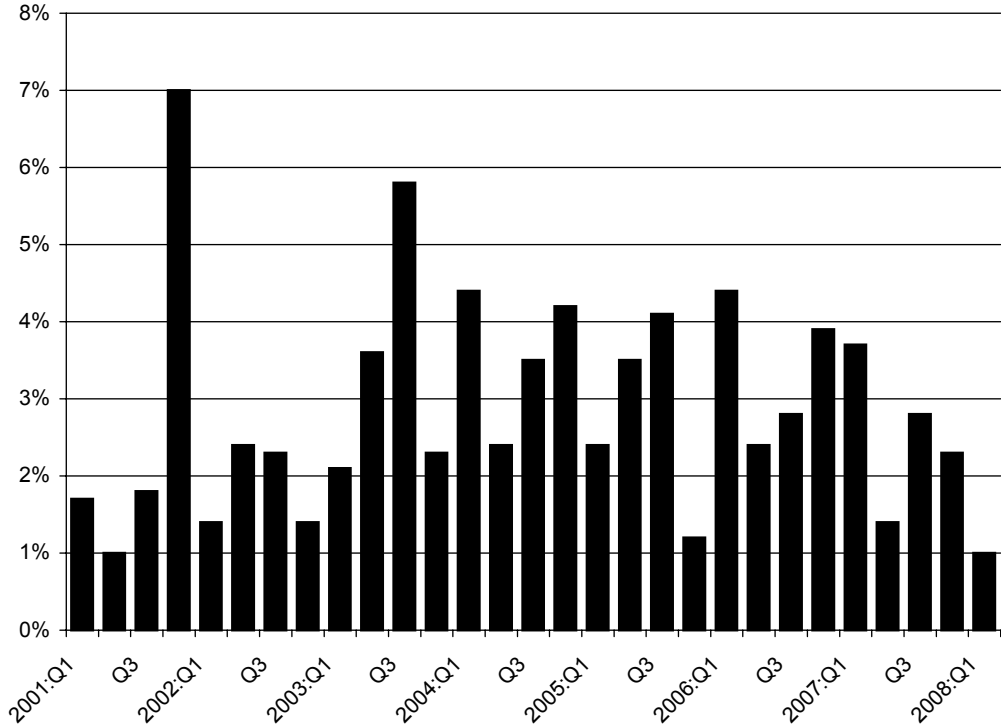
THE NATION

Real GDP grew only 0.6 percent in the first quarter of 2008. The weakness was concentrated in residential construction, which fell 27 percent at an annualized rate. Residential construction has been a significant drag on the national economy for eight consecutive quarters, and there is little indication that the end to the decline is near. New and existing home sales continue to fall. Inventories of homes available for sale remain large. The number of new homes being built is still declining. The subprime mortgage debacle and subsequent financial market turmoil, waves of home foreclosures, and credit tightening appear to have reinforced the housing slump.

More troubling, consumer spending increased by just 1 percent in the first quarter —its slowest quarterly rate in nearly seven years (Figure ECO-01). Granted, it is only one quarter, and consumers have bounced back from a quarter of weak spending a number of times in the past seven years. However, the retrenchment by consumers is consistent with sharp declines in consumer confidence surveys in the last three months to levels that historically have been associated with recessions. Consumer spending is being squeezed by slower job growth, falling home prices, higher energy and food prices, high consumer debt levels, and the falling dollar.

Elsewhere in the GDP report, business investment in structures and equipment and software fell in the first quarter. Government spending increased modestly. But what

Figure ECO-01
U.S. Real Consumer Spending
Year-over-Year Growth



Source: U.S. Bureau of Economic Analysis

kept real GDP from falling in the first quarter was an increase in inventory investment of \$20 billion by businesses, which most likely was not intended.

National labor markets weakened in the first four months of 2008. Nonfarm payroll employment fell each month, with the losses averaging 65,000 per month. In comparison, nonfarm payroll employment rose with an average monthly gain of 94,000 in the first four months of 2007. The national unemployment rate averaged about 5 percent in the first four months of 2008. A year ago, it averaged 4.5 percent in the first four months.

