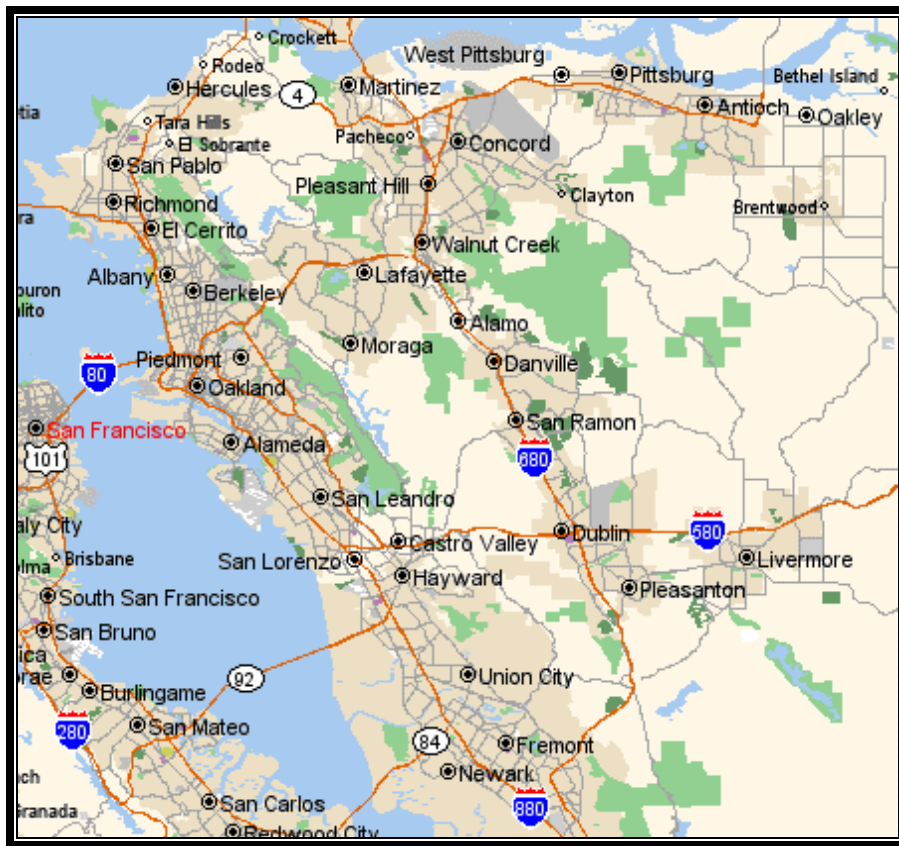


# East Bay Economic Outlook

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## **Overview and Outlook:**

The US grew at a solid 8.2% in the 3<sup>rd</sup> quarter of 2003 and all indications are that growth will be also be good in the last quarter when the BEA announces its calculations later this month. It appears as if the recovery is finally underway. Two signs were especially positive—business spending—particularly on information technology—increased sharply, and corporate profits also grew sharply. This is good news for Bay Area tech firms that may finally start to see the red ink disappearing. Do not expect this new investment to turn into jobs immediately, however. The Bay creates new technology. It doesn't build old systems. Nevertheless, now that investment is on the rise, demand for these new and better products will follow close behind.

While a recovery does seem to be underway, there remain two dangerous imbalances at the National level—the current account deficit and low private and public savings. For the economy to become healthy, personal and government spending need to slow, and savings rates need to rise. In 2004 look for so-so growth, 3%, as gains from increasing exports and business spending are offset by weak consumer spending. Employment in the US should also start to expand early next year. Alternatively if consumers do not pull back on spending this year overall economic growth rates could be higher, but the nation may be setting up for yet another downturn, this time consumer led, in 2005 or 2006.

Closer to home, the Bay Area has still not recovered from the 2000-2001 tech bust. San Francisco and San Jose continued to lose payroll jobs while the East Bay saw the third straight quarter of flat employment figures. It seems as if the economic problems of its two neighbors have finally started to affect the mainly buoyant economy on the sunny side of the Bay. Yet in the East Bay, like the rest California there are jobs being created—they just aren't being picked up on the payroll statistics. Employment gathered through household surveys in Alameda and Contra Costa showed sharp gains in the 4<sup>th</sup> quarter of last year, a sign that things may not be as bad as they look on the surface.

One big problem in the State is the real estate situation. With mortgage rates rising somewhat in the last part of 2003 we should have seen price appreciation start to cool. Instead price appreciation actually accelerated in the last part of 2003 as panicked buyers tried to lock in on low rates. At the same time the pace of new home building has also picked up steam, and the Bay Area is now adding a new unit for every 2 people moving into the region. Up to recently we have been of the opinion that much of the gains in real estate in California have been justified by the fundamentals. This last surge in the market is not. Both prices and building show the beginnings of a dangerous trend that, if not slowed soon, could lead to

a serious crash in the housing market in 2005.

The other big issue the State is currently debating is how to handle the budget deficit. The Governor is currently on tour touting his \$15 billion borrowing package. This may be necessary to tide the State over in the short run, but a fundamental imbalance still exists between revenues and expenditures that have very few solutions beyond a major reform in law on either the expenditure or revenue side of the equation, or a major hike in the already high income and business taxation rates. There is no easy way out at this point.

With a growing economy, the outlook for the Bay Area for 2004 has been upgraded slightly. We look for the East Bay to add 16,000 jobs in 2004, a gain of 1.6%. San Francisco and San Jose will add 8,000 and 4,500 jobs respectively, a .8% and .5% gain. Taxable sales will also be going to grow again, 3.5% for Alameda and 2.7% for Contra Costa County. Growth will go into the 6% range in 2005 unless the economy slows for the reasons mentioned.

**Bay Area Forecast**

Forecasts in Italics

	Payroll Employment (SA)			Taxable Sales (Thousands of \$ )	
	East Bay	San Francisco	San Jose	Alameda	Contra Costa
2003 Q1	1,049,998	979,079	883,510	\$4,893,635	\$2,717,496
2003 Q2	1,045,867	973,510	872,507	\$5,288,454	\$2,955,626
2003 Q3	1,043,360	971,824	865,159	\$5,473,463	\$3,093,401
2003 Q4	1,043,801	968,159	862,709	<i>\$5,776,444</i>	<i>\$3,369,290</i>
<i>2004 Q1</i>	<i>1,047,454</i>	<i>969,467</i>	<i>862,231</i>	<i>\$5,112,518</i>	<i>\$2,873,808</i>
<i>2004 Q2</i>	<i>1,050,808</i>	<i>970,617</i>	<i>862,808</i>	<i>\$5,558,420</i>	<i>\$3,132,041</i>
<i>2004 Q3</i>	<i>1,055,873</i>	<i>973,064</i>	<i>864,594</i>	<i>\$5,656,297</i>	<i>\$3,145,905</i>
<i>2004 Q4</i>	<i>1,060,587</i>	<i>975,951</i>	<i>867,346</i>	<i>\$5,977,026</i>	<i>\$3,460,960</i>
<i>2005 Q1</i>	<i>1,065,740</i>	<i>981,226</i>	<i>873,887</i>	<i>\$5,316,979</i>	<i>\$2,979,509</i>
<i>2005 Q2</i>	<i>1,072,135</i>	<i>986,807</i>	<i>879,727</i>	<i>\$5,809,702</i>	<i>\$3,278,376</i>
<i>2005 Q3</i>	<i>1,078,567</i>	<i>992,584</i>	<i>886,355</i>	<i>\$5,960,089</i>	<i>\$3,320,967</i>
<i>2005 Q4</i>	<i>1,085,669</i>	<i>999,724</i>	<i>895,520</i>	<i>\$6,360,551</i>	<i>\$3,675,322</i>

## **The National Economy: The Twilight Zone Economy**

The big news that arrived after the October UCLA-EDAB update was of course the 3<sup>rd</sup> quarter GDP growth numbers. While economists differed in their opinions on whether the growth rate for that quarter was going to be good or not so good (with the UCLA Anderson Forecast firmly in the latter camp) no economist expected the 8.2% (SAAR) number that finally did arrive.

The big question on everyone's mind is whether this is the signal that the doldrums that have afflicted the economy over the last two years have finally ended, implying that 2004 will be a high growth recovery year. The short answer is—hopefully not. While the numbers are clearly good news for the economy, in the middle of them may lie the roots of the next downturn in the economy. Before explaining this cryptic answer, we first need to delve into the data a bit further and understand what it means.

