

## EAST BAY QUARTERLY FORECAST

### INTRODUCTION

East Bay EDA is pleased to provide the East Bay Quarterly Update, with an introduction and outlook authored by Jerry Nickelsburg, Senior Economist with the UCLA Anderson Forecast. We are redesigning East Bay EDA's Quarterly and Monthly reports and welcome your thoughts and suggestions. Click here to [Download the PDF \(529k\)](#) version of this report.

To view the Bay Area "by the numbers", download the [Quarterly Indicators Sheet for Q4](#). This one-page summary includes GDP, CPI, employment, housing, construction permit, hotel, airline passenger, and foreign trade data.

### EAST BAY RECESSION DYNAMICS

Jerry Nickelsburg  
Senior Economist  
UCLA Anderson Forecast

#### **"problems are only opportunities in work clothes" ... Henry J. Kaiser**

This quotation from East Bay industrialist Henry Kaiser aptly characterizes where the region is today; there are plenty of problems, but there are also plenty of opportunities. Understanding how they will sort themselves out as we approach the end of this –the deepest recession in almost 80 years – is the challenge of describing the incipient recovery. Looking backward, the recession had two phases. The first was centered on housing and finance markets. Excess home appreciation and a burgeoning of employment in these sectors led to the subsequent sharp contraction during this phase. The second phase was dominated by the global recession. As a locus of international trade and of wholesale and distribution activity for the Bay Area, the East Bay saw job loss accelerate in the manufacturing and trade sectors. Now at the cusp of a U.S. economic recovery, we find evidence of a turning point in East Bay economic activity, but that evidence is extremely weak, particularly with respect to how the recovery will unfold.

Some have said that because the East Bay had greater excesses in home appreciation, residential construction and housing related employment, and because it experienced the downturn in these key sectors a bit earlier than other parts of the Bay Area, that the East Bay should come out of the recession earlier and faster as well. This is not necessarily the case. The East Bay is part of a more complicated Bay Area economy. The demand for housing depends not only on income and employment generation within the narrowly defined region, but also on these factors in San Francisco and the Silicon Valley as well. Though home prices have fallen, the cost of commuting has risen. Increases in the demand for houses is the aggregate of the demand generated by those finding work outside the region and choosing to live in the region, by those finding work in the region, and by the natural increase in the number of households due to demographic forces. So the "first in, first out" theory does not well describe the East Bay recovery.

The key sectors to watch for as the recovery unfolds are international trade, domestic distribution, manufacturing, health care, government and technology. Export generated jobs in international trade and in East Bay manufacturing should be a plus going forward. U.S. policy and public and private investment in health care, infrastructure and technology will be a plus as well. On the negative side are retail and wholesale trade, imports, and government. Residential construction is a mixed picture and depends critically on total Bay Area job generation. When we add all of these up, there is cause for optimism. The opportunities created by the problems in construction, finance, government and consumer related sectors provide a pool of skilled and semi-skilled labor to facilitate the expansion in other sectors, and in the long run, investment in green technology and new manufacturing techniques provide a bright future.

But there is a caveat. Changes in the sectoral balance of employment require dislocations. This is not a fast process which leaves us with a very mixed picture for the East Bay through 2010. In this East Bay Report we highlight the employment, trade and housing trends which point the way to the reallocations of labor and the recession recovery.

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EAST BAY EDA

*Serving the East Bay — the Bright  
Side of the San Francisco Bay*