Energy and food prices shot up in the first three months of 2008, with the average price for regular-grade gasoline reaching \$3.60 per gallon and the crude oil spot price \$116 per barrel by the end of April. A year earlier, regular gasoline sold for \$2.97 and the crude oil spot price was \$59 per barrel. The average cost of food at home in the first quarter of 2008 was 5.2 percent higher than a year earlier. A year earlier, this measure of inflation was 2.7 percent. The increase in food and energy prices, coming at a time when the

economy has decelerated appreciably, puts the Federal Reserve in a difficult position. In an effort to give the economy a boost, the central bank has eased monetary policy on seven occasions in the last eight months, lowering their target for federal funds from 5.25 percent to 2 percent. Believing that the committee was risking higher inflation, some members of the Federal Reserve monetary policy committee have dissented on the last three votes to ease policy.

CALIFORNIA

Growth in nonfarm payroll employment slowed in California in 2007, with employment peaking in the third quarter and then slipping in the fourth quarter. The state lost jobs again in the first quarter of 2008, although to a lesser extent than the nation.

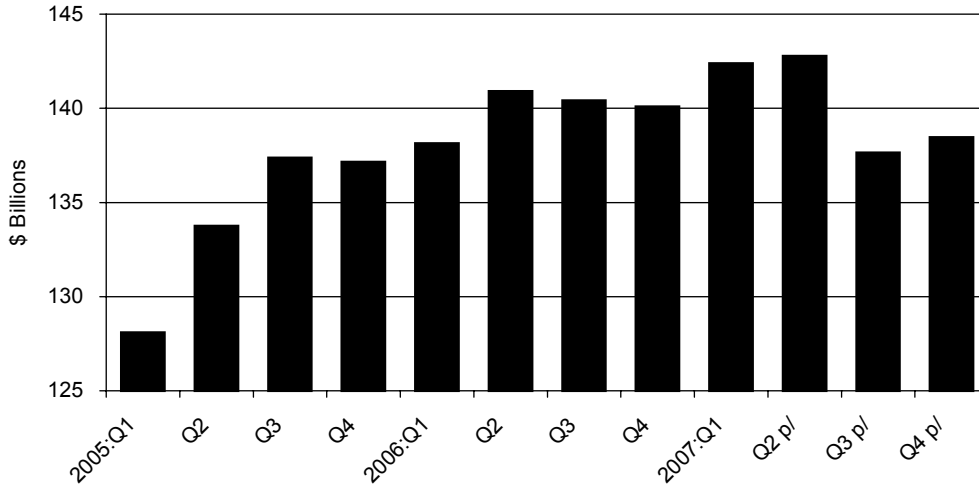
The annual average of nonfarm payroll employment increased by 102,900, or 0.7 percent in 2007, down from 259,000, or 1.7 percent, in 2006. Eight of the 11 major industry sectors saw employment grow in 2007. Educational and health services, government, leisure and hospitality, and trade, transportation, and utilities posted the biggest gains in jobs. Together, construction, financial activities, and manufacturing lost nearly 95,000 jobs. The San Francisco Bay Area economy had the strongest job growth of the major regional economies. The state's unemployment rate averaged 5.4 percent in 2007 and was 5.9 percent in the first three months of 2008.

California personal income grew by an estimated 5.9 percent in 2007, slightly lower than the 6.5-percent gain in 2006. Taxable sales, however, peaked in the second quarter of 2007 and were down 3 percent from the peak in the fourth quarter of 2007 (Figure ECO-02). New vehicle registrations fell again in 2007, likely playing a role in the slowdown of taxable sales.

Made-in-California exports grew by 5 percent to a new record level of \$134.2 billion in 2007; however, high-tech exports fell 1.9 percent. In 2006, total exports increased by 9.4 percent. Leading export destinations (in order) were Mexico, Canada, Japan, mainland China, South Korea, Taiwan, Germany, the United Kingdom, Hong Kong, and Singapore. Exports to these markets expanded, except for Mexico, Singapore, and Japan.

