

East Bay Economic Outlook

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Overview and Outlook:

While job growth has been tepid in the Bay Area due to continued consolidation in the tech industry and ongoing losses of public jobs in the East Bay, nevertheless 2004 was a good year by all other accounts. Taxable sales are up, office and industrial vacancies have been falling, and a new wave of tourism has come to the state. The domestic computer industry has experienced solid growth and exports originating from California exceeded the previous peak hit in 2000. Revenues for firms based in California are up, and of course housing prices continue to rise even as builders bask in unprecedented demand for new houses to be built.

Unfortunately the US and California economy have been enjoying a degree of prosperity based on very shaky grounds. Housing prices, tax cuts and low interest rates have been fueling a consumption boom over the past four years, a trend that helped minimize the impact of the tech bust in the US economy overall as well as in the Bay region. In large part local spending has supported the relatively soft landing of the area even as massive numbers of jobs were lost and incomes shrank rapidly. As the residential center of the Bay region, the East Bay was the biggest beneficiary of this trend, so it did not experience the dramatic losses of its two neighboring communities.

Yet, while we can thank this new American patriot for helping the economy weather the tough times of the last four years, we have in the meantime built up a new set of dangerous imbalances within the economy. The trade deficit is at an all time high along with consumer debt levels. Savings rates are at an all time low. And the housing sector is completely distended, with prices appreciating beyond anything remotely sustainable in the long run. Yet while these problems should be a worry for the government, there appears to be little desire to tackle the issues, with ethics probes, culture wars and Senate rules seemingly dominating both the time and energy of the policy makers who should be very worried about these problems.

For now the housing market and the economy continue to chug along. In our view the question is no longer if these problems will create another recession, only when. Preliminary numbers for the current year seem to suggest that 2005 will be a decent year for growth, with a falling dollar creating enough external demand to offset a housing market that has peaked, but has yet to see any declines. Look for moderate payroll job growth around the Bay, with the East Bay and San Francisco likely adding roughly 1% by the end of the year, and San Jose remaining flat or adding a small number of jobs on net. But 2006 will likely be a poor year, with a cooling market taking a large bite out of consumers' desire to spend. At that time those budget problems that are preventing California from making necessary investments for its long run health will only become that much worse.

The National Economy: The Real Worry is still Real Estate

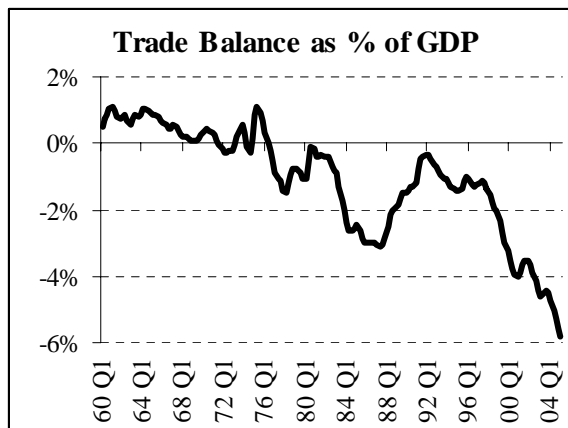
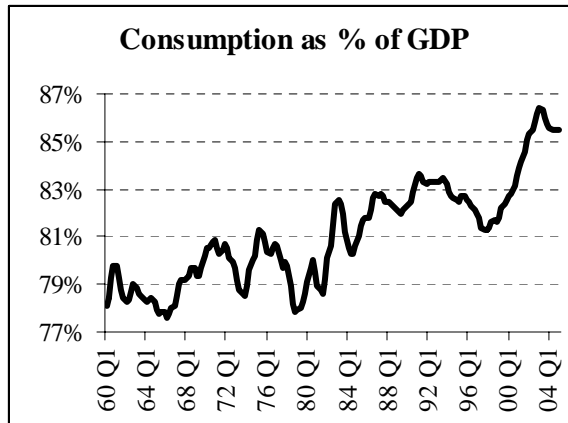
The preliminary estimate of first quarter economic growth came in at 3.1% (seasonally adjusted annual rate) completing two full years of solid economic growth. While news reports talked of the disappointment in the deceleration, it should be kept in mind that the average real growth rate for the US economy over the past thirty years is slightly less than 3.3%. Even if the US economy were behaving normally (which it is not) we would be expecting some return to a more average pace of growth by this point in the business cycle, especially given that the economy had been producing at a pace above its long run trend.

The slowdown is being attributed to many factors. Oil prices remain a favorite culprit, even though historically speaking oil prices have not come anywhere close to their previous high. The average price of a gallon of gasoline hit something around \$2.25 recently for the US overall. When we adjust for inflation we see that gas prices came close to \$3.00 per gallon in 1981. Furthermore, the US as a nation, and people as individuals, are less oil dependent now than they were then inasmuch as our income has grown faster than our consumption of petroleum products. In 1981 your average consumer was spending around 6% of their income on petroleum products. Today even with the price increases we have seen, this proportion is still far below 4%. If the price of a barrel of oil hits \$70 we may have to start to worry, but at the moment petroleum products are not the worry.