The reason that the 8.2% growth rate came as such a surprise to most economists is that none of the standard indicators of economic growth—employment, unemployment, capacity utilization and industrial production—registered such dramatic increases. To get some idea of the peculiarity of the 3<sup>rd</sup> quarter, a simple regression linking economic growth to changes in employment, unemployment, and industrial production was created. While the specifics of this basic model will not be described in detail here, it can explain over two thirds of the quarter to quarter variation in national output.<sup>1</sup> Using this model to create an estimated GDP growth rate for the 3<sup>rd</sup> quarter we arrive at the annualized figure of 3.8%, a solid rate but far less than half of the actual rate of growth for the third quarter as estimated by the Bureau of Economic Analysis. Indeed, the difference between the estimated and actual value is larger than any error this model produces through the entire sample period. This was clearly a very unusual period.

So what drove this unusual result and what does it mean for 2004? The contributions to GDP growth are shown in the next table. These numbers represent how the various sources of demand added to overall growth in national output. Let's talk about the good news before we delve into the reason for the strange growth rate. As we have been saying since the beginning of the downturn, the 2001 recession and the following doldrums were the direct result of the investment bubble of the late nineties period when the promises of information technology were causing firms to spend enormous amounts of money to invest in the new technology and to expand capacity to meet the supposedly permanent increases in aggregate

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<sup>1</sup> Note that this type of model is not a forecasting model per se—since it uses contemporary variables to explain GDP growth. Such contemporary variables also need to be forecasted in order to be able to create future estimates of GDP growth, a process that adds more variability into the process.

### **GDP Growth Regression**

*Dependent Variable: GDP growth 1983Q1-2003Q2*

*All independent variables in change form*

<b>Variable</b>	<b>Coef.</b>	<b>t-Stat.</b>
Industrial Production t-1	-0.121	-2.091
Industrial Production	0.301	4.913
Unemployment t+1	-0.561	-2.330
Payroll Employment	0.315	1.841
Intercept	0.005	7.003
GDP Growth t-2	-0.669	-7.563
Moving Average (-2)	0.956	28.915
R-squared	0.662	

demand that were going to result.

Unfortunately the massive increases in investment in this period were not followed by profits. The promised IT revolution simply never materialized. By 2000 businesses began to sharply curtail new spending on capital equipment and structures. This shock pushed the US into the downturn. Since World War II this was the country's first true business cycle downturn led by lack of business spending rather

than a decline in consumer spending. It was a mild downturn, however, because consumers and the government continued to spend despite job losses, falling incomes and shrinking tax revenues.

Consumption without growth is at best a short-term option, however. For the US economy to get back on normal footing the baton of growth must be passed from consumers and the government back to foreign buyers and private investors. Excess capacity, an overvalued US dollar and weak business profits have all contributed to keeping demand in these sectors weak, hence causing the economic doldrums the nation has suffered. We only had one driver of growth as opposed to a full range of drivers.

The third quarter was a clear indication that the shift has definitely started. Exports contributed almost a full percentage to total growth, while imports increased only a modest amount. The continued fall of the US dollar has helped sustain this process. Preliminary numbers for October and November show a very healthy 8% increase in export revenues compared to the previous year, even as imports stay relatively level. The trade gap has begun to close, but it has a long way to go to balance out. The rise in business spending was another positive development.

Also good news was that non-residential investment added one and one quarter percent to total growth. Most growth in this area was in purchases of information technology equipment. IT is back. This is good news for the Bay region, although not immediately. Nominal spending has almost caught up to the peak seen in 2000, while real spending is above the previous peak. The forces of depreciation have finally worked their magic on this sector of the economy and firms have begun to update their equipment. Unfortunately this spending may not immediately benefit the Bay Area since most investment goods are not produced in the region. Still, the profit reports for many of the tech companies based in the Bay area

over the past two quarters have been very strong—a likely precursor to hiring. Investment in new structures still remains weak, however, and it is likely that excess capacity in the supply of commercial space will continue to dog this segment of the economy for some time.

While these are good signs of recovery, they fail to explain the large growth rate seen. As it turns out, the all-American consumer is still the primary driver of the economy, debt and all. Residential investments and consumer spending accounted for over two thirds of the total growth. In short, while the numbers look like a move towards recovery, we are still in a primarily consumption-driven economy. Why has growth not been seen in industrial production or employment? In part, it is because many of the goods consumers buy are produced overseas and simply distributed here. Hence services were a primary point of growth in the economy.

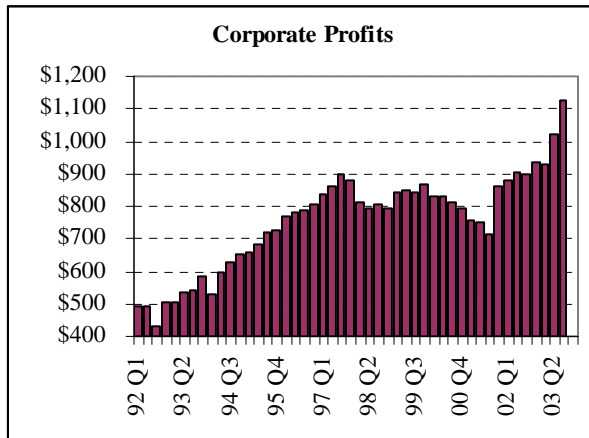
Additionally all this consumer spending is being handled by companies who are concentrating their efforts on the bottom line—trying to get their businesses profitable again after the IT bubble debacle.

### Contributions to GDP Growth

Source: Bureau of Economic Analysis (BEA)

Sector	Cont.
Gross domestic product	8.20
Personal consumption expenditures	4.89
Durable goods	2.23
Nondurable goods	1.48
Services	1.19
Gross private domestic investment	2.17
Fixed investment	2.30
Nonresidential	1.25
Structures	-0.04
Equipment and software	1.30
Residential	1.05
Change in private inventories	-0.13
Net exports of goods and services	0.80
Exports	0.92
Imports	-0.12
Government	0.34
Federal	0.09
State and local	0.25

Graph 1



Source: BEA

Most of the gains were in the value added by local firms, especially on the service side. As a result, for the second quarter in a row, corporate profits grew at nearly a 10% clip (non-annualized), spread across almost all sectors except retail. This is good news for investors and workers because higher profits imply future demand for business investment and workers.

The problem with all this good news lies on the consumer's balance sheet. Overall

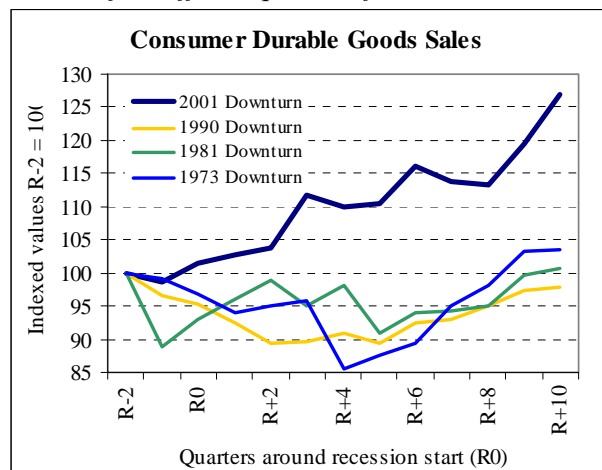
consumer spending on goods, services and housing grew at an 8% annual clip led by spending on durables and houses which grew at a 26% annualized rate. Such a rate of growth is not unexpected following a normal downturn. Most downturns in the US are led by declines in spending on houses, cars and furniture, and at this point in the business cycle consumers are catching up with their long run spending needs. Usually this is good news for the economy.

This downturn was different, however. It was led by business, but consumers never followed. Aggressive rate action by the Fed, which has pushed interest rates to lows not seen in decades combined with a high valuation of the US dollar that has made imported goods cheap, has continued to spur on consumer spending despite the loss of jobs, stock market wealth and generally weak income growth. The problem arises this time because consumers are not catching up for purchases deferred from the past. Instead, consumers are borrowing from the future.

Remember that in 2000 there were three major imbalances in the US. The third quarter numbers show that the investment-profit imbalance is being remedied. But the savings imbalance and the external imbalance are still major problems, and these problems are not being helped by deficit spending by consumers and local and federal levels of government. Net national savings remains at the remarkably low level of 1%, and the external imbalance remains at slightly less than 5% of GDP. Despite the low interest rates, consumer debt levels and debt servicing payments are at an all time high. This situation is simply not sustainable in the long run.

