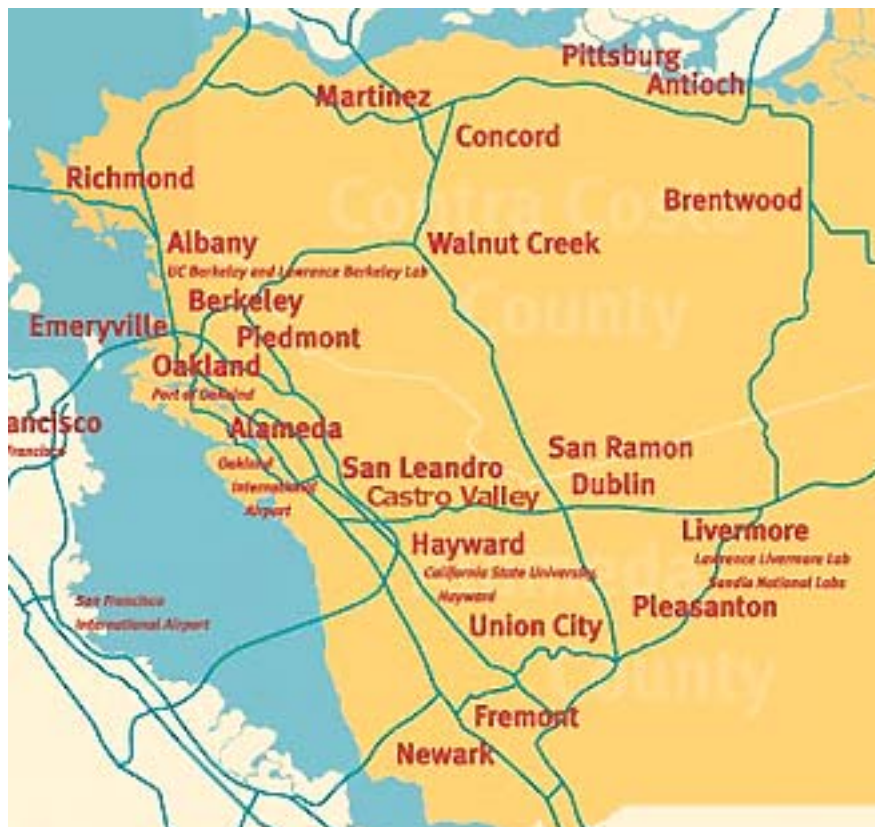


# East Bay Economic Outlook

October 2004

Created for the  
East Bay **Economic Development Alliance for Business**  
and the Contra Costa Council

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## **Overview and Outlook:**

The Bay Area and the East Bay are clearly in the midst of a recovery -- albeit a slow one. The depth of the region's 2001 downturn is not something that lends itself to a rapid recovery even in the best of overall economic circumstances, and the US economy is certainly not in the best of economic circumstances either. The good news is that the tech sector is recovering, firms in the region are doing well, vacancy rates are falling, employment in key sectors of the economy is stabilized or returning to growth, and the labor force is growing in all three economies. The ongoing government budget crisis, weak non-residential construction and a national economy without much room for strong expansion will continue to hamper growth, however. Expect slow job growth for the next year -- at best 1% to 1.5% for the East Bay, slightly less in San Francisco and below 1% for San Jose. Retail sales, however, will grow at a more normal pace of 4% for most of the region. There is greater uncertainty looking out past one year. The US economy has a severe problem with consumers who have over-spent, and that real estate bubble just keeps getting larger. The next problem the East Bay faces will likely be external, but the ramifications of another economic slowdown will be felt everywhere. Keep an eye out.

While the region is not currently doing well, everything is in place for strong growth in the future once the current economic turmoil has passed -- as it inevitably will. The Bay Area and the East Bay remain a high income, high human capital region with a core of high tech companies that remain, and will remain, industry leaders. All the right elements are in place for the region to maintain its place as one of the strongest economies in the nation. Look for Contra Costa to continue to grow its population at a healthy 1.6% annual pace, while in Alameda growth will be somewhat slower -- 1.2%. We expect the population of the East Bay to surpass 3.5 million within 25 years.

The largest threat to the long run health of the Bay Area economy actually comes from outside the 6-county region. While the East Bay and its neighbors are prepared for long-run growth, much of the rest of the state is seeing the continuation of its growing educational gap, and as a result a severely widening income distribution. This is due in large part to the large immigrant population, and not much is to be done about this in the short term. But the state needs to be thinking towards the future -- the next generation of these new residents needs to be given all the resources needed to succeed in the future, and on that count the state is clearly not doing what it could be. In tough times it is easy to focus on internal issues, but the leaders of the East Bay, San Francisco and San Jose need to take a strong leadership role in helping fix the problems that dog the state as a whole.

## Bay Area Demographic Profiles: 2003

	United States	California	Contra Costa	Alameda	San Fran. MSA	San Jose MSA
Total population	282,909,885	34,650,690	989,855	1,433,586	1,653,855	1,648,486
% < 18	25.7%	27.0%	25.9%	24.8%	19.1%	25.0%
% > 65	12.0%	10.3%	10.7%	9.9%	13.4%	9.9%
White	67.8%	44.8%	55.2%	38.9%	50.6%	41.5%
Hispanic	13.9%	34.6%	20.2%	20.3%	17.2%	24.6%
Black	11.9%	6.0%	9.1%	13.1%	4.3%	2.5%
Asian	4.1%	11.7%	12.1%	23.4%	24.5%	28.8%
Other	2.4%	2.9%	3.5%	4.2%	3.5%	2.7%
Foreign Born	11.9%	26.5%	22.3%	30.5%	31.4%	36.5%
% Without High School	16.4%	19.8%	10.6%	14.1%	11.6%	13.0%
% Bachelor and Above	26.5%	29.1%	38.7%	39.3%	47.7%	44.1%
% Poverty	12.7%	13.4%	8.5%	10.9%	7.7%	7.3%
Total households	108,419,506	11,856,538	348,449	518,471	671,752	561,430
Average household size	2.61	2.92	2.84	2.77	2.46	2.94
% Children < 18	32.2%	35.3%	35.1%	32.1%	24.1%	34.3%
Median household income	\$43,564	\$50,220	\$69,835	\$61,731	\$65,060	\$76,544
Total housing units	120,879,390	12,656,882	371,177	549,102	725,084	596,526
Vacancy Rates	10.3%	6.3%	6.1%	5.6%	7.4%	5.9%
Ownership Rate	66.8%	58.1%	70.2%	57.5%	49.9%	62.7%
% Single Family Homes	60.8%	57.1%	66.4%	56.3%	38.5%	55.7%
% High Density Units	17.4%	22.9%	15.2%	25.6%	33.1%	22.3%
% Crowded Housing	3.8%	9.9%	5.3%	8.0%	7.1%	8.9%
Median House Expenses	\$1,204	\$1,660	\$2,066	\$2,034	\$2,396	\$2,394
% > 30% Income	30.4%	41.7%	41.9%	44.6%	44.8%	42.8%
Median Rent	\$679	\$890	\$1,119	\$1,105	\$1,197	\$1,239
% > 30% of income	46.6%	50.8%	48.2%	48.3%	44.1%	43.4%
Commute Public Transport	4.8%	5.0%	8.5%	11.2%	18.1%	2.8%
Mean travel time to work	24.3	26.5	32.1	27.2	26.6	23.4
<i>Occupations</i>						
Management, professional	34.1%	35.2%	40.2%	44.2%	48.5%	50.6%
Service occupations	16.1%	16.4%	16.6%	13.0%	13.8%	12.8%
Sales and office	26.2%	25.9%	25.7%	25.1%	24.6%	21.3%
Construction, extraction	9.5%	8.9%	9.2%	7.4%	5.3%	7.7%
Production, transport	13.3%	12.1%	8.2%	10.2%	7.4%	7.4%
Median earnings	\$26,236	\$27,302	\$36,806	\$32,700	\$37,947	\$40,699