Outsourcing is another boogie man whose threat to the nation has been grossly overestimated. With the falling dollar and a recovering world economy, US output of electronics and computer products surged in 2004. Only over capacity problems in the industry left over from the late nineties rush prevented this increase from having a larger impact on employment and profits. This is not to say that outsourcing isn't important. But it is an issue that, for better and for worse, will have gradual effects on the economy over time. It will not be a short run driver of economic performance.

Of course, as noted, the economy is *not* in a normal place despite these other non-issues. Rather it remains distinctly out of whack, as it has been since the 2001 downturn began. Remember the odd nature of this recession. Most economic cycles start with a shock to the economy that causes a slowdown in consumer spending on houses and durables. The reduced aggregate demand leads to a pullback in business investment and the economy contracts. The 2001 downturn was very odd in that it was the only business cycle that started with, and was primarily, a decline in business spending. There was very little response in consumer behavior at all.

The lack of consumer response to the economic slowdown minimized the overall impact of the tech-bust, but has created long run problems that remain in the economy. Take a brief gander at the following graphs. One shows current national consumption (consumer spending combined with government non-capital spending) as a percent of GDP and another shows the trade deficit as a percent of GDP. For 30 years 79% of national output went to current consumption, while the balance went towards public and



Source: BEA, Data smoothed

private investment. In the eighties this increased by three percentage points to 82%. It remained at this level right through the nineties, including through the period of time when the tech bubble drove business spending up to record highs along with both major stock market indexes. Yet in 2001 even as the economy slipped into a mild recession something strange began to happen. Current consumption began to grow strongly, consuming another four full percentage points of national production before finally topping off at 86%.

How are we financing this consumption binge? By borrowing from the rest of the world. Remember that the trade deficit reflects the difference between total production and total spending in an economy (where spending is current consumption plus public and private investment). When spending is

greater than production, we have to borrow from the rest of the world. The US is currently on a credit card binge that could make the worst shop-a-holic nod knowingly.

The trade deficit started to widen in the late nineties. But the trade deficit then was different than it is now. Then, the widening of the trade gap was largely because foreign investors wanted a piece of the 'new economy' that was supposedly forming. This debt went towards investment that could (presumably) pay it off in the long run. This was good debt of a sort—borrowing to create future growth. But now the debt we are racking up is going to fund current spending—bad debt because we are borrowing from the future to have our fun today. To put some perspective on the magnitude of the issue, the US economy on net has borrowed roughly \$2 trillion from the rest of the world over the past four years. This represents about 16% of current GDP.

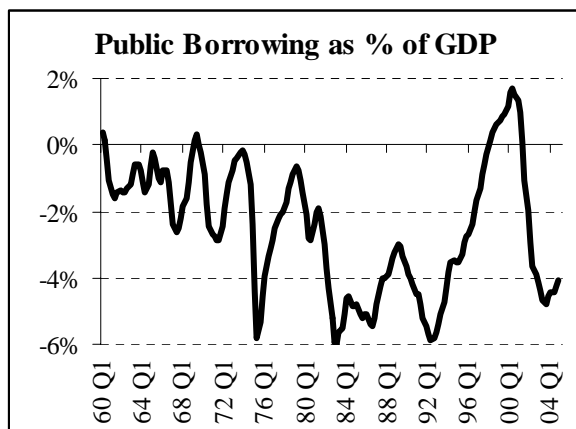
Past Performance is no Guarantee of Future Returns

What could be driving this worrisome binge? Part of it is certainly the low return environment facing investors. While the markets have been performing well over the past couple years, they have not yet surpassed the level they were at in 2001. Bond yields remains similarly low. Investors used to the crazy late days of the stock market boom find such returns hard to stomach to say the least.

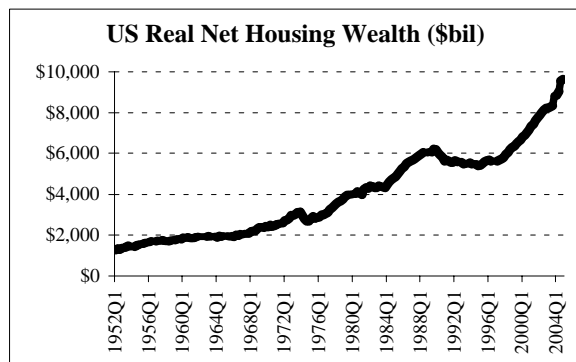
Another reason for the binge has been the truly horrendous fiscal policies currently being pursued by the government. Fiscal prudence went out the window with Reagan in the eighties when public borrowing increased to an all time high as a percent of GDP (see graph). The nineties saw a return to budget balancing—admittedly more as a function of the end of the cold war, government gridlock and an economic boom than to any deliberate strategy on the part of our elected leaders. However, fiscal prudence is apparently passé, and as soon as control of the legislative and executive branches of government came under the control of the same party they moved quickly to reverse the situation. The Bush tax rate reductions and spending increases quickly drove public borrowing up yet again even as defense spending ramped up as a result of the actions that took place after September 11th. At the same time these tax rate reductions did have their intended effect—most of the increase in disposable incomes that people received as a result went straight to consumer spending. Unfortunately the last thing this nation needed was more consumer spending.