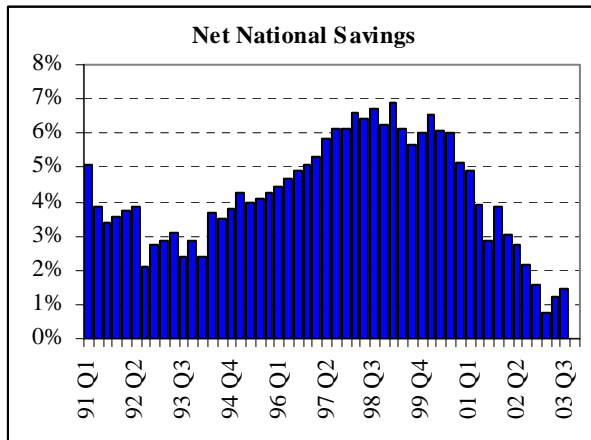
The only way for the situation to balance itself out is by a dramatic slowdown in consumer or government spending. This will necessarily weaken the overall growth situation as the economy readjusts itself to the new patterns of demand. So the forecast for overall economic growth remains cloudy. The fourth quarter of 2003 looks to be another solid period of growth. Retail sales were up 6% over the previous year and even up a percent from the very solid third quarter (even in seasonally adjusted terms). Industrial production continues to increase and while employment has not begun to add a significant number of new

**Graph 2**  
*R0 is the first official quarter of the recession*



Source: BEA, NBER

**Graph 3: Net Savings as % of GDP**



Source: BEA

jobs, at least payroll employment has ceased to fall. Unemployment is falling at a slow pace as well. Look for the final number to be between 3.5% and 4% when it is released at the end of this month.

As for 2004 and beyond, the situation depends critically on whether consumers will get spending back into line with income. If this process begins this year, as we hope it does, it will be a largely unimpressive year with an overall growth rate between 2.5%

and 3.5%. On the other hand, if consumers continue their profligate consumption, growth rates could hit recovery level rates of 4 to 5%. But if this happens we will be sowing the seeds for the next US downturn, a normal consumer-led cycle, that will begin in 2005 or early 2006. So keep an eye on consumer spending and realize that news that is too good in 2004 will end up being bad news in 2005 or 2006 as a sudden decline in demand for houses and cars pushes the US into another downturn.

As for employment, the productivity boom of 2002 and 2003 has certainly begun to run out of steam. Labor markets are getting back into shape and we can expect firms to start hiring again over the course of the next few months. Job growth will not be that strong, however, until later in the year, and some productivity growth will continue to diminish demand for new employees. Unemployment will continue to fall, but the lowest it is likely to drop, will be to the mid 5 to 6% range. Do not expect this rate to drop below 4% again anytime in the near future, if at all.

Price inflation will likely begin to warm up in the coming year when all the liquidity injected into the economy starts to take hold in a recovering economy that allows firms more room to raise prices. The falling dollar will also lead to higher input costs for firms producing products in the US. Look for 2-3% inflation for 2004, but keep an eye on the US dollar and oil prices in coming months. A continued fall in the dollar or another sharp rise in oil prices could cause inflation in the US to reach a more serious level.

It is unlikely that the Fed will consider raising rates dramatically over the coming year unless inflation really starts to kick in. If this happens Greenspan will be in an awkward position. If he raises interest rates to fight price inflation, he could start a consumer-led recession sooner rather than later. Yet if he

**Summarized UCLA Anderson Forecast for the Nation (December 2003)**

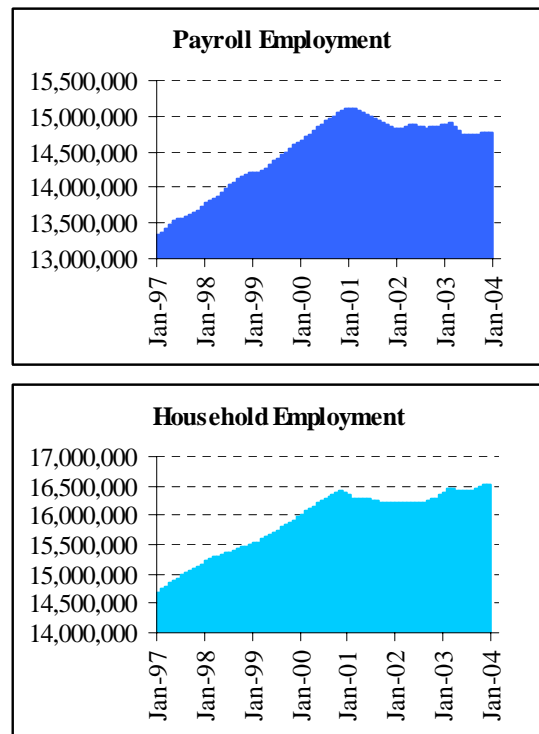
	03Q3	03Q4	04Q1	04Q2	04Q3	04Q4
<b>Growth (SAAR)</b>						
GDP	8.2%	3.4%	2.8%	2.9%	3.3%	3.5%
Non-Res. Inv	11.1%	14.4%	9.2%	8.7%	7.4%	5.7%
CPI Inflation	2.3%	1.2%	2.6%	3.0%	2.1%	2.1%
<b>Levels (SA)</b>						
Payroll Emp.	129.8	129.9	130.1	130.5	131	131.7
Fed Funds	1.0%	1.0%	1.1%	1.3%	1.4%	1.7%
10-year	4.2%	4.3%	4.4%	4.6%	4.9%	5.2%

allows inflation back into the economy, he will send jitters through the financial community. Neither direction has many good outcomes. In the meantime the consumer bubble continues to rise. One easy fix would be to raise interest rates enough to slow consumer spending. This would imply slow growth in '04 but a diminished probability of a consumer led cycle in the following years. Unfortunately the political perils of any dramatic Fed moves in an election year are clear. A sharp rise could create calls of election fixing by the Republicans. Don't look for the Fed to move unless its hand is forced.

**California Labor Markets: Where are those jobs?**

The California economy has been getting back on track as has the US economy overall. Economic activity seems to be increasing, but we don't see it in the payroll employment statistics. Payroll employment reached its lowest point in the state in the third quarter of last year. By the end of the year some new payroll jobs had started to come back, but at a very slow pace. During 2003 California personal income did better, rising by an estimated 3.6% -- not a great figure, but solid. Estimates of taxable sales growth are also positive. Both these figures represent a solid economy, not one with a shrinking workforce. The same can be said about real estate prices and new residential construction; these continue to be very strong despite what appears to be a lack of jobs.

**Graph 4: California Employment**



Source: California Employment Development Division (EDD) UCLA Anderson Forecast

California also continues to add new population at a rapid pace, primarily to the Southern California region. This suggests economic prospects are being offered to these new residents. Next month it is expected that 2003 California payroll job growth will be revised upwards, somewhere on the order of approximately 1% or so.<sup>2</sup> But this isn't nearly enough to align payroll trends with these other indicators.

The employment figures from household surveys paint a much different picture. Since the peak in March of 2001 the state has lost approximately 325,000 payroll jobs out of its 14-plus million jobs that were in place. However, according to household survey data for the same period of time, 225,000 jobs have actually been added, for a net difference of well over a half million jobs.<sup>3</sup> The jobs that do not appear on the payroll statistics are workers who are technically self-employed. This informal sector in the state now totals over 1.7 million workers, more than 10% of the workforce. It appears that jobs are being added to the state's economy, but not in traditional employment establishments.

Given its demographics, it isn't a surprise that the informal sector is so large in California. There are a large number of immigrants, many illegal, who prefer to stay under the radar screen. But this can hardly explain a full 10% of the workforce. Where are these jobs?

The Current Population Survey data provides some clues in questions about industry of employment and self-employment. The accuracy of this type of data is somewhat suspect because it depends on the ability of all respondents to correctly categorize themselves. Nevertheless we can get a rough idea of the distribution of informal jobs across the various sectors by looking directly at the self-employed.

The following table breaks this out for the 2003 California labor market. In total, there were 2,000,000 people who claimed to be self-employed workers. This is more than the 1.7 million informal workers mentioned previously, but this can easily be explained by discrepancies caused by individuals who have two jobs or have incorrectly categorized themselves. As a result, these numbers should be taken lightly.