## **The National Economy: An aged economy in a young body**

*Michael Bazdarich, Senior Economist: UCLA Anderson Forecast*

After a strong burst in late-2003 and early-2004, the U.S. economy has fallen into what has come to be called a “soft patch.” The Federal Reserve, the federal government, and many Wall Street analysts look for this soft patch to fade soon, with strong growth supposedly resuming presently. Our forecast predicted this “soft patch” to occur, and we expect it to linger through the foreseeable future. If anything, a downturn from the present U.S. growth rates of around 3% is more likely than an upturn.

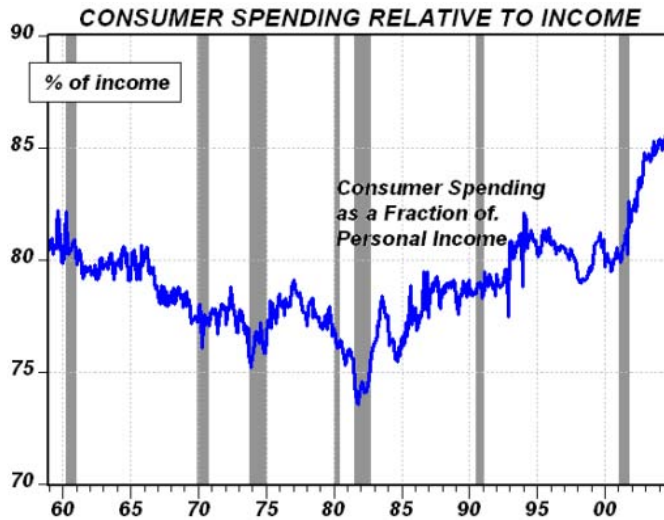
Behind this near-term disagreement is our belief that on many aspects of the economy, Washington and Wall Street just don’t get it. Yes, in chronological terms, the expansion is still young, and this supposed youth is what drives many to think that strong growth (a “normal” expansion”) will resume. However, in most relevant respects, this expansion is very old, with the consumer, housing, and even investment sectors displaying vulnerabilities they would normally have only after a long expansion. In our opinion, these vulnerabilities preclude a sustained resumption of strong growth, and they leave the economy susceptible to possible downside shocks. In other words, while the expansion may look young, it is as rickety as an “elderly” one.

Hollywood has created a whole genre of “body-switching” movies examining what happens when an older person switches bodies with a young person. These allusions come to mind considering the present U.S. economy. Following the 2001 recession and subsequent slump, GDP has been growing for a little less than three years. Jobs and industrial output have been growing for only about a year. By those perspectives, this expansion is young and should have a long future ahead of it. However, for a variety of reasons, this is not going to happen.

The consumer and housing sectors never fell into recession in 2001 or after. They continued to grow, fed by stimulus from the Federal Reserve and federal government. Consumers and housing simply aren’t positioned to embark on strong expansions from here. Meanwhile, the capital goods sector is still bloated by the aftermath of the late-1990s’ Internet rush. Our story has been, and still is, that there is nothing for this sector to “recover” from. The 2001 recession, following the Internet rush, merely pulled capital spending from far above normal back to normal. Consequently, the capital equipment sector is also incapable of single-handedly driving strong economic growth. Let's work through the evidence on each of these items.

### *Consumers Maxed Out*

Across the business cycle, consumer spending typically grows in line with incomes. Consumers usually pull back spending relative to income during recessions, and then ramp up spending faster than incomes early in an expansion. It is this faster-than-incomes growth in consumer spending that helps drive the strong GDP growth usually seen in a recovery. Presently, consumer spending has ALREADY been proceeding faster than incomes for the last seven years. Furthermore, spending is far above previous record high shares of income. There is simply no potential for consumer spending to rise faster than incomes (for spending as a share of income to rise sharply even further) in the next year or two.



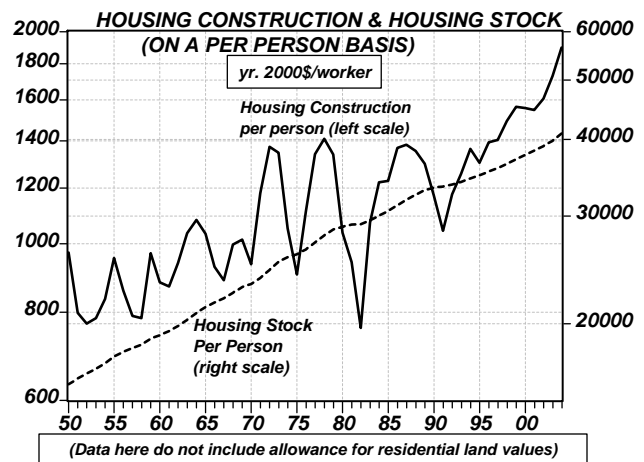
Our forecast looks for consumer spending to grow at about the same rate as personal income over the next year to two. The consumer will not be leading the economy, but following. In this case, in order for income and spending to grow rapidly, they will have to be driven by strong growth in OTHER economic sectors. This is just what has been happening over the "soft patch" period of the last four months. Spending has indeed stabilized as a share of incomes, and aggregate economic growth has slowed. With the tax cuts and Fed rate cuts behind us, a major consumer upturn is just not in the cards.