Oh, an explanation. I use the term ‘tax rate reductions’ rather than ‘tax cuts’ for a very good reason. When the government cuts spending and taxes, this is a true tax cut. When the government increases spending and reduced taxes it must borrow to make up for the shortfall. Of course these borrowed funds need to be repaid at some future day.

What the current administration has done has been a tax *deferral* rather than a tax *cut*—unless of course you happen to be close to retirement. The current government is playing a shell game with the US taxpayer, and sadly the future generations will yet again be left holding the bag when the smoke clears. And who says we don’t have much in common with the Europeans?



Source: BEA, Data smoothed



Net wealth is total value – mortgage balances
Source: Federal Reserve Board

But these two situations alone cannot explain all the rapid expansion of consumer spending in the US. The third and quite possibly the largest factor is real estate. The gross value of owner occupied real estate has increased by something on the order of \$7 trillion dollars over the past 5 years, an increase of over 65%. When we take out mortgages and adjust for inflation, this still works out to a real net increase in wealth of over \$3 trillion. Remember that the total output of the US economy last year was slightly less

Median Prices for Resale Properties

Source: DataQuick

	Resale Houses			Resale Condos		
	Mar-01	Mar-05	Change	Mar-01	Mar-05	Change
Alameda	\$356,500	\$565,000	58.5%	\$298,000	\$425,000	42.6%
Contra Costa	\$298,000	\$535,000	79.5%	\$220,000	\$360,000	63.6%
Marin	\$599,500	\$917,500	53.0%	\$345,000	\$507,500	47.1%
Napa	\$275,000	\$551,000	100.4%	\$203,000	\$369,000	81.8%
San Francisco	\$543,250	\$745,500	37.2%	\$602,000	\$683,000	13.5%
San Mateo	\$554,000	\$790,000	42.6%	\$365,000	\$510,000	39.7%
Santa Clara	\$500,000	\$665,000	33.0%	\$343,000	\$425,000	23.9%
Solano	\$210,000	\$405,000	92.9%	\$125,000	\$263,000	110.4%
Sonoma	\$320,000	\$527,500	64.8%	\$208,500	\$360,000	72.7%
Los Angeles	\$225,000	\$460,000	104.4%	\$165,000	\$360,000	118.2%
Orange County	\$320,000	\$615,000	92.2%	\$195,750	\$415,000	112.0%
San Diego	\$265,000	\$535,000	101.9%	\$180,000	\$380,000	111.1%
Riverside	\$157,000	\$350,000	122.9%	\$156,000	\$327,000	109.6%
San Bernardino	\$137,000	\$294,000	114.6%	\$108,750	\$260,000	139.1%
Ventura	\$270,000	\$575,000	113.0%	\$178,500	\$386,000	116.2%

than \$12 trillion. Of course these numbers do not take into account the increase in value of rented properties. That would add even further to the increase.

Nowhere in the US has this run up in property prices been so dramatic as in California. Over the past four years prices in Southern California have essentially doubled for both condos and houses. The Bay Area has seen a slightly slower advance, with prices in Napa growing the fastest at 100% and slowest at a mild (?) 33% in economically very hard hit Santa Clara County. Of course the Bay Area saw dramatic increases in prices in the late nineties that were not seen elsewhere, so when traced back to 1997 the price increases are about the same across the state. A rough estimate has the total value of all residential units in California going up by \$1.6 trillion between 2001 and 2004. In 2004 alone the increase in property prices added up to something on the order of \$25,000 per adult in the state. Personal income per adult in the state is slightly over \$40,000 to give a rough idea of just how large this number is.

Increase in Value of California Housing Stock

2001 to 2004 Estimate

	Average Stock	Increase in Price	Increase in Stock Value
Homes	7 Million	\$175,000	\$1,225 Billion
Apartments	5 Million	\$88,000	\$440 Billion
Total			\$1,665 Billion
California Total Personal Income			\$4,714 Billion

Of course you may ask yourself why consumers would suddenly start spending now on the basis of housing wealth. Why not back in the late nineties when the stock markets were booming, adding \$5 trillion in wealth to household balance sheets between 1996 and 2000? Wouldn't that have had the same effect? The answer is that housing wealth seems to have a more direct impact on consumer behavior than equity wealth.

Simple Consumer Spending Equation
 Sample Period 1980-2001, all variables in log form

Variable	Coef	SE	t-stat
Spending Lag 1	0.5889	0.0992	5.94
Spending Lag 2	0.1963	0.0881	2.23
Ch. Equity Wealth Lag 1	0.0130	0.0063	2.07
Ch. Housing Wealth Lag 3	0.0610	0.0390	1.56
Income	0.2248	0.0403	5.57
Inflation	0.4256	0.1323	3.22
Ch. Interest Rates	0.0012	0.0009	1.39
Ch. Interest Rates Lag 1	-0.0010	0.0010	-1.01
Unemployment Lag -1	-0.0065	0.0011	-5.68
Unemployment Lag 1	0.0071	0.0012	5.90
Intercept	-0.1302	0.0402	-3.23

The best way to illustrate this is with a simple model of consumer spending. Drivers in this model include past spending, inflation, income, unemployment and interest rates. Also included are measures of housing and equity wealth as measured by the Fed.