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<sup>2</sup> The monthly payroll numbers are estimates based on the Current Employment Statistics (CES) survey. A more complete sample of payroll jobs is collected through the ES202 data series used for collecting unemployment insurance premiums from companies. This cannot be used for month to month data as the more complete data takes a number of months to fully process. Each year the EDD recalibrates their statistical estimates based on the CES data by matching the data to the ES202 data. The Bureau of Labor Statistics recently released Q2 ES202 data for 2003, and the numbers are above the current estimates for the CES data, implying an upward revision next month.

<sup>3</sup> Payroll statistics are collected directly from employers, and therefore are the most stable source of employment data available. Unfortunately the payroll statistics do not pick up self-employed workers, nor by definition can it pick up the unemployed—workers who are actively seeking a job but do not currently have one. To measure these two components of the workforce a second survey is utilized—a household survey which polls people at their home rather than at their place of work. . This is the Current Population Survey, which is used to construct the unemployment numbers.

The largest sector of self-employment is Professional and Business Services, with over 420,000 jobs—not what one might expect given the demographics of the region. Still, many professionals do tend to be self-employed. Trade and Construction weigh in with 300,000 and 240,000 workers each. These sectors are not as surprising. Many workers in Wholesale and Retail Trade are informal workers employed on a temporary basis or employed ‘under the table’. Manufacturing also adds close to 100,000 jobs, while Other Services (which includes personal services) and Leisure and Hospitality combined

account for over 300,000 more. What can be clearly gleaned from these numbers is that these jobs are not *just* in household services. They are spread across the map in sectors that are both ‘good’ and ‘bad’ in terms of income. In short, the state’s economy is stronger than the payroll numbers alone would seem to indicate.

A recent research paper claimed that there has been a shift in the workforce from high paying jobs (manufacturing) to low paying jobs (retail) in the US. This is true in the payroll statistics. Unfortunately the change from SIC to NAICS makes it difficult to accurately trace the pattern of informal jobs. However, it is clear that these informal jobs aren’t necessarily all ‘bad’ jobs.

What might be driving these results? Part of the answer may be related to weak corporate profits leading to weak demand for new workers, leading to people deciding to strike out on their own. In the long run this may be good for the economy, encouraging both entrepreneurship and innovation.

Unfortunately there is a more likely reason unskilled labor is moving out of covered jobs -- the state’s rapid increase in labor costs. The surging cost of premiums for both workers’ comp and healthcare insurance may be discouraging companies from adding low or mid-skill workers to their payrolls and encouraging them to meet their labor needs through sub-contracting and temporary workers. Of course by

### California Employment: Payroll vs. Household 2003

Source: Current Population Survey, UCLA Anderson Forecast

	Payroll	Self Emp.
Farm, Logging, Mining	353,600	61,527
Construction	788,800	243,347
Durable Goods Manu.	1,004,100	66,593
Nondurable Goods Manu.	580,100	42,638
Wholesale and Retail Trade	2,245,400	307,271
Transportation, Utilities	489,400	53,648
Information	471,300	64,859
Finance & Insurance	589,700	64,900
Real Estate & Rental	272,900	113,978
Professional & Business Serv.	2,113,800	424,434
Educational Services	253,058	26,467
Health Care & Social Asst.	1,273,800	186,112
Leisure & Hospitality	1,407,500	161,086
Other Services	501,200	169,675
Government (non-education)	2,440,242	
<b>Total</b>	<b>14,784,900</b>	<b>1,986,534</b>
Total Household	16,477,884	
Difference	1,692,984	

moving workers off payrolls into a self-employment situation we end up removing many of the standard protections that formal workers enjoy, not to mention costing the State labor tax revenues. If we want to identify a culprit for the rising rate of uninsured persons in California, we do not need to look much farther than this trend. If SB-2 actually goes into force, requiring additional firms to provide health coverage to workers, look for this trend to worsen substantially. The unintended consequence of this law may be to reduce coverage for many low-skill workers who will no longer be able to find traditional payroll jobs as a result of the increased cost of employing them.

The patterns of change that have been seen since the beginning of the downturn continue to be seen throughout the state. Payroll jobs continue to slowly bleed away in San Francisco and San Jose. San Jose is now down an amazing 19% from the employment peak seen in March of 2001, while San Francisco is down almost 13%. The household numbers in each of these areas have not declined by as much.<sup>4</sup> Unemployment has fallen in these two economies due to the continued shrinkage of the labor force rather than because of the creation of new jobs.

The East Bay saw employment basically stay flat over the 4<sup>th</sup> quarter of 2003, but household employment surged over half a percent. While payroll employment in the East Bay has fallen by over 2% the past three years, household employment has actually risen by 1.6%. Indeed the number of payroll jobs in the six-

### California Employment by MSA

*Seasonally adjusted numbers*

	Payroll Employment			Household Employment			Unemployment		
	Dec-03	3-mth	3-yr	Dec-03	3-mth	3-yr	Dec-03	3-mth	3-yr
California	14,760,200	0.1%	-2.2%	16,531,200	0.5%	0.9%	6.5%	-0.1%	1.8%
East Bay	1,042,600	-0.1%	-2.1%	1,238,000	0.6%	1.6%	5.8%	-0.2%	3.1%
San Francisco	966,400	-0.5%	-12.1%	883,600	-0.2%	-8.8%	5.2%	-0.1%	2.9%
San Jose	862,000	-0.3%	-18.8%	845,200	0.2%	-15.9%	7.2%	-0.4%	5.5%
Sacramento	743,400	0.1%	2.2%	834,800	0.7%	6.2%	5.6%	0.1%	1.8%
Fresno	371,000	0.8%	1.2%	405,000	1.1%	5.3%	13.2%	-0.8%	-0.6%
Los Angeles	4,002,200	-0.1%	-2.6%	4,431,500	-0.1%	0.1%	6.8%	-0.2%	1.7%
Orange	1,418,400	0.4%	0.0%	1,539,800	1.0%	3.8%	3.7%	0.0%	1.3%
San Diego	1,238,600	-0.3%	1.3%	1,439,900	0.3%	5.2%	4.2%	0.0%	1.3%
Riverside	1,102,500	0.3%	7.1%	1,622,700	1.0%	11.2%	5.9%	0.0%	1.0%
Ventura	291,100	-0.5%	-2.5%	400,400	-0.2%	0.9%	5.4%	0.2%	1.1%

<sup>4</sup> Caution must be used here, however, as the distinction between payroll and household employment numbers is less clear at the local level. Household employment registers in the county of residence while payroll employment is recorded in the county of employment making inter-county commuting a problem for interpreting the numbers.

county region was 33,000 more than household employment in December 2000, as many workers were commuting in from the outlying counties. As of December 2003 the six-county region now registers 100,000 more household jobs than payroll jobs. This increase represents about one third of the growth in informal jobs in the State. Again, the Bay Area economy overall remains in rough shape with a large decline in both household and payroll jobs, but it may not be quite as bad as the payroll numbers alone would indicate.

As for the rest of the state, Sacramento was growing solidly through the start of the economic downturn, but has seen its economic fortunes reversed with the State's budgetary problems. Fresno is the one region in the central portion of the state showing solid growth. In the Southern California region Orange County and the Inland Empire have begun to get back on a solid growth path. San Diego has been one of the stronger economies in the nation, but it too is a government center that has been hit by the State budget cuts in recent months. Ventura and Los Angeles appear to be the weakest two economies in the region, both seeing job losses over the past quarter. Still, household employment across the Southern California region is above where it was three years ago, the fundamentals in the region remain in place.

### **The California Budget: Between a revenue rock and an expenditure hard place**

In recent weeks the Governor has gone on the road touting his proposal for the State to borrow \$15 billion to cover expenses in the near term and consolidate debt the government has racked up over the past few years. What happened to put the State into such a place? It all started in the late nineties with the Internet

rush. In fiscal year 1998 (July 1997 to June 1998) the State brought in approximately \$55 billion in general fund revenues and spent just under this amount. Starting in early 1999 revenues flowing into the State coffers started to swell with income taxes collected on gains made in an increasingly hot stock market. By fiscal year 2000 revenues had increased to over \$70 billion and in 2001 reached a new high of \$78 billion. Unfortunately this new prosperity was as shaky as the stock market bubble it was built on, and when the market collapsed so did California's income.