*Housing Starting To Slow*

The U.S. housing sector is in much the same position as the economy. Housing construction typically declines sharply during recessions, building up the "potential energy" that leads to a strong rebound as the economy recovers. The housing rebound is usually a major driver of the economy's recovery, but these are not typical times. Instead of housing declining during the 2001 recession, housing construction rates have been rising without a break for the last fourteen years.

In order for housing to drive rapid growth, housing construction rates must rise sharply, just as it typically has in previous recoveries. However, as the chart shows real housing construction per-capita is already 30% higher than it has ever been before. Typically housing tops out after four or five years of expansion, but, again, housing construction rates have already been rising for fourteen years without a breather.

To cast these points in terms of housing starts, current U.S. population growth is consistent with sustained housing start rates of 1.5-1.6 million units per year. However, housing starts are currently above 2 million units per year. In order for housing to drive this recovery in a "typical" manner, starts would have to rise to 2.4-2.5 million units -- even further above sustainable rates. This is not going to happen. We look for housing starts to slowly decline back to sustainable levels of 1.5-1.6 million units per year.



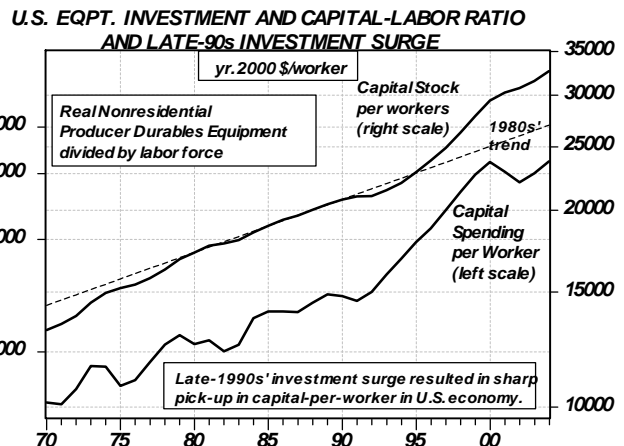
While that would still be consistent with a "strong" housing market and while that would mean further increases in homeownership rates, it would also mean that housing will exert a slightly negative impact on GDP growth and on the economy in general.

*Investment and Inventories in the real world*

Once again, the consumer and housing expansions are in fact very old. Capital spending has been rising for only about a year, but it has problems of its own. In the euphoria of the late-1990s' Internet Rush, producers overestimated the near-term potential size and profitability of the E-economy; they overestimated the associated, sustainable growth rate of the U.S. economy; and they overestimated the potential effects of Y2K. All of this led to a substantial over-investment.

As seen in the accompanying chart, real equipment investment per worker more than doubled in the 1990s, and capital stock per worker grew by 60%. Even after three years of slumping U.S. investment and a year of industrial recovery, remaining stocks of equipment-per-worker are still 20% higher now than they would have been had 1980-95 investment trends been sustained. From the perspective of productive capacity, high-tech sectors are utilizing only about 70% of their existing capacity, compared to more than 90% at the height of the Rush, and non-tech sectors are utilizing less than 76% of their existing capacity, compared to a 1990s' high of more than 81%.

Furthermore, in order for capital investment to drive rapid growth the way it did in the late-1990s, it would have to jump as sharply from CURRENT levels as it did in the late-1990s from mid-1990s' levels. We don't NEED that large a jump, and we are not going to get it. Capital spending should continue to rise modestly, even robustly from here. However, it is not going to jump rapidly enough to power strong aggregate growth in the economy considering the sagging consumer and housing sectors.



Finally, inventory investment already looks to have peaked in this expansion. The same emerging technologies that have stimulated the demand for capital equipment have reduced demand for inventories, by giving firms better control over deliveries and over inventories themselves. Inventory-sales ratios have been dropping steadily for the last twenty years, and this downtrend does not look spent. Furthermore, inventories are a goods/merchandise phenomenon (as opposed to services or structures), and goods sales have been falling as a share of total GDP for fifty years. On both counts, inventory investment is no longer a big enough portion of the economy to drive rapid GDP growth the way it did in the 1970s' or 1980s' expansions. Meanwhile, relative to the declining inventory-sales ratio trends of the last two decades, current inventory-sales levels do not look low at present. In this sense, there is nothing for inventories to recover from, just as there is nothing for capital spending to recover from.

Inventory investment did pick up in Q2, providing a substantial boost to GDP growth at that time. However, that pick-up was most probably an involuntary one, due to consumer sales slowing suddenly before retailers could cut back on their orders. Retailers are now getting inventories under control, and retail inventory investment has pulled back to zero as of the July data. So while inventories were a strong positive for the economy in Q2, they will most likely be a negative in Q3 and will probably be a neutral factor for the economy thereafter.

*Old expansion on the inside...*

Once again, in a truly young expansion, consumers would be a driver of growth, and even were they to temporarily pull back on spending, there would be sufficient growth potential in the capital spending, inventory, and housing sectors to sustain a recovery. In other words, a “young” expansion would have the dynamism to ride out dislocations. The present U.S. economy doesn’t have those immunities. There is NO potential upside in consumer spending, inventories, or housing, and there doesn’t appear to be much upside potential in capital spending. The one potential positive for the economy is exports, and even there, after strong growth in late-2003 and early-2004, exports have sputtered in the last few months.

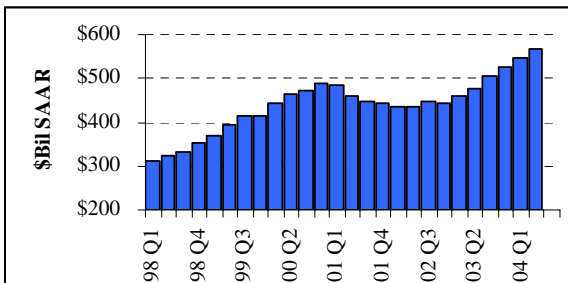
Our models indicate that with neutral consumer, government, and inventory sectors, a softly declining housing sector, and strong growth (12% per year) in exports and equipment investment, GDP growth will proceed at a 3% pace, about the same as in Q2. Wall Street calls this a "soft patch." We say it is the best the economy can do. And in order to sustain even that pace, again, capital spending and exports will have to remain on robust-growth paths. If consumers should pull back or if investment or exports should sputter, even 3% GDP growth would quickly become a fond memory. In the body-switching movies, the spells are eventually broken, each person goes back to his or her own body, and everything ends well. We are unlikely to be so lucky in real life. Wall Street and Washington are calling for 4%+ growth. There is no way that is going to happen.