For those of you who may be interested in the technical details, the derived

coefficients of the model are included in the table. While we cannot directly interpret the coefficients on these variables due to the complex lag structure, what stands out here is that housing wealth has about 4.5 times the direct impact on consumer spending that equity wealth does, .061 to .013. Why so much greater? One reason is that home wealth is more widely distributed than equity wealth across the population. It could be that people use equity wealth for retirement and home wealth for consumption. It could be due to the different tax ramifications of drawing cash out of equity compared to your house. Or perhaps it is that people are more skeptical of gains in the stock market than they are of gains in their own house.

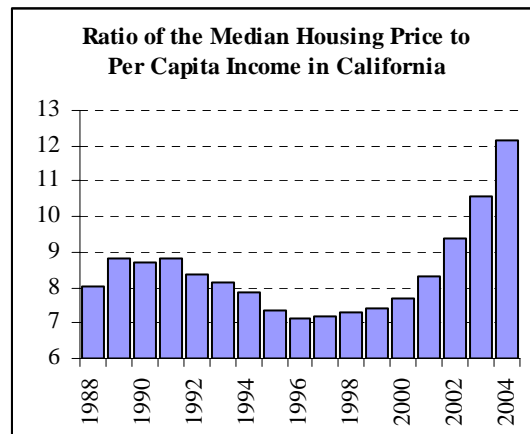
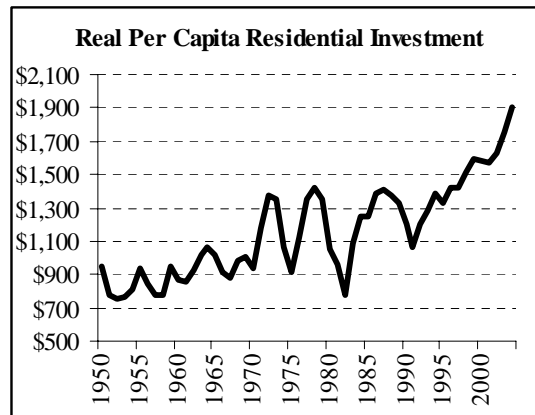
Whatever the reason, the next step of course is to use this model to pose a question—if the housing market had cooled over the last two years and equity growth increased at a reasonable 6% annual rate rather than the blistering 12% rate it has, what might this have done to consumer spending? Note that this is an extremely conservative question since it is also reasonable to expect that housing equity wealth might only rise at the overall pace of inflation, given the weak economy. Yet even with a conservative scenario the answer is startling—even here it would have shaved something on the order of \$700 billion off consumer spending over the past two years, an amount about 3% of GDP and suspiciously close to the increase in current spending away from the long run mean illustrated above. Had this run up in real estate values not occurred, the trade deficit would likely be considerably smaller and the strong economic growth of the last two years substantially reduced.

Add it up and what we have is an America borrowing from the rest of the world to increase consumption on the basis of a perceived increased in housing wealth. Unfortunately this perception of wealth is just that—perception. The housing market has become dangerously distended over the past few years, and we are currently in bubble conditions, a problem magnified by the strange business cycle of 2001. Typically the housing sector is very cyclical, with investments in housing declining prior to a slowdown in the economy. Housing price growth slows and then falls (in real terms). In 2001 not only did housing investments and prices not slowdown, but they actually accelerated and have continued to accelerate right through 2004. In a very real way we

are currently in the 14th year of this real estate cycle, not in the 3rd.

Don't think it's a bubble? Consider some of these basic facts:

- Nationally, real per capita investment in real estate has been at an all time high level since 2002. Currently we are pouring new investments in at a pace 75% higher than the long run average.
- We are currently building one new residential unit for each 1.4 people entering the population. The average household size in the US is 2.8 and the long run average pace of building is 2 people per new unit.
- The cumulative real increase in housing prices during the 1980's bubble was 47% for the west coast. In the late seventies it was 67%. Since the beginning of the current run up in prices, houses have appreciated by 84% in real terms and counting.
- The ratio of median housing prices to per capita income in the state has increased by 50% since 2001 (see chart) from 8.1 to 12.1. Even at the height of the late eighties bubble this ratio never exceeded 9.
- In the late eighties there were two years of hyperactive market activity, with 340,000 units being sold within the Southern California region (including San Diego) each year. Annual sales have been running at higher than this level since 2001, and hit 360,000 units in 2004. This is exactly the type of frenetic activity that characterizes a bubble market, with many buyers quickly purchasing and then flipping their properties to cash in on profits.



Source: DataQuick, BEA

Of course just as in the midst of the tech bubble there were many analysts trying to justify what was clearly a stock market bubble, now there are many analysts trying to explain why there isn't a housing bubble. My two favorite justifications are low interest rates and the California supposed housing supply shortage.

As for interest rates, the *level* of interest rates is completely unimportant for price appreciation, rather it is the *change* in mortgage rates that is important. Why this is so comes from the fact that a house is an asset, and has a fundamental value based on the stream of future revenues it provides to the owner, whether this is in the form of the direct net rents collected by a landlord or the implied net rents of an owner occupied building.