The State government reacted to all these revenues by quickly expanding programs, hiring new workers and

#### **California General Budget Revenues and Expenditures**

*Numbers adjusted to reflect real current flows*

*Source: California Department of Finance, UCLA Anderson Forecast, MB Economic Consulting*

	Revs	Exps	Diff.
1997	\$49	\$49	\$0
1998	\$54	\$52	\$2
1999	\$59	\$58	\$1
2000	\$72	\$66	\$6
2001	\$77	\$78	-\$1
2002	\$64	\$77	-\$13
2003	\$66	\$77	-\$11
2004 est.	\$68	\$74	-\$6

increasing benefits. It was an easy time to be an elected official. Expenditures surpassed \$78 billion at the end of 2001. All in all the State doubled general fund spending between 1994 and 2001—an impressive feat.

It had to be clear that the budget was going to be a problem by March of 2001 when NASDAQ had already lost close to two-thirds of its value. But with the November elections approaching, dramatic cutting of programs or raising of taxes would have been bad politics. As a result, no steps were taken to address the issue. Instead, accounting tricks were used and internal funds were raided to avoid making any unpopular decisions. When the numbers are examined and these tricks removed, it is clear that revenues dropped in fiscal year 2002 (ending in June 2002) to roughly \$64 billion, while expenditures stayed at greater than \$75

billion. \$10 billion in debt was racked up by the time Gray Davis' second term was barely six months old. Revenues recovered slightly in the following year, but unfortunately the chaos of the recall and the inability of the State to address the issue in a decisive way prevented any major cut in spending, and another approximately \$11 billion in debt was accumulated.

**Change in General Fund Spending FY1998-FY2004**

	FY 1998	FY 2004	Ch
Health and Human Services	14.64	25.19	10.55
K-12 Education	22.08	30.72	8.64
General Government (w/ VLF)	2.26	4.99	2.73
Higher Education	6.63	8.68	2.05
Youth and Correctional	4.14	5.64	1.5
Legislative / Judicial / Executive	1.57	2.41	0.84
Business Transport and Housing Resources	0.27	0.51	0.24
Labor and Workforce Dev	0.72	0.87	0.15
State and Consumer Services	0	0.12	0.12
Environmental Protection	0.39	0.44	0.05
Technology Trade and Commerce	0.11	0.1	-0.01
	0.05	0.01	-0.04

Source: California Department of Finance

It seems likely that by the end of the current fiscal year the State will have incurred around \$6 billion in debt. Where did the money go? It went largely to two areas, Health and Human Services and K-12 Education. These two areas accounted for two thirds of total spending increases and represent over two thirds of general fund spending.

It is abundantly clear that our new Governor is currently between a revenue rock and an expenditures hard place. Unless another stock market bubble forms, State revenues will certainly not be returning to their formerly high levels any time soon without a tax increase. This is a structural, not a cyclical gap. And on top of that there is something between \$15 and \$20 billion in accumulated external debt and IOU's to raided internal funds that resulted from the short term fixes over the past three years. These will absorb

most natural increases that might occur.

Cutting expenditures without touching Health and Human Services or K-12 education would require gutting any number of other areas such as correctional institutions which is not likely to happen, nor even potentially possible. Whatever your particular political views are on these two major State programs, it is clear that once expended, trying to contract these programs down again will be very difficult. In the case of K-12 it would also be illegal. Indeed when revenues do return, the State will actually be required by Prop 98 to match the new revenues and make up for past drops in spending. In his budget for next year the Governor has proposed decreasing spending on H&HS by approximately \$1 billion and the political fur is already flying.

Is the \$15 billion in debt a good idea? It will certainly give the Governor some needed breathing room while he decides what moves to make in the next two years. However it needs to be understood that this \$15 billion is at best a short term fix—the budget problems the State has are not going away, only diminished slightly over time. Further, incurring debt does not imply that taxes are being avoided—only

that taxes are being deferred. This money will need to be paid back with interest in the future, and again, that will become a budget issue down the line.

**California vs. US State and Local Tax Receipts, FY 1999-2000**

Source: US Census

	US	California
Per Capital Taxes	\$4,439	\$5,016
<i>Type of Tax</i>		
Property	28.6%	21.9%
Sales and gross receipts	35.5%	33.1%
Individual income	24.3%	33.0%
Corporate income	4.1%	5.5%
Motor vehicle license	1.9%	1.5%
Other taxes	5.7%	5.1%

Is California truly a high tax place? The answer is, maybe surprisingly, no. State and local taxes collected in California in FY2000 totaled about \$5,000 per person compared to \$4,400 per person in the US overall. This is higher, but given the higher income in California compared to the US

overall as well as the higher cost of living the difference is understandable. Why is California considered to be so business-unfriendly? Probably because while the state is average in overall taxation, it has high personal and business income taxes compared to other places. The reason for this is simple—Prop 13. Property taxes in California make up only 22% of the total budget revenues compared to 28.6% for the nation overall. This is particular startling when one considers that property values in the state are some of the highest in the nation.

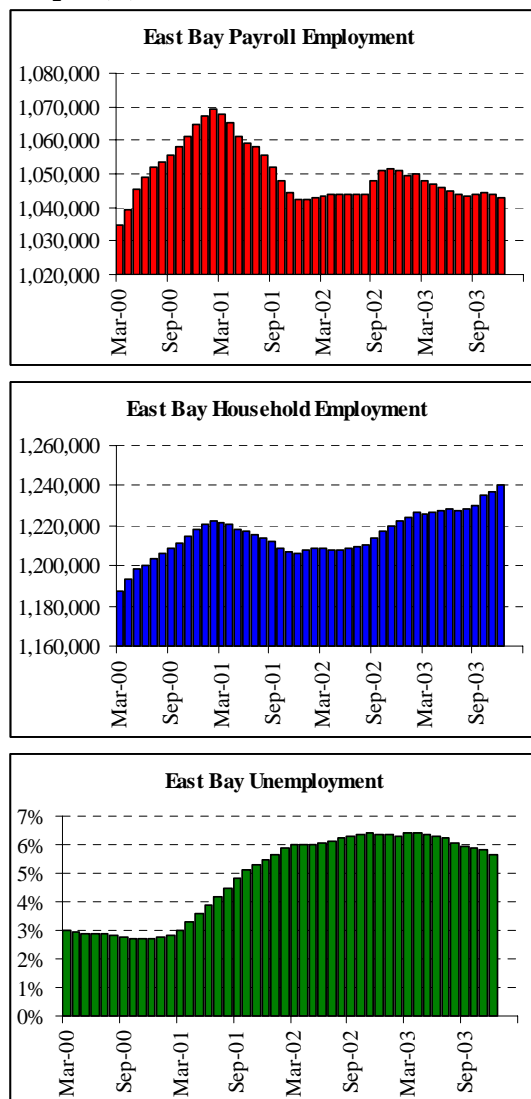
The problem is that income taxes are highly distorting, and are easily avoidable. It simply drives a portion

of the economy underground, or into neighboring States where residence can be established but business still conducted here. Property taxes are hard to avoid and do not distort incentives as much. On top of that the current system creates vast inequities, with new homebuyers shouldering the burden of taxes even as they struggle to make mortgage payments, while those who have lived in their property for many years and who have built up large amounts of equity pay very little. The same can be said for businesses. Those who are established and have been in place for many years will have an advantage over potential entrants who have to pay higher taxes. It is clear that in the long run the State needs to address, and repeal, Prop 13.

### East Bay Economic Activity: Mixed Results

As already discussed, the East Bay had another quarter of flat payroll job numbers, with the total number of jobs remaining at about 1.04 million. Still, the region remains the one bastion of relative economic stability in the Bay area as its two neighboring economies have yet to see any positive job growth despite the growing national economy. Unemployment has been falling in the region despite this, falling nearly half a percentage point to 5.7% in December. The reason of course is that, as in the rest of California, jobs measured by the household survey have been expanding even as payroll jobs have been falling. Indeed, according to the household survey, another 10,000 jobs were added to the East Bay between September and December of this year. Unfortunately the extensive commuting between the East Bay and its neighboring economies makes it difficult to interpret whether these jobs are outside the East Bay (commuting jobs) or are new informal jobs in Contra Costa and Alameda counties. The lack of new payroll jobs elsewhere in the Bay Area makes the latter option clearly more likely.