## The East Bay and Bay Area: A slow recovery, but a recovery nonetheless

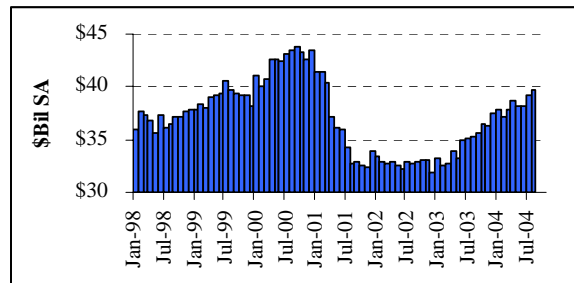
There is little doubt the tech sector that is such a vital driver in the Bay region has begun to pick up steam at the national level. Real spending by businesses on information processing equipment and software has increased by 28% over the past six quarters. Domestic shipments of computers and electronics products reached \$40 billion in August, up 20% from six quarters previously. This latter number represents *sales* by domestic firms, while the former represents *purchases* by domestic firms. The recovery of the tech sector has not been restricted to the United States either—worldwide semiconductor sales are up by 50% over the same time period, from \$12 billion to over \$18 billion.

While the tech sector is clearly humming, the business indicators for the Bay region remain weak overall. Still, there are clearly some positive signs of recovery. On a seasonally adjusted (SA) basis, revenues for public companies headquartered in the region have risen steadily since the first half of 2002. For the 224 companies based in the East Bay, revenues have risen from slightly under \$40 billion to over \$50 billion per quarter -- an increase of 35% over two years. For the 1100 firms based in the 6-county area revenues have increased by 25% from \$136 billion to \$173 billion. On the corporate side recovery has been quicker in the East Bay. International exports from the San Francisco customs district (including the value of goods leaving the area by both air and ship) have been growing recently -- up 20% over the past 18 months to \$3.2 billion per month. In historical perspective, however, the trade numbers remain far below the \$5 billion peak reached in 2001.

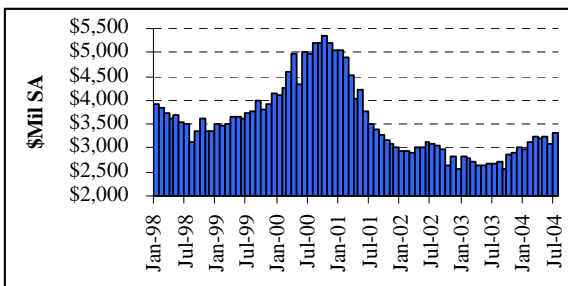
Investment in Information Technology  
\$Billions Real, SAAR. Source: BEA NIPA



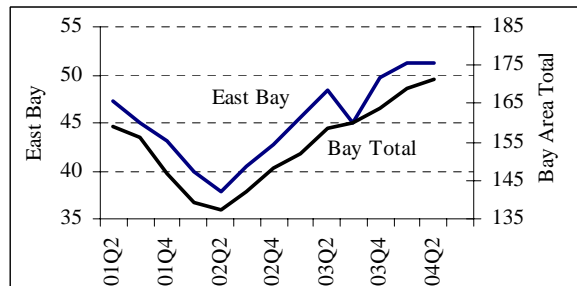
Shipments: Computers and Electronic Goods  
\$Billions, Nominal, SA. Source: Census, UCLA Forecast



Exports, San Francisco Customs District  
\$Millions, Nominal, SA. Source: Census, UCLA Forecast



Bay Area HQ Corporate Revenues  
\$Billions, nominal, SA. Source: CRSP, UCLA Forecast



In many ways the Bay area economy is going to continue to feel weak, if for no other reason than the metric many are using to gauge current economic performance is the growth

during the heady days of the late 90s. Similarly the second quarter of 2004 saw \$2.13 billion in new venture capital funding pour into the area, the largest infusion of private equity into the area since 2001 and up 50% from the levels hit in 2002 and 2003, yet barely a fifth of the peak rate hit in 2000. Hotel occupancy rates -- a measure of business activity, particularly in the East Bay and San Jose -- have recovered from the 2003 slump but remain at 60%.

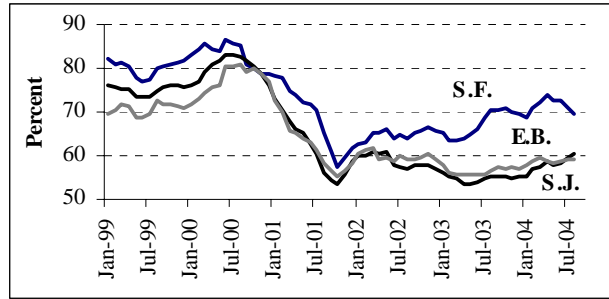
On the commercial side a similarly weak but improving picture emerges. While the San Francisco industrial space market has seen two quarters of positive net absorption, the East Bay and San Jose continue to see vacancy rates rise. Vacancy rates remain at 10% for the region. Office space is showing slightly better signs. All three markets have shown positive net absorption, with San Francisco tallying up a solid 1.72 million square feet of space in the first half of 2004, a gain of about 1.4%. San Jose gained close to a percent, while the smaller East Bay office market remained steady. Still, vacancy rates remain at 18% for the overall region. Not surprisingly the non-residential construction market remains weak. San Francisco has seen the most improvement, with new permits rising to \$300 million (est.) in the 3<sup>rd</sup> quarter of 2004. The East Bay continues to run at a rate of about \$250 million per quarter in 2004, while San Jose has finally steadied at \$200 million.