The mortgage rate is an important component in this calculation, since a drop in mortgage rates creates a drop in the discount rate that must be applied to future revenues and hence the property value goes up today. A very rough rule of thumb is that a one percentage point change in the mortgage rate changes the value of a property by 10% in the opposite direction. Thus the fall in mortgage rates between 2000 and early 2003 added considerably to the value of a house here in the US. But when mortgage rates bottomed out at the start of 2003 they no longer had any influence on the fundamentals of a house's price.

The second big myth revolves around the housing shortage that supposedly exists in California. Remember that supply and demand for housing do not impact housing prices, they impact *rental* prices, since rent is the value of housing services right now. A tight housing market will see rents rise, and with rents so will rise the price of the asset that provides the service—the house. If we truly have a housing shortage in California we should see it in rental growth, which of course we don't. Rental growth was very strong in the late nineties, particularly in the Bay Area. But since 2000, rental markets have been very soft in most of the state (with the exception of the inland empire) not even keeping up with inflation, and rents have actually fallen sharply in the Bay Area. This does not appear to be a tight market.

Annual Apartment Rental Growth: California

	96-00	00-04
East Bay	11.6%	-8.0%
Inland Empire	8.2%	4.5%
Los Angeles	6.4%	2.6%
Orange County	6.8%	1.8%
Sacramento	5.0%	1.9%
San Diego	6.4%	2.6%
San Francisco	12.9%	-8.5%
San Jose	12.4%	-10.8%

Of course if you look at the ratio of new population to new building you would get another picture. It would seem that we are not building enough—an issue that feeds the story of the housing shortage supporting real estate prices. We do have a housing shortage—but it is for low income apartments for the rapidly growing low-skilled segment of the population. California has a higher proportion of over-crowded housing (defined as more than one person living per room) than any other state in the nation presently. Yet despite this problem, rents have not been rising. The issue is that most of the people are new immigrants with few skills and low incomes. While this is a segment of the population that needs more attention, it is not a segment of the population that drives housing prices to say the least. The number of households with more than one person per room within the structure is higher in California than anywhere else in the US. This includes a shockingly large 20% of all households in Orange County and Los Angeles.

The situation in the Bay is slightly less dire—only 7.5%. When these folks are removed from the equation it turns out that California has been building just about the right number of houses.

Housing and Population Growth

Total Change over 10 years

	New Units	Pop Growth	Ratio
ALAMEDA	44985	174,600	3.88
CONTRA COSTA	48216	151,698	3.15
MARIN	6554	14,385	2.19
SAN FRANCISCO	20325	57,663	2.84
SAN MATEO	14717	50,153	3.41
SANTA CLARA	64852	191,385	2.95

In the Bay Area there was a housing crunch in the boom nineties, but since the downturn housing has ‘caught up’ to population growth. Over the past decade the ratio of new population to new housing is about 3.1. Average household size is about 2.8. The market is building at about the right pace aside from the demographic issues detailed above. This is good to some extent since a housing market without much excess supply will be more stable when the slowdown arrives. But the pace is growing and could become too fast, especially in the condo market.

Now ‘bubble’ is a contentious word, especially in the development community. This is because the word often carries the connotation of a rapid decline in prices when it ends. Housing markets are not very liquid when they cool, however, and prices do not tend to fall rapidly. Instead prices stay flat until the fundamentals can ‘catch up’, so to speak, with the nominal price level. Yet it should be kept in mind that this does not mean there will not be a price correction, only that the price correction will be protracted rather than rapid. The areas of the nation that saw the largest increases in prices in the late eighties had to wait the longest for appreciation to kick in again in the nineties—what goes up must come down, even though the speed may vary.

Any sign of a slowdown yet? In California housing appreciation rates are starting to slow, and inventory to sales ratios are rising. Overall units sold have peaked out and dropped a little. Yet in historical context the market is still very hot, and the indicators are all strong. At the national level the market has also peaked but has yet to show any substantial signs of slowing. Bubble markets are by their very nature difficult to predict. Despite warnings from economists starting as early as 1997 the stock market bubble carried on for over three years, and security markets tend to shift much more rapidly than housing markets. There are many potential sparks that could trigger problems—interest rates and the job markets could both cause a sharp slowdown in the market. But whatever the trigger, eventually this housing market must slow down.

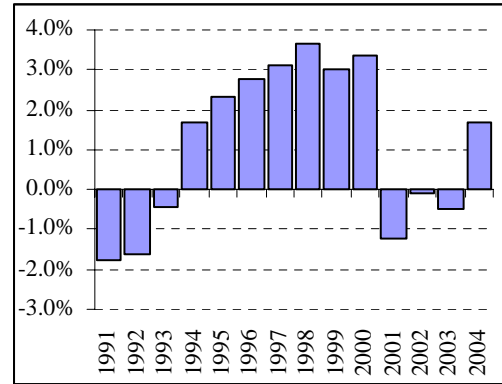
Add it all up, and it’s a difficult situation. When the housing market starts to cool, as it inevitably must, this will create heavy downward pressure on consumer spending due to the removal of the wealth effects. Add this to the slowdown in new construction and the loss of construction and real estate jobs and at best, all we can hope for is mediocre growth in California and for the US overall. At worst, housing could lead the US into a new recession, this time a more traditional consumer led downturn. Forewarned is forearmed.