**Graph 5,6,7**



Source: EDD, UCLA Anderson Forecast

### East Bay Payroll Employment

*Data seasonally adjusted and smoothed*

*Source: EDD, UCLA Anderson Forecast*

	Dec-03	Ch June to Sept	Ch Sept to Dec
Total, All Industries	1,042,700	-1400	-1100
Construction	69,200	900	1800
Durable Goods Manu	61,400	-100	200
Nondurable Goods Manu	35,900	-600	-600
Wholesale Trade	51,600	200	-200
Retail Trade	109,900	100	-1200
Transportation, Utilities	38,600	-200	-400
Information	32,900	-200	-100
Finance and Insurance	43,300	600	0
Real Estate and Rental	18,700	100	100
Professional, Scientific	67,000	-500	-1400
Management of Companies	24,100	-100	-700
Administrative and Waste	56,900	-100	-200
Educational Services	17,000	-200	-700
Health Care and Social Asst	110,200	400	900
Leisure and Hospitality	83,900	1000	2000
Other Services	38,400	200	500
Federal Government	18,600	300	0
State and Local Government	77,600	-400	200
State and Local Education	82,700	-2800	-1400

Looking closer at the payroll data, no significant trend changes can be seen in the individual sectors. Driven by the continued hot housing market in the area, construction continued to be a solid sector, adding 1,800 jobs to the 900 added in the third quarter. The Retail sector which failed to add the number of jobs it typically does over the holidays, was disappointing and not good news for taxable sales. Professional Services and Educational Services also saw a loss of jobs over the last quarter of 2003.

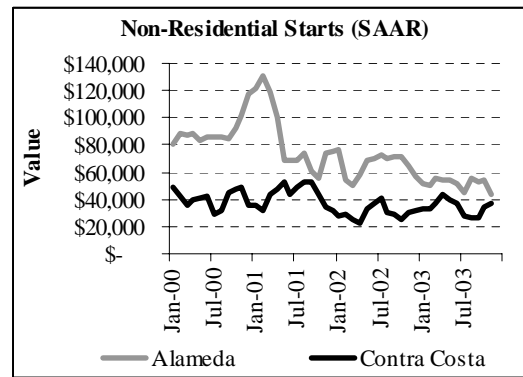
Positive job gains were seen in the Healthcare and Leisure industries. There was also a slowdown in the rate of job losses in State and Local

Education. Given Prop 98 it seems unlikely that the education sector can lose many more jobs, but other government positions, so far untouched, may soon go on the chopping block.

While jobs aren't painting a very rosy picture of economic activity in the East Bay, other business statistics are. Office vacancies in the region remains level at 17%, but availability rates dropped sharply in the 4<sup>th</sup> quarter according to the statistics collected by CB Richard Ellis. Lower availability rates imply less vacant space moving into the market in the near future. This in turn implies that the market is continuing to firm up and rents may begin to stabilize. Alameda and Richmond remain the weakest markets in the region while Oakland, San Leandro and Berkeley are some of the stronger ones. The market for industrial space remained stable as well with warehouse vacancy rates dropping very slightly (.2%). Rates for all spaces continue to fall. Non-residential construction permits in the East Bay have remained stagnant at between \$80 and \$100 million per month. Like its two neighboring economies, most of these new permits are for renovation work—very few permits for new construction are being issued. Excess supply in industrial and office space will likely dog this sector of the economy for some time.

Airport traffic in October and November was up a solid 5% over the same time last year. Curiously one of the weakest sectors seems to be in hotels. Occupancy rates to date are down nearly 4 percentage points from last year, and average room rates have fallen another \$10 on average.<sup>5</sup> Nevertheless, the East Bay has added 3,000 jobs in Leisure and Hospitality during the past 6 months. It seems that while these new passengers are not sleeping over, they are at least eating in the East Bay. Another good sign comes from the initial estimates for 3<sup>rd</sup> quarter taxable sales. For the first time in a long time they are above last year for the same quarter. Taxable sales in Alameda county were about 1% above Q3 2002, while for Contra Costa they were up 3%.

**Graph 8**



Source: CIRB, UCLA Anderson Forecast

### East Bay Residential Real Estate: Overheating

As with most of California and indeed with the rest of the US, the last quarter of 2003 saw frenetic activity in the real estate markets. Prices and turnover surged as buyers have been frantically trying to

lock in low mortgage rates before they go away. According to statistics by DataQuick, median prices in the Bay Area increased by 3% over the last quarter of 2003 and 11% over the previous year—an amazing statistic when we consider the relatively weak economy in the region. This is the sixth straight year of double digit increases in housing prices. Total unit sales were over 32,000 combined for the last quarter of 2003. This is the greatest level

#### Housing Prices: East Bay

All units combined, data smoothed

Source: DataQuick, UCLA Anderson Forecast

County	Total Sales 2003 Q4	Median Price Dec 03	3 month change	1 year change
Alameda	6,729	\$415,000	1.9%	9.5%
Contra Costa	6,363	\$522,000	4.0%	13.4%
Marin	1,186	\$551,000	5.3%	14.7%
Napa	559	\$515,000	2.9%	8.7%
San Francisco	2,147	\$567,000	1.3%	6.4%
San Mateo	2,636	\$531,000	2.5%	10.1%
Santa Clara	8,069	\$408,000	2.2%	11.2%
Solano	2,429	\$369,000	4.6%	17.4%
Sonoma	2,558	\$437,000	5.1%	15.9%
<b>Total Bay Area</b>	<b>32,676</b>	<b>\$459,000</b>	<b>2.9%</b>	<b>11.5%</b>

<sup>5</sup> PKF Consulting

seen since the last quarter of 1988. This date should ring a bell for those around at that time, for it was very near the peak of the late-80's California real estate bubble -- a comparison that should be remembered.

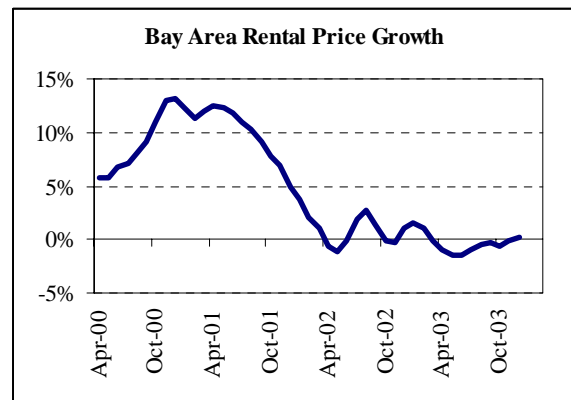
As has been discussed before in this report, real estate has a fundamental value based on the present value of all future net-rents (or implied rents in the case of owner occupied units). As the future growth rate of rents increases, so do property prices. Similarly, when mortgage rates go down the discount on future rents decreases, also raising the current price of property. During the rush years, the rapid growth in the region kept growth in the demand for housing one step ahead of supply, driving rents up by 7 to 10% per year between 1996 and 2001, and property values followed. When the downturn began, the demand for housing softened, but aggressive Fed rate actions caused mortgage rates to drop sharply and helped maintain housing price appreciation. Hence I have maintained that real estate prices were not in a bubble through the early part of 2003: the fundamentals largely justified prices.

Recently I have begun to shift my view. All these drivers have started to turn the other way in the second half of 2003. Mortgage rates stopped falling while the rental market continued to soften as a result of slow population growth and continued jobs losses.

Indeed rental prices fell in the second half of the year. This should have led to prices softening or even falling in the area. Instead, the threat of higher interest rates and the perception by buyers that appreciation is a given in the market has led to price appreciation actually accelerating in the second half of the year. One problem is the misunderstanding that low interest rates are somehow 'good' for buyers while high interest rates are 'bad'. Actually there is an important offsetting effect that is not understood. All else being equal, low mortgage rates cause prices to rise, while high rates cause prices to fall. Hence, a consumer is not necessarily worse off if interest rates rise—the higher rate paid is offset by a smaller mortgage.