*Consumers carry the load*

While the business side of the economy is seeing slow growth, the consumer side continues to be somewhat stronger—particularly in residential housing. Taxable sales in the East Bay hit \$9 billion in the first quarter of this year (seasonally adjusted), up 8% over last year and putting the total close to the peak hit in 2000. In San Jose and San Francisco there has also been a rebound in sales, although they remain below their previous peaks. San Jose has seen a 10% increase in retail sales since last year, while San Francisco is up 6%. Average annual growth in the three Bay economies was 7%, 8% and 5% respectively during the nineties, so these numbers are clearly indicative of an expanding Bay Area economy.

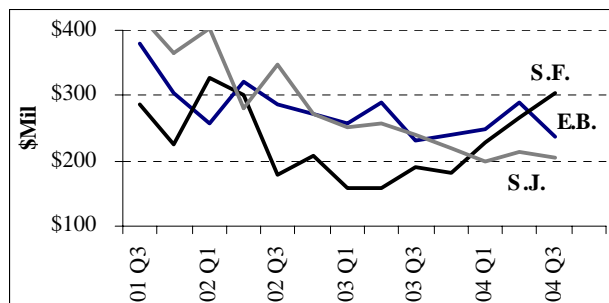
**Hotel Occupancy Rates**

Percent, SA. Source: PKF Consulting, UCLA Forecast



**Non-Residential Construction Permits**

\$Million, SA. Source: CIRB, UCLA Forecast



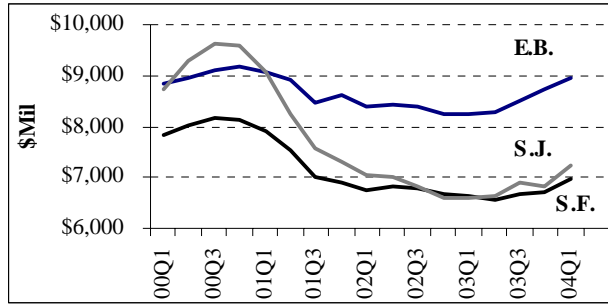
**Commercial Market Statistics**

M – million square feet. Source: CBRE

	East Bay	San Jose	San Fran
<i>Industrial</i>			
Vacancy Rate Q2	11.2%	9.4%	10.1%
Net Abs. 04 YTD	-0.70 M	-.57 M	1.97 M
Total Stock	188.4 M	87.5M	72.7 M
<i>Office</i>			
Vacancy Rate Q2	17.5%	17.7%	19.0%
Net Abs. 04 YTD	.08 M	.47 M	1.72 M
Total Stock	28.1 M	53.7 M	122.1 M

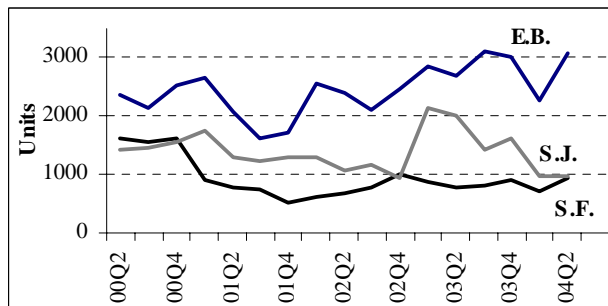
### Taxable Sales

\$Millions, SA. Source: California BOE, UCLA Forecast



### Residential Construction

Total New Permitted Units, SA. Source: CIRB, UCLA Forecast



### Residential Housing Market Statistics

All Houses, NSA. Source: Dataquick

	No Sold Aug-04	Pct. Chg	Median Aug-04	Pct. Chg
Alameda	2742	2.2%	\$497	18.3%
Contra Costa	2560	1.1%	\$468	17.3%
Marin	478	3.5%	\$717	14.4%
Napa	226	20.9%	\$511	16.9%
San Francisco	735	16.5%	\$668	20.1%
San Mateo	986	-8.2%	\$649	14.7%
Santa Clara	3017	-0.9%	\$539	13.2%
Solano	1015	10.8%	\$377	19.7%
Sonoma	915	-4.7%	\$462	19.1%
Bay Area	12674	1.5%	\$520	16.3%

On the housing front, prices continue to rise even as building remains strong. While price growth lagged behind the rest of the nation for a while, bubble fever has finally returned to the Bay Area residential real estate markets. Every county in the region has experienced a double-digit increase in housing prices since last year. The median price of a house in Alameda is now \$497,000 while it is \$468,000 in Contra Costa. This puts prices at 120% above where they were in 1997. The East Bay continues to build an average of 3000 new units per quarter, while San Jose and San Francisco are adding another 1000-1500 each—for an annual total of something over 21,000 units. This is an impressive accomplishment for a region that added 39,000 people to the population base in 2003, a ratio of less than 2 new people per new unit.

There has been much discussion of late of whether the prices seen are indicative of a bubble. The answer to that question is, in short, yes. With rental prices flat, new residential construction proceeding at the current overly rapid pace and mortgage rates that have bottomed out and are now rising (albeit slowly) housing appreciation should currently be *at best* very slow.

Instead the Bay region is getting swept up in the wave of speculative buying that continues to drive prices and has been building in other parts of the nation. When this bubble will start to deflate is still a mystery. There are definitely signs of some slowing in the market—rising levels of inventories and slower sales in some markets—this translates basically into the market cooling from white-hot to red-hot. One bit of comfort can be gained from the fact that housing markets traditionally don't 'pop,' rather they slowly deflate as long as the economic fundamentals of a region are decent. Keep an eye out, however.

*Jobs: when will growth return?*

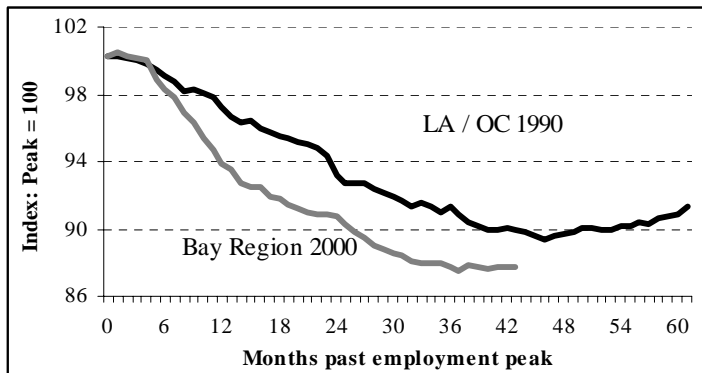
Of course the real worry for the East Bay in general and of course for the Bay Area overall is the job situation. While the job losses have largely come to a halt, there is little sign of a significant bounce in the data either. The East Bay has added just over 5,000 jobs over the past year, just one half of one percent. San Francisco is even with last year's employment level, but it