California and the Bay

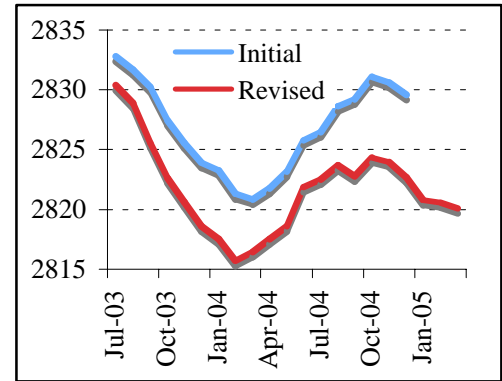
With the data revisions that came out in February it is now clear that the state's labor markets are showing a solid if not spectacular recovery. The state added 245,000 non-farm payroll jobs over the past twelve months, a 1.7% Q4 to Q4 growth rate that is on par with the overall US economy. The news of the upward revision was hardly surprising, given that many other indicators of economic performance have been showing similar signs of recovery. On the other hand, the better growth rate was less due to a large upward revision in current employment and more due to a downward revision in employment in 2003—the loss of jobs that year appears to be worse than initially expected, something on the order of -.5%.

The Bay area also saw some revisions. One large change was the addition of San Benito County into the San Jose MSA. San Benito only has about 15,000 payroll jobs total, but be aware that the statistical base has changed. As expected, both San Francisco and the East Bay saw downward revisions in the payroll employment estimates for 2004. For San Francisco the change was substantial, nearly 1.3% of total employment. For the East Bay the number

Non-Farm Payroll Job Growth
(Q4 to Q4 Changes)



Bay Area Non-Farm Employment

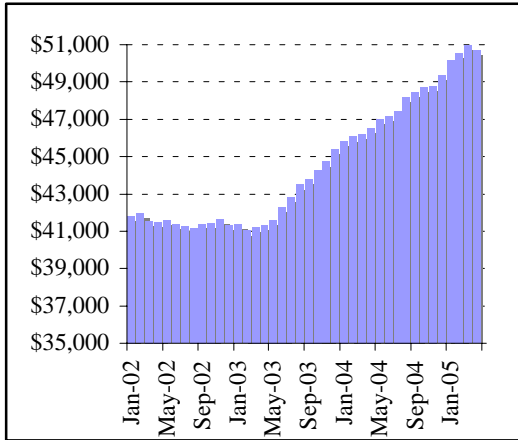


Bay Area Employment

Data Seasonally Adjusted, 000's

	<i>East Bay</i>			<i>San Francisco</i>			<i>San Jose</i>		
	Nov-04	Mar-05	Change	Nov-04	Mar-05	Change	Nov-04	Mar-05	Change
Total Non-Farm	1024.3	1023.0	-1.3	939.9	943.0	3.1	860.2	852.0	-8.3
Construction	70.8	71.8	1.0	43.3	43.6	0.3	41.4	40.5	-0.9
Manufacturing	99.4	99.6	0.2	44.5	44.6	0.1	171.1	169.2	-1.9
Wholesale	48.7	48.1	-0.6	26.6	26.6	0.0	34.7	34.4	-0.3
Transport	33.9	33.9	0.0	44.5	44.8	0.2	13.4	13.3	-0.1
Retail	109.6	109.2	-0.3	93.6	93.3	-0.3	81.3	80.6	-0.8
Information	30.4	29.9	-0.5	43.9	43.8	0.0	33.6	33.8	0.1
Financial	67.9	68.5	0.6	89.1	89.8	0.7	35.2	35.6	0.3
Professional Serv.	147.1	146.2	-0.9	175.4	175.5	0.1	166.6	162.9	-3.7
Education Health	119.1	121.7	2.6	100.0	100.3	0.3	95.0	95.4	0.4
Leisure Hospitality	81.6	82.1	0.5	113.7	115.6	1.9	68.6	67.8	-0.8
Other Services	37.1	36.6	-0.5	36.5	36.3	-0.2	24.8	24.9	0.1
Government	177.2	174.4	-2.8	128.2	128.7	0.5	93.9	93.6	-0.3

US Shipments of Computers and Electronic Goods (\$Mil, Census)



was more moderate, less than half of one percent. Surprisingly San Jose had an upward revision in their jobs of about 10,000 after adjusting for the addition of San Benito. Nevertheless when added up, the revisions have dampened the recovery that began in early 2004.

More of a worry is the recent loss of jobs that has hit the area in recent months. The East Bay has seen a net loss of 1,300 jobs since last November, while San Jose has lost an additional 8,300 jobs. Only San Francisco has seen any growth, adding 3,100 jobs over the past 5 months. The largest weakness in the East

Bay continues to be in the public sector, where an additional 3,000 jobs have been lost, primarily in non-education positions. Professional services have been weak in all three areas, as has job growth in information sectors. San Jose has also lost more manufacturing jobs. San Francisco's growth compared to the other two regions is based primarily on tourism—leisure and hospitality jobs increased by 2,000.