It is clear that the housing market is currently overheating in California and especially in the Bay region. This spells potential problems in the future when prices inevitably move back to their long run levels. A

**Graph 10**  
*Annualized Changes*  
*Source: Bureau of Labor Statistics*



### Median Home Prices by City: East Bay

City/Area	Dec-04	Dec-03	% Chg	City/Area	Dec-04	Dec-03	% Chg
<i>Alameda</i>				BYRON	\$422,500	\$385,000	9.7%
ALAMEDA	\$532,000	\$447,500	18.9%	CLAYTON	\$599,000	\$398,500	50.3%
ALBANY	\$442,000	\$469,500	-5.9%	CONCORD	\$366,500	\$312,500	17.3%
BERKELEY	\$537,500	\$463,500	16.0%	CROCKETT	\$332,000	\$355,000	-6.5%
CASTRO VALLEY	\$444,500	\$437,500	1.6%	DANVILLE	\$673,750	\$660,000	2.1%
DUBLIN	\$499,500	\$531,750	-6.1%	DIABLO	\$1,372,500	\$1,127,000	21.8%
EMERYVILLE	\$375,000	\$317,000	18.3%	EL CERRITO	\$469,000	\$440,000	6.6%
FREMONT	\$464,000	\$432,000	7.4%	EL SOBRANTE	\$400,000	\$350,250	14.2%
HAYWARD	\$375,000	\$339,000	10.6%	HERCULES	\$340,500	\$393,500	-13.5%
LIVERMORE	\$452,000	\$442,500	2.2%	LAFAYETTE	\$820,000	\$719,250	14.0%
NEWARK	\$410,000	\$390,000	5.1%	MARTINEZ	\$398,000	\$310,000	28.4%
OAKLAND	\$365,000	\$300,000	21.7%	MORAGA	\$694,500	\$628,000	10.6%
PLEASANTON	\$556,000	\$488,500	13.8%	OAKLEY	\$330,000	\$298,500	10.6%
SAN LEANDRO	\$405,000	\$365,000	11.0%	ORINDA	\$924,000	\$805,000	14.8%
SAN LORENZO	\$382,000	\$348,000	9.8%	PINOLE	\$398,000	\$350,000	13.7%
UNION CITY	\$438,500	\$420,000	4.4%	PITTSBURG	\$320,000	\$283,000	13.1%
<i>Contra Costa</i>				PLEASANT HILL	\$455,000	\$400,000	13.8%
				RICHMOND	\$317,500	\$265,000	19.8%
ALAMO	\$1,200,000	\$817,500	46.8%	RODEO	\$359,000	\$289,000	24.2%
ANTIOCH	\$348,000	\$333,000	4.5%	SAN PABLO	\$332,500	\$246,000	35.2%
BETHEL ISLAND	\$516,500	\$221,500	133%	SAN RAMON	\$613,500	\$590,000	4.0%
BRENTWOOD	\$400,000	\$383,000	4.4%	WALNUT CREEK	\$455,000	\$452,000	0.7%

collapse in property prices on top of an already shaken economy could end up leading to the same type of long run downturn that afflicted Southern California in the early nineties.

There are other disturbing trends as well. There has been a sharp increase in the use of adjustable rate mortgages (ARMs) by buyers in the US, and particularly in California. Nationally, the use of ARMs has doubled from 13% to 26% over the past year. In Contra Costa and Alameda the number has increased from an already high 40% to 65%. Buyers using ARMs are exposing themselves to two types of risk. The direct risk is from increases in interest rates. Rising federal deficits and a world economy that is back on a growth path imply less capital available in the market and rising interest rates over the coming year. The secondary risk comes from the already inflated prices. As interest rates rise, housing prices fall. New owners may find their monthly payment rising even as their housing equity shrinks.

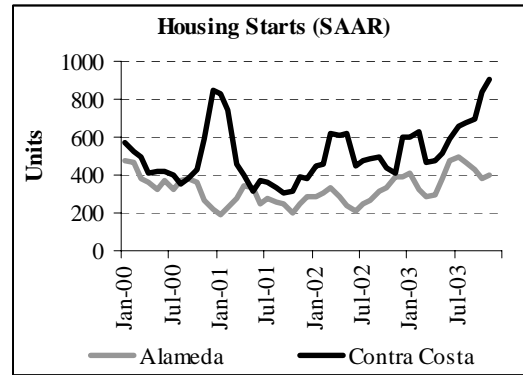
Also worrisome is the rapid increase in building in the Bay area. As seen in the employment statistics new construction in the East Bay has been solid. Most of these gains have, not surprisingly, been on the residential side of the market. Contra Costa in particular has seen a sharp increase in permits for new units in the last part of 2003, with permits for new units getting close to 1000 per month. Alameda is also up to around 400 per month, compared to the 200 to 250 units it was building in 2001. Demand for new

housing is being driven again by families trying to buy up to new units while interest rates are low. The development industry has been responding to serve these customers.

The big question, though, is whether all this new residential construction is viable in the depressed Bay Area. Certainly current demand remains strong in the region despite the downturn, in part because of pent up residual demand from the late nineties. But this pool is relatively small. Housing certainly

was tight in the region as population growth rates rose with the economic prosperity of the region, but in general, development kept up with increasing demand. The ratio of new population to new housing units in the East Bay was between 4 and 5 through the late nineties, slightly above San Francisco. In San Jose

**Graph 9**  
Data smoothed



Source: CIRB, UCLA Anderson Forecast

**Bay Area Population**

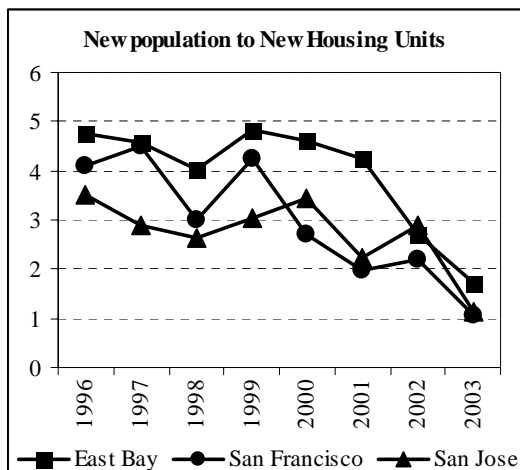
Source: California Department of Finance, UCLA Anderson Forecast

	1/1/2003	1/1/2004*
ALAMEDA	1,496,200	1,503,700
CONTRA COSTA	994,900	1,008,000
SAN FRANCISCO	1,759,000	1,762,700
SANTA CLARA	1,729,900	1,738,800

\* Estimated

the ratio was surprisingly about 3 to 1, quite low, but a number driven in part by the many young tech workers without families flooding into the region looking for work.

**Graph 11**



Source: CIRB, UCLA Anderson Forecast

Recently demand for new housing is starting to soften as people leave the area. Outward migration has slowed population growth in the area dramatically. The East Bay has seen population growth fall from 2% per year in 2000 to less than 1% per year. San Francisco saw population growth basically fall to zero, while San Jose has fallen to less than .5% per year. As a result, the region overall is currently building one new housing unit for every 1.5 people entering the area -- a level that is not sustainable in the long run. Indeed during the building boom in Southern California in the late eighties this rate only dropped to about 2 new people for each new unit, a rate higher than the one seen in the Bay Area in 2003. If the market

suddenly slows, which it may very well do at some point over the next year, developers may find themselves with unsold stock.

## **The Balance of the Bay: Still in the trough**

*By Joe Hurd, California Economist for the UCLA Anderson Forecast*

San Jose's economy, by far the hardest hit local area in California's '01-'03 downturn, continues to struggle. Payroll employment stopped plunging late last year, but hasn't started to rise yet. The total decline over the past three years has been more than 19%, and gets the region's payroll job count back to where it was at the end of 1995. Moreover, some further hits may be coming, as budget cuts will take some jobs away, commercial construction is likely to slow, and residential construction may slow further. Also, many of the jobs that were lost over the past three years, particularly in manufacturing, are not going to reappear. It will take time for new businesses to form in other industries and for them to hire workers. Overall, San Jose's rebound in 2004 will be weak and it will be well into 2005 and 2006 before the economy will pick up any real steam.