California home building and residential real estate markets slowed considerably in 2007. The number of single-family residential units permitted fell 37 percent in 2007, after falling by 30 percent in 2006. In the first quarter of 2008, they were down 61 percent from a year ago. Existing single-family detached home sales fell 26 percent in 2007. The median price fell 16 percent from December 2006 to December 2007.

Figure ECO-02
California Taxable Sales
Seasonally Adjusted



Source: California State Board of Equalization; p/ preliminary estimate

Figure ECO-03
Selected U.S. Economic Indicators

	2007 (Est.)	2008 (Projected)	2009 (Projected)
Real gross domestic product, (2000 dollar) (Percent change)	2.2	1.2	1.7
Personal consumption expenditures	2.9	1.4	1.4
Gross private domestic investment	-4.9	-8.4	1.0
Government purchases of goods and services	2.0	1.8	0.2
GDP deflator (2000=100) (Percent change)	2.7	2.0	2.0
GDP, (Current dollar) (Percent change)	4.9	3.2	3.8
Federal funds rate (Percent)	5.02	2.02	2.09
Personal income (Percent change)	6.2	4.2	3.6
Corporate profits before taxes (Percent change)	3.9	-14.7	18.0
Nonfarm wage and salary employment (Millions)	137.6	137.9	138.4
(Percent change)	1.1	0.2	0.4
Unemployment rate (Percent)	4.6	5.3	5.8
Housing starts (Millions)	1.34	0.91	1.13
(Percent change)	-25.8	-32.2	24.1
New car and light truck sales (Millions)	16.1	14.9	15.2
(Percent change)	-2.4	-7.5	1.9
Consumer price index (1982-84=100)	207.3	213.5	218.2
(Percent change)	2.9	3.0	2.2

Forecast based on data available as of April 2008.
 Percent changes calculated from unrounded data.

THE FORECAST

The struggling housing sector will continue to weigh on the state and national economies in the next two years, but economic growth should begin to improve late this year or in the first half of 2009 (Figure ECO-03 and Figure ECO-04).

Figure ECO-04
Selected California Economic Indicators

	2007	Percent change	Projected			
			2008	Percent change	2009	Percent change
Personal income (\$ billions)	1,521.3	5.9%	1,589.0	4.5%	1,654.8	4.1%
Nonfarm W&S employment (thousands)	15,170.0	0.7%	15,140.4	-0.2%	15,225.9	0.6%
Natural resources and mining	25.8	3.0%	26.4	2.3%	27.4	3.9%
Construction	891.6	-4.5%	812.7	-8.9%	819.1	0.8%
Manufacturing	1,460.2	-1.9%	1,424.5	-2.4%	1,385.5	-2.7%
High technology	377.8	-0.9%	368.1	-2.6%	354.5	-3.7%
Trade, transportation, & utilities	2,911.0	1.1%	2,928.2	0.6%	2,948.4	0.7%
Information	471.6	1.2%	454.5	-3.6%	454.2	-0.1%
Financial activities	906.2	-3.1%	868.1	-4.2%	849.6	-2.1%
Professional and business services	2,265.4	1.1%	2,293.8	1.3%	2,337.5	1.9%
High technology	304.5	3.8%	316.9	4.1%	329.4	3.9%
Educational and health services	1,668.6	3.4%	1,702.6	2.0%	1,727.7	1.5%
Leisure and hospitality	1,559.8	2.7%	1,594.0	2.2%	1,634.3	2.5%
Other services	512.4	1.1%	516.4	0.8%	520.7	0.8%
Government	2,497.4	1.8%	2,519.2	0.9%	2,521.5	0.1%
Unemployment rate	5.4%		6.4%		6.6%	
Housing permits (thousands of units)	112	-31.5%	70	-37.5%	96	37.6%
Consumer price index (1982-84=100)	217.4	3.3%	224.7	3.4%	231.3	2.9%

Forecast based on data available as of April 2008.
 Percent changes calculated from unrounded data.