Export Values: California Products (MISER data)

	2003	2004
TOTAL ALL INDUSTRIES	\$93,994,882	\$109,967,840
COMPUTER AND ELECTRONIC PRODUCTS	\$36,714,650	\$42,247,151
MACHINERY, EXCEPT ELECTRICAL	\$9,433,879	\$12,592,999
TRANSPORTATION EQUIPMENT	\$8,643,619	\$11,759,483
CHEMICALS	\$5,963,655	\$6,644,089
AGRICULTURAL PRODUCTS	\$4,784,249	\$5,204,366
FOOD AND KINDRED PRODUCTS	\$4,168,177	\$4,158,863
ELECTRICAL EQUIPMENT, APPLIANCES	\$2,936,388	\$3,440,160

While these losses are certainly a setback, it seems to reflect a continued response to the issues of overcapacity created in the late nineties rather than to any new employment trend due to new weaknesses inside the economy. The falling dollar has definitely been a boost for the local economy. Domestic shipments of computers and other electronic goods have been rising at a solid pace throughout 2004, and international exports that originated in California grew at a spectacular pace in 2004. Demand for tech products is up, as are revenues. Yet overcapacity continues to squeeze the bottom lines of firms, creating a need for consolidation within the industry. The Oracle takeover of PeopleSoft was a well-publicized example of this process, but it is happening at many levels. This will continue to be a damper on job growth within the region throughout 2005.

Indeed by any other measure besides jobs the Bay Area is clearly in recovery mode. Taxable sales grew in all six major counties in 2004 when compared to

Taxable Sales Growth

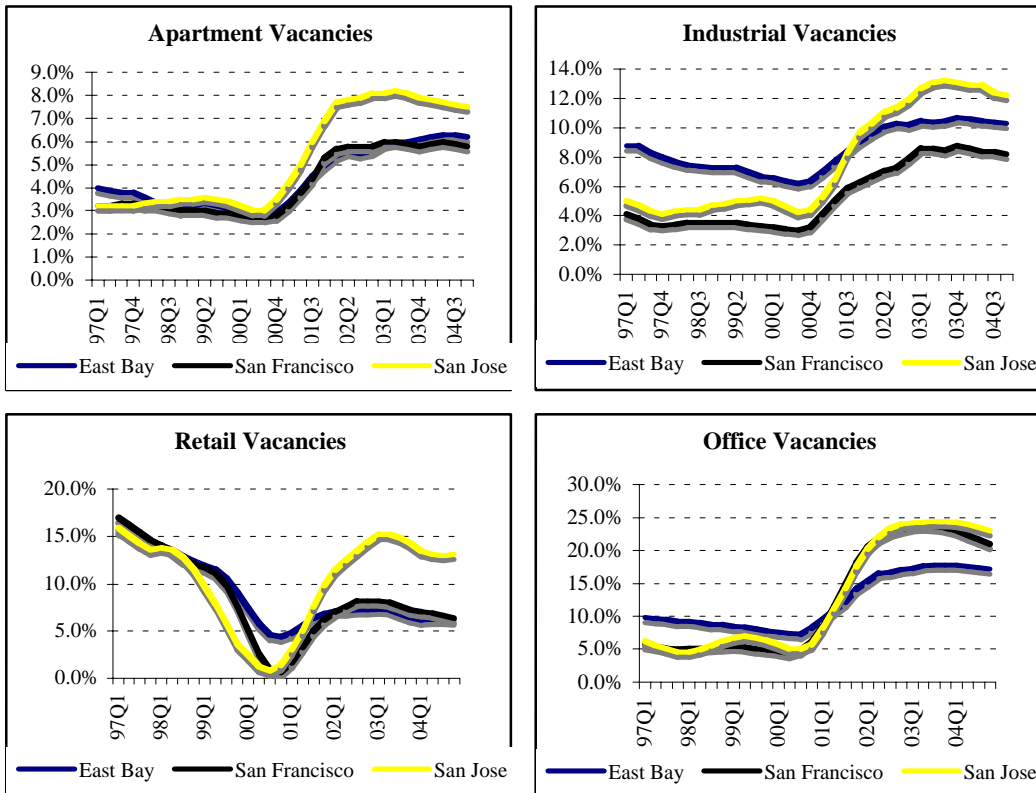
County	2004 Est	Gr.
ALAMEDA	22,814,518	6.73%
CONTRA COSTA	12,931,354	5.79%
MARIN	4,015,629	3.20%
SAN FRANCISCO	12,104,645	5.29%
SAN MATEO	11,950,618	5.21%
SANTA CLARA	28,544,495	5.48%

2003, with end of the year growth the fastest. Office and industrial vacancies, while still high, have been falling over the past year. Traffic through major airports has recovered to near pre-September 11th levels and hotel occupancy rates are up across the state. Non-residential vacancy-rates have begun to decline almost everywhere, and taxable sales across the

state are growing at double-digit rates. The ports continue to move record amounts of goods, and non-residential construction permits rose for the first time since 2000. One result of this recovery has been that the revenues flowing into state coffers continues to exceed forecasts, taking some of the pressure off state and local governments even as the budget debate battles in Sacramento heat up. Hopefully this brief reprieve will not dampen the push for reform, as it is questionable how long this current recovery will last, as we shall see.