As the table below illustrates, the damage done to San Jose was remarkable. The unemployment rate was 1.4% in October, 2000, but the collapse caused it to soar to 9.0% by the end of 2002. The unemployment rate has since fallen to 7.2% (seasonally adjusted) in December 2003, but that reduction has been spurred by the flow of people leaving the area, or at least the labor force, so they don't get counted in the unemployment statistics. Also, note the industries that were crushed the hardest, losing roughly a third of

### **San Jose MSA Peak-to-Trough Employment Changes**

	Peak (1,000)	Tough (1,000)	Drop (1,000)	% Ch	Peak Date	Trough Date
Total Non-Farm Payroll	1059.9	855.2	-204.7	-19.3%	Dec '00	Dec '03
Goods Producing	313.8	220.3	-93.50	-29.8%	Dec '00	Dec '03
Construction	51.3	39.6	-11.7	-22.9%	Jan '01	Mar '03
Manufacturing Durable Gds	243.9	163.9	-80.0	-32.8%	Dec '00	Dec '03
Service Producing	746.1	634.9	-111.2	-14.9%	Dec '00	Dec '03
Prof & Business Services	234.6	156.2	-78.4	-33.4%	Dec '00	Dec '03
Information/Telecom	47.3	31.6	-15.6	-33.0%	Dec '00	Aug '03
Retail Trade	91.8	78.9	-12.9	-14.0%	Sep '00	Dec '03
Leisure & Hospitality	73.9	67.1	-6.7	-9.1%	Mar '01	Jun '03
Education and Health	96.2	NA	NA		Dec '03	
Government	97.9	95.6	-2.3	-2.3%	Apr '02	Dec '03
Household Employment	1,007.1	841.0	-166.1	-16.5%	Dec '00	Aug '03
Labor Force	1,027.5	909.1	-118.4	-11.5%	Dec '00	Dec '03
Unemployment Rate	9.0%	1.4%			Dec '02	Oct '00

their employees during the past three years, were the manufacturers of durable goods, the information providers, and those providing business and professional services. The manufacturing activities have relocated, and won't come back, or they closed down and won't restart in the Bay Area. They are gone. The information segment is absorbing new technology and cell phones, and voice traffic over the Internet continues to eat away at the traditional telephone provider's markets. Hiring will not be big. Company management – the main part of business and professional services – will only grow as new firms restart, or existing ones expand. Those will be slowly moving trends. The one large sector that didn't decline over the recession was health and educational services. It, however, may feel some downward pressure in 2004 with school districts in financial binds.

Another area that will take time to recover is the construction industry. Non-residential construction will be slow to rebound because the fundamentals are weak and cannot change rapidly: vacancy rates for downtown office buildings soared from about 2½% in 2000 to about 30% near the end of 2003. Rents for those buildings dropped by nearly half over the same time. Those two trends point to plunging revenues for owners. Not surprisingly, given those conditions, the value of non-residential building permits is running at about half the rate seen in 1998 and 1999 and is about a third the size seen in the peak year of 2000. On the residential side, the chronic shortage of housing is being offset, slightly, by economic forces. After years of surging prices, 2001–2003 has seen some ups and downs in San Jose's existing home prices. Any upward pressure on interest rates will have a strong downward push on prices.

The home rental market reflects the weak economy. Rents, according to RealFacts, dropped about 6.5 % from the fourth quarter of 2002 to the fourth quarter of 2003. The fraction of rental houses that were not occupied rose from 6.6% to 6.9%. The weak labor market is likely to keep the lid on rental market prices. Moreover, demographic information shows that as the recession deepened, San Jose saw outward population flows to other regions. That outflow has likely continued, as is suggested by the sharp drop in the labor force over the past two years. Despite the broad signs of weak housing, building permits for homes were actually stronger in 2003 than the other recession years, but not soaring.

Traffic at the San Jose Airport has plunged over the past few years. The passenger load for January through November of 2003 – the latest data available -- was off 16.6% from the comparable part of 2001. Hotel room rates also continue to fall, according to PKF consulting. San Jose's room rates fell more than 13% in 2003, a bigger drop than any other Northern California city reported. The vacancy rate on hotels was down to about 56%, the lowest of any near-by area.

It has been a long drop for the San Jose area. In 2001, the last time that a comparison was made, by the Bureau of Economic Analysis, San Jose had the second highest per capita income in the whole United States. That high-income flow supported housing and lots of service sector jobs. New data will almost certainly show that San Jose has lost much of that ground. Thus, with the destruction of the dot.com bubble and the management jobs that went with them, the state's problems, and the other structural barriers noted already, San Jose will be lucky to see payroll job change that is not negative in 2004. The outward population flows noted by reports from the State's Department of Finance reflect a net of 14 thousand people moving out of the San Jose Area -- evidence of the seriousness of the situation.

The San Francisco Area economy was easily the second hardest hit region in the state during the 2001-2003 recession. As can be seen in the next chart, the region's job count fell about 12.5%, 137,000 total, and is currently at the level it was in 1997. Moreover, the recent employment movement is fairly flat, mimicking the "jobless" rebound seen in the U.S. and California. San Francisco's job losses were concentrated in the services sector. The region's lack of manufacturing and its volatility could help San Francisco rebound, all other things being equal. However, some service sectors, such as information technology, can have sizeable multipliers, and government jobs, which will be weak, are also a good part of the employment base. Thus, the San Francisco outlook is better than San Jose's, but not robust for the next year either.

The table below shows that the recession raised the region's unemployment rate from a remarkable 2.1% to 6.2% at the end of 2002. Since then San Francisco's unemployment rate has gone down to 5.2%, which

**San Francisco MSA Peak-to-Trough Employment Changes**

	Peak (1,000)	Tough (1,000)	Drop (1,000)	% Ch	Peak Date	Trough Date
Total Non Farm Payroll	1,098.9	961.9	-137.0	-12.5%	Dec '00	Dec '03
Goods Producing	108.7	90.4	-18.3	-16.8%	Dec '00	Dec '03
Construction	48.8	42.4	-6.4	-13.1%	Mar '01	Aug '03
Manufacturing	61.5	47.7	-13.7	-22.3%	Dec '00	Jun '03
Service Producing	990.2	871.5	-118.7	-12.0%	Dec '00	Dec '03
Prof & Business Services	248.3	179.3	-68.9	-27.8%	Dec '00	Dec '03
Information/Telecom	69.6	45.6	-24.0	-34.5%	Jan '01	Dec '03
Retail Trade	102.7	95.0	-7.7	-7.5%	Sep '00	Dec '02
Financial Activities	104.0	94.6	-9.4	-9.1%	Apr '01	Dec '03
Leisure & Hospitality	119.2	109.9	-9.2	-7.7%	Mar '01	Mar '03
Education and Health	100.4	NA	NA		Dec'03	
Government	134.8	129.0	-5.8	-4.3%	May '00	May'01
Household Employment	974.4	875.9	-98.5	-10.1%	Nov '00	May '03
Labor Force	995.4	929.9	-65.6	-6.6%	Dec '00	Dec '03
Unemployment Rate	6.2%	2.1%			Dec '02	Jan '01

is below the state's rate. The labor force has shrunk about 6.6%, reflecting discouraged workers and perhaps, outward migration. The decline is milder than that seen in San Jose, however. San Francisco's net payroll job shrinkage of 137,000 was, as noted before, centered on the services providing sector. Nearly half of the losses were in the Professional and Business Services sector, reflecting firms going under, and the downsizing of management. Information technology saw the biggest percentage decline, a huge 34.5% plunge. San Francisco's tourism related sector eroded to the tune of 9,200 jobs while Financial Activities dropped 9,400. Looking ahead, the trend of outsourcing could slow the rebound in Financial Activities and in Information. One sizeable sector that did not shrink was Education and Health Services. Moreover, the outlook for the health side is strong, though the educational component might be hurt by the state's budget problems

San Francisco's real estate markets will continue to suffer. The non-residential side has seen huge rises in vacancies from about 4% in the central business district before the downturn, to about 25% in the third quarter of last year. Rents have plunged from a high of about \$76 a square foot to \$29. The new permit data show the valuation of nonresidential permits granted in 2003 is running at about one third of the rate seen in 2001. Until rising occupancy and rents signal the need for more space, new construction will stay low. The region's residential markets have seen quite a bit of price volatility in the past few years. As can be seen in the chart, price changes on the sale of existing homes have been in the single digits. That represents a big slowdown from earlier episodes driven by low-rates. Rental housing rates are dropping too according to data from RealFacts. The entire region's rents fell about 4.8%, from the fourth quarter of 2002 to the fourth quarter of 2003, to \$1,544 per rental unit. The vacancy rate dropped from 5.7% to 4.9%, partly reflecting the reaction of renters to the falling prices. The level of residential building permits stayed very low, averaging about 3,400 units through most of 2003. For comparison, in the year 2000, 6,300 permits to build were issued. San Francisco's tourism business is seeing mixed results. Hotel occupancy rose slightly in 2003, from under 65% in 2002 to about 68% in 2003 according to PKF. (December is missing from both periods.) Room rates fell about 5% over the same period. SFO's air traffic continues to be far below what it was at the beginning of the recession. That is partly due to losing a major client (Southwest).

The San Francisco region has been hit very hard and looming problems for state and local governments, and looming job cuts, will hold down the rebound. San Francisco should see payroll employment flatten and perhaps rise fractionally in 2004. The area's big service sectors, Business and Professional Services, Finance, and Information will improve slowly. With the schools and local and state agencies cutting, and with outsourcing still an issue, the odds are on slower, not faster growth in the near term.