Bay Area Employment Trends  
 SA. Source: California EDD, UCLA Forecast

	Aug-04	3-Month Change		1-Year Change	
<b>Payroll Employment</b>					
East Bay	1,026,600	700	0.1%	5,300	0.5%
San Fran	953,000	2,400	0.3%	900	0.1%
San Jose	842,000	-2,700	-0.3%	-10,500	-1.2%
Sacramento	755,200	-5,600	-0.7%	300	0.0%
<b>Household Employment</b>					
East Bay	1,208,100	6,600	0.5%	25,900	2.1%
San Fran	862,300	8,100	0.9%	12,100	1.4%
San Jose	819,800	1,500	0.2%	3,100	0.4%
Sacramento	841,600	200	0.0%	14,300	1.7%

is encouraging that it has added 2,400 jobs over the past three months. San Jose has continued to slowly lose jobs, and lost another 2,700 jobs over the past three months. Sacramento has also begun to fall into the loss category as the state government employment cuts have begun to take hold.

Employment Indexes from Past Downturns  
 Employment Peak = 100, SA. Source UCLA Forecast



Perhaps the best news on the payroll side is that critical sectors of the economy are starting to see some signs of growth. The durable manufacturing and information sectors in San Jose have both started to see jobs return as have finance, information and tourism in San Francisco. The East Bay has been, and continues to be, the most economically stable part of the region. Job growth here is simply slow across all sectors.

While the payroll numbers are not pretty overall, the household employment numbers paint a slightly better picture—hence the fall in unemployment seen in the region. Remember that household employment figures come from a survey of people rather than a survey of employers. The advantage of this calculation is that it picks up those who are not covered by unemployment insurance—whether they are informal workers, the self-employed or subcontractors.

While the payroll numbers are not pretty overall,

Since last year, the East Bay has added 26,000 jobs as reflected in the household survey - a gain of 2.1%. San Francisco has added an additional 12,000 jobs. In part this reflects a state trend toward expanded informal employment. The greater Los Angeles region currently has 1.5 million informal employees, up from 1 million at the start of the downturn. It should be noted, however, that empirical evidence seems to indicate these jobs don't pay as well as traditional payroll jobs. It should also be noted that since these numbers come from a smaller sample, the regular revisions to the data are often quite substantial.

Bay Area Payroll Employment by Sector and 6 month changes  
 SA data. Source EDD, UCLA Forecast

	East Bay		San Francisco		San Jose	
	Aug-04	Ch.	Aug-04	Ch.	Aug-04	Ch.
Construction	70,000	700	41,600	-1,600	37,700	700
Durables	59,700	100	22,500	400	160,900	2,300
Non-Durables	36,800	0	23,600	300	11,300	-800
Transportation	37,000	300	45,000	100	13,200	-400
Wholesale	50,700	1,000	27,900	0	34,100	500
Retail	109,300	700	95,700	1,400	80,900	0
Information	30,400	0	46,000	500	31,200	1,300
Financial Services	69,300	1,300	91,600	1,600	34,500	-700
Professional	143,700	-500	177,600	-300	158,700	-3,200
Education / Health	118,900	700	100,400	1,500	93,500	300
Recreation / Other	118,900	-500	151,800	1,800	91,900	-300
Government	178,100	-900	125,300	-2,800	90,200	-2,700

While job growth in the region may seem to be frustratingly slow to catch on, it is important to remember that economies are organic, and the healing process takes time. The following chart graphs out the path of employment through two of the worst regional downturns in recent US history—the Bay Area starting in 2000 and the Los Angeles/Orange County downturn that began in 1990. The Bay region in total has lost more jobs in percentage terms than the LA/OC region did, and it happened at a faster pace. Nevertheless it is clear that the healing process is actually occurring faster. It took nearly 4 years for employment to bottom out in Southern California, while the Bay Area is already beginning its recovery.

Yet if history is any guide, expect job growth to remain slow for at least another year. While the return of tech will help, excess capacity in many non-commercial markets and the issues in the housing market will continue to dampen growth, as will the government budget crisis. Look for the East Bay to add between 1% and 1.5%, with San Francisco close behind. San Jose will add less than a percent to its labor pool.

Unfortunately the weak US economy poses the largest long run threat for a full recovery in the region. If the national economy begins to substantially weaken within the next two years, a distinct possibility in our minds, this will of course hamper the Bay Area tremendously. But one positive note -- a consumer led downturn will not have the same dramatic impact on the region as the tech led downturn of 2001.

## Long Run Demographics for California and the East Bay

The net result of our current demographic forecast is that for the rest of this decade, state population growth will slow slightly from the current rate of about 1.7% per year. Population will hit 40 million by 2011. Growth will slow to 1.3% per year in the teens and slow further to 1% in the twenties. Total population will close on 50 million by 2030. As for the East Bay, we see continued strong population growth there as well. Alameda will add over 500,000 new residents by 2030 putting the population at just over 2 million, a growth rate of 1.1% per year.

### East Bay Population Forecast

Source: UCLA Anderson Forecast

000's	Contra Costa	Alameda
2000	954	1,451
2005	1,034	1,517
2010	1,118	1,604
2015	1,217	1,706
2020	1,328	1,814
2025	1,444	1,921
2030	1,560	2,022

Contra Costa, due to its higher rate of net in-migration and younger population, will be the fastest growing county in the 6-county region, adding 1.7% per year to reach nearly 1.56 million by 2030.

This forecast may come to a surprise, since some other forecasts have been trimming population numbers recently. This section discusses some of the main issues and explains why the Forecast still predicts solid population growth.

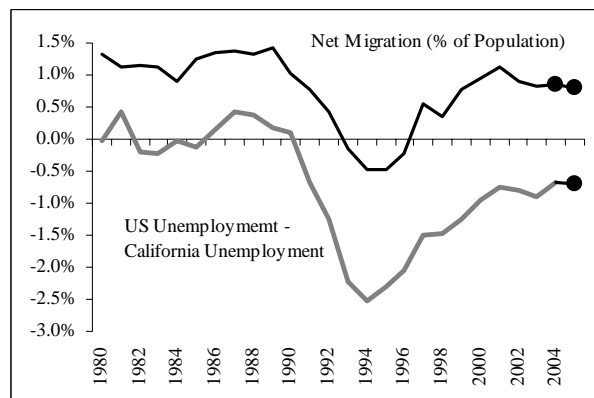
### Population Drivers

The growth of population has three drivers—birth rates, death rates and net migration. Consider net migration first. One of the large issues has been migration into and out of the state. The worry has been that high housing prices will drive people out of the region. Of course this runs contrary to the basic evidence—indeed even as housing prices have surged over the last few years, so too has the flow of population into the state. Between 1998 and 2003 net migration averaged nearly 1% of the population per year. This is one of the basic misunderstandings of property prices—they are an effect of people moving into the state, not a cause of them moving out.