California, including the Bay Area, experienced a solid economic expansion in 2004 even if jobs did not respond as strongly as we might have liked. Yet what we have here is an economy that is being driven forward largely by real estate. An economy has three major sectors; one that sells goods and services to other economies, another that sells goods and services within the economy, and the public sector. Manufacturing, wholesale trade, information, logistics, and some professional and hospitality services all

Bay Area Vacancy Rates



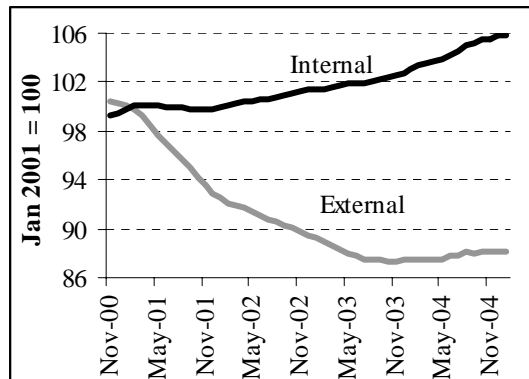
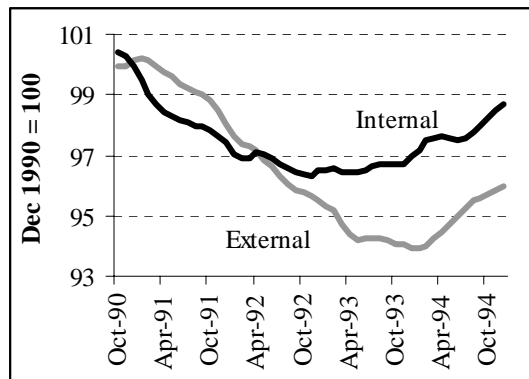
fall into the first category, while construction, retail, education, healthcare, administration and financial activities tend to fall into the second category. These external sectors are typically where local recessions begin, and the losses spill over into the internal sectors. On the opposite end of the cycle, growth in the external sectors will lead to increased demand for internal sectors and the overall economy will experience growth.

What has been happening in California in recent years, however, does not fit this pattern. Consider the paths of employment in these two sectors in California over the past recession and the 1990 downturn. In both cases the loss of external jobs pushed the state economy into the downturn. When there was recovery in the external sector starting in early 1994, the internal sector responded by also adding new jobs at an accelerated pace. For the most recent downturn the pattern is completely different—in this case internal jobs decline only for the first few months of the downturn despite losing an unprecedented number of external jobs (13% between 2000 and 2003 compared to 6% of the state total between 1990 and 1994). Perhaps more critically the recent increase in jobs in the state have been all on the internal side of the economy, on net the state has yet to see any substantial recovery of the external sectors.

Certainly some of this difference can be attributed to the massive run-up in external jobs in the late nineties on the back of the Internet rush bubble. After all, a big run-up will lead to a big decline. What this really represents is the peculiar nature of the 2001 downturn—a recession unusually led by business spending, with almost no consumer response whatsoever despite job and income losses.

Indeed it is amazing how internal demand could have remained so strong during this past downturn. The State's economy is being hurt during this cycle by a weak public sector due to the ongoing budget problems—something that did not occur in the early nineties. Incomes were hit worse in the state this time as well—real per capita income fell by 7% between 1990 and 1994 but by 1995 had returned to the previous peak. This time real per capital income has fallen by 9% from its peak and is nowhere near its previous peak, and likely won't be for quite some time. When Southern California lost many jobs in the early nineties real estate

Indexes of California Private Payroll Employment (Seasonally Adjusted Data, Smoothed, Employment peak = 100)



prices went down substantially. Yet in the Bay Area prices only paused despite a proportionally higher loss of jobs. Indeed all in all, the Bay area has fared remarkably well despite some of the worst job losses seen at the local level in US history.

If what I have said so far hasn't been enough to worry you, consider the following statistics. Of the 243,000 private payroll jobs that California added on net over the last two years, 122,000 of them are jobs directly related to the housing market—either in construction, real estate or credit intermediation. In short, a sector of the economy that makes up 10% of total private sector jobs is accounting for 70% of the total job gains. As with the overall US economy, the real estate market will begin to cool over 2005 and with it one of the primary drivers of the current economic expansion of the state.

Add it up and California will definitely feel the pinch when markets start to cool. The question is whether increased external demand due to the falling dollar will be enough to offset weak internal demand for goods and services. The boom economies in the Southern California region are definitely at great risk. But the problem of wealth driven demand is as large an issue in the Bay region, including the East Bay.

The forecast for the Bay Area for 2005 remains optimistic, although I am scaling back my forecasts for job growth yet again due to the bite of consolidation in the tech industry. Look for 1% growth in the East Bay by the end of the year, with an equal level of growth in San Francisco. San Jose will likely see positive job growth, but just barely. Taxable sales growth will remain strong as long as the housing market keeps up the momentum. Yet all this strength will quickly diminish when the market cools. Expect a weak 2006, and a new wave of budget problems given the sad lack of real budget reform in Sacramento to date.