What does drive migration over time? Part of it is purely environmental—there has been a common trend in the US for people to leave the crowded and climatically challenged Northeast for greener and warmer pastures in the South and West. Furthermore California has long been a gateway community for new immigrants entering the nation. The already existing large immigrant populations here as well as its geographic position explain this role. These trends have been going on for years, and are unlikely to end anytime soon short some catastrophic climatic change.

Short run changes in these long run demographic movements are caused mainly by the fluctuations in relative economic performance in the state compared to the US overall. In fact a very simple measure of performance can be used to explain most of the past net migration fluctuations—the difference in unemployment between the State and the US overall. The following chart shows how closely the paths of these two variables move. The deep downturn in the early nineties caused unemployment to rise to 2.5 percentage points above the national average and was met with a similar outflow of people. Remember that unemployment in California is falling, because of the expansion of the informal sector, particularly in Southern California.

California Net Migration and Relative Unemployment  
Source: EDD, UCLA Forecast, DOF



This is not to say that housing isn't an issue in California. Prices certainly play a role in *where* this new population settles. There is little surprise that the East Bay and the Inland Empire are the fastest growing spots in the state. Both represent the most affordable places to live in their respective aggregate economic regions. But housing takes a back seat to economic opportunity, and families will crowd into tight markets for economic opportunity as can be seen by the crowded housing conditions in many communities in the state.

An important factor to watch is the natural increase in the population, births minus deaths. New births have been falling as a percent of the population over the last few years, but this is due to the boomers moving out of their reproductive years, not due to falling fertility rates. Indeed, fertility in the US has bucked international trends—while fertility rates in other developed nations such as Japan and those in Europe continue to fall, here in the US they have actually risen over the past three decades, from 1.7 children per female to over 2 children per female. While slow international immigration may stem this trend slightly, don't expect there to be a collapse in the number of babies being born anytime soon.

On the other side of the equation is the interaction of two trends that will completely change the demographics of the nation over the next three decades. Death rates continue to fall at an astonishing pace—they have halved in the past 15 years among almost all age groups. As a result, expected life span at birth continues to rise sharply. Combine this with the boomer wave that is nearing retirement and you end up with a rapidly aging population.

California has a somewhat younger population than the rest of the US. Currently in the US overall 36% of the population is 45 years or older. In California this proportion is 31%. This is due to the patterns of net immigration into the state. Nevertheless the same boomer trend that is going to have such a dramatic effect on the US economy overall is very much in place here in California. In 1970 the population of California was dominated by the young, half the population was below the age of 30. This was due to the new population in the fifties and sixties, many of these folks the first wave of boomers, and of course the children of boomers.

The number of people under twenty will grow by about 16% over the next 25 years, from slightly over 10 million to slightly over 12 million. Those from 20 to 39 will remain the largest demographic group in the population and will expand from 10 million to something over 14 million—a growth rate on the order of 37%. Those from 40 to 59 will grow from eight million to 12 million in the same time period, about a 45% increase. And those over sixty will expand from their current level of 5 million to, again, about 12 million. This is an increase of almost 150%.

The political implications of this shift are clear, but consider a few of these factoids. In 1970 the ratio of people under 20 to those over 65 was 4 to 1. By 2000 this had dropped to 2.8 and by 2030 it will hit 1.3. For those wondering whether schools or medical care are going to be the primary budget issues in the future, it is clear what this implies. Also disturbing is what might be dubbed the 'support ratio'. In 1970 there were six working age Californians for each retiree. In 2000 it was 5.5, by 2030 it will be 3 to 1. The cost of providing services to the elderly is rising more rapidly than inflation. At the same time the burden is being shifted to a smaller group of people. And as bad as this is here in 'young' California, it's going to be worse in the rest of the US.

A similar change in demographics will be seen in the East Bay over the same period of time, but it will not be as dramatic due to the nature of the area. As the coastal areas become increasingly dense, inland areas will absorb most of the new growth, and continue to be the more affordable locations. New families tend to locate in such places, including the East Bay, keeping the relative birth rate high. Nevertheless both Contra Costa and Alameda will see their population of 60 and over more than double in the next 25 years.

While California is no longer the land of empty space it once was, as a state we are far from becoming ‘too dense’ for growth, despite crowded regions such as Los Angeles, the East Bay and even Orange County. The largest challenge the state faces is changing a growth pattern based on developing yet another field or pasture to a growth pattern that grows through urban renewal and infill.

This battle is just beginning, but if history is any guide, those who are anti-growth and fight against in-fill projects may succeed in preventing the area from adding the necessary infrastructure and facilities needed to handle increasing population density, but they will have little success in actually discouraging those who would move into the area. Build it and they will come. Stop building it and they will come anyway. California needs to accept population growth as a given and begin to plan accordingly, and not let the anti-growth lobby’s quixotic crusade continue to impede development.

*Income and the future*

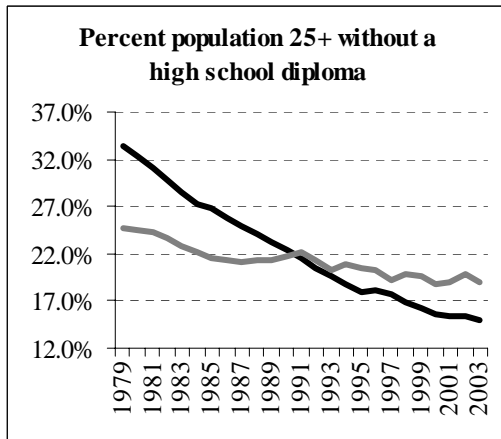
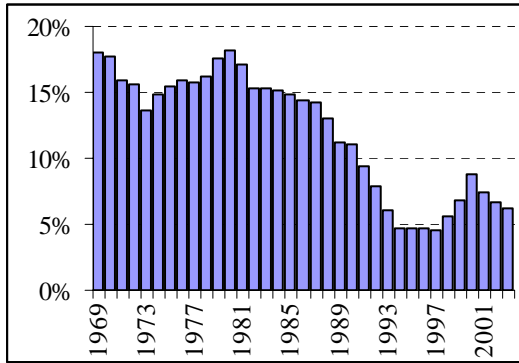
California’s budget issues are having an effect on many aspects of the state’s economy. Clearly our severely strained transportation systems are in need of an overhaul. The ongoing issues with energy have also to be resolved. The tax and regulatory systems continue to be very business and entrepreneur unfriendly, and will remain a drag on the state’s growth. At a deeper level our political infrastructure is also in need of fixing as our state politicians have yet to figure out how to work together to fix some of these major problems. Cooperation has improved recently, but no major problems have yet to be tackled. Instead the state continues to tweak problems at the margin, accomplishing only minor adjustments.

One of the ongoing concerns for the state has been the erosion of the income gap between California and the rest of the US. Until 1985 California enjoyed a per capita income that was generally 15% higher than the US overall. Yet this advantage has been steadily disappearing over time. The gap had been reduced to 4% by 1994. The Internet rush caused a brief turnaround, but the gap is again shrinking. Why this is happening is hardly a mystery. In 1979 35% of all Americans hadn’t completed high school. Here in California the percentage was 25%. Yet in 2003 the relative levels had reversed themselves. Now the national level is 16.5%, while here in

*Population Forecast by Age*

	2000	2010	2020	2030
<b>California</b>				
0-19	10,287	10,923	11,539	11,979
20-39	10,436	11,847	13,822	14,274
40-59	8,525	10,663	11,098	12,371
60+	4,762	6,461	9,208	11,864
<b>Contra Costa</b>				
0-19	278	305	370	449
20-39	259	300	376	408
40-59	273	315	306	362
60+	143	198	277	341
<b>Alameda</b>				
0-19	396	412	448	497
20-39	471	468	522	554
40-59	388	465	469	488
60+	196	260	374	483

California Income and Education  
Level Relative to US Average



Note: US % is the black line, California's is the grey line

system that will help overcome this challenge. Sadly, it seems that the state is not willing to take this challenge. Consider some of the following statistics -- California currently spends \$7,000 per public student, ranking us 28<sup>th</sup> in the US in an educational environment that is clearly one of the most expensive. The cost is due to the substantial challenges created by a social environment with so many different types of immigrants as well as the high cost of living. In terms of share of personal income spent on education, the state comes up shorter. We spend 3.8% of total income on public K-12 education, ranking us 37<sup>th</sup> in the US.

California the number has only declined to 20%. At the same time the number of Californians with a Bachelor degree or more continues to be above the rest of the US, and especially for those with an advanced degree. As a result income inequality has increased substantially in the state. The educational 'haves' are doing very well, while the educational 'have-nots' are not.

The reason for this shift, of course, is international immigration. Over a quarter of all Californians were born overseas, and many came from places that did not invest in human capital nor provide the same opportunities available to natural born U.S. citizens. While these people are hard-working, the reality is that skills have become increasingly important over the last few decades as a result of international trade and technological change. Indeed one of the best indicators of economic prosperity is human capital, and economic growth in the US has been largely clustered around locations with high levels of human capital.

While it will be difficult to significantly boost the skills of this generation of new immigrants, for the next generation there is much that can be done. The most important investment in the future of California is in our educational

California Public Education in Comparison: 2002 Data

	California	US Rank
Spending Per Teacher 01-02	\$54,348	1
Spending Per Student 01-02	\$7,055	28
Student Teacher Ratio	14.10	48
Non-Instructor / Instructor Ratio	.53	6
Public spending on K-12 education as % of Personal Income	3.8%	37

Although California teachers rank number one in the US in terms of annual income, the state also has one of the highest non-instructor to instructor staffing ratios in the US. The result, of course, is that California has one of the highest student-to-teacher ratios in the nation, and at best has limited resources left to spend on the students themselves. It is hardly surprising then that the performance of students in California public schools is so poor. This issue threatens the long run economic vitality of the state probably more than any other trend. In the short run many areas are trying to make up for the gap through the use of local bonds, but the issue will remain a drag on the state's economy unless serious financial reform can be put in place. Admittedly the problems are not just financial. Along with reforms on the money side of the system, there is clearly a need for an overhaul on the regulatory side to encourage better management and teaching, and to have proper oversight and responsibility. But both problems need to be fully acknowledged.

Ranking of Selected Bay Area Economies  
*Out of 233 largest counties by population*

	Bachelor or more		Household Income	
	%	Rank	\$	Rank
Alameda	39.3%	42	\$61,731	39
Contra Costa	38.7%	44	\$69,835	15
San Francisco	48.6%	9	\$57,833	57
San Mateo	42.8%	24	\$69,219	17
Santa Clara	44.1%	18	\$76,544	7

In contrast to this bleak picture, the Bay Area does not have the same scale of education difficulties that face the state as a whole. The largest portion of those problems are located in the Central Valley and the southern portions of the state. Indeed, despite the fact that 20% of the population of Contra Costa were born overseas, along with over 30% of the population in Alameda and the rest of the Bay, well over 40% of the population 25 and older in the region has a bachelor degree or more, putting it in the top 20% of major urban counties in the US. This bodes very well for the economic growth of the area in the long run, both in terms of jobs and income. On the income side the region stacks up even better. Despite the recent problems in 2003 Santa Clara still had the 7<sup>th</sup> highest median household income among major counties in the US. Contra Costa weighed in at 15<sup>th</sup>, while San Mateo was 17<sup>th</sup>.

In summation, the Bay Area, especially the East Bay, have all the elements for a return to strong growth -- both now and in the long run. There is an educated population, high income, and a technology core that will continue to lead the world in innovation and new ideas. Times are tough now, but this is an unavoidable consequence of the days of excess that occurred in the late nineties. Recovery is clearly underway. Yet the region cannot afford to ignore the greater issues that face California. The growing education gap, while not directly reflected in the Bay Area, will indirectly affect the region because of the strains it will put on the state's budget as well as the fact that the issues facing other areas will inevitably begin to spill over into the Bay Area. While it is easy to focus on the Bay Area's internal problems, local political and business leaders need to keep their eyes focused on broader, longer run goals, and realize that they need to participate significantly in the issues that will play a large role in the economic future of the state, even if those issues do not directly impact the Bay -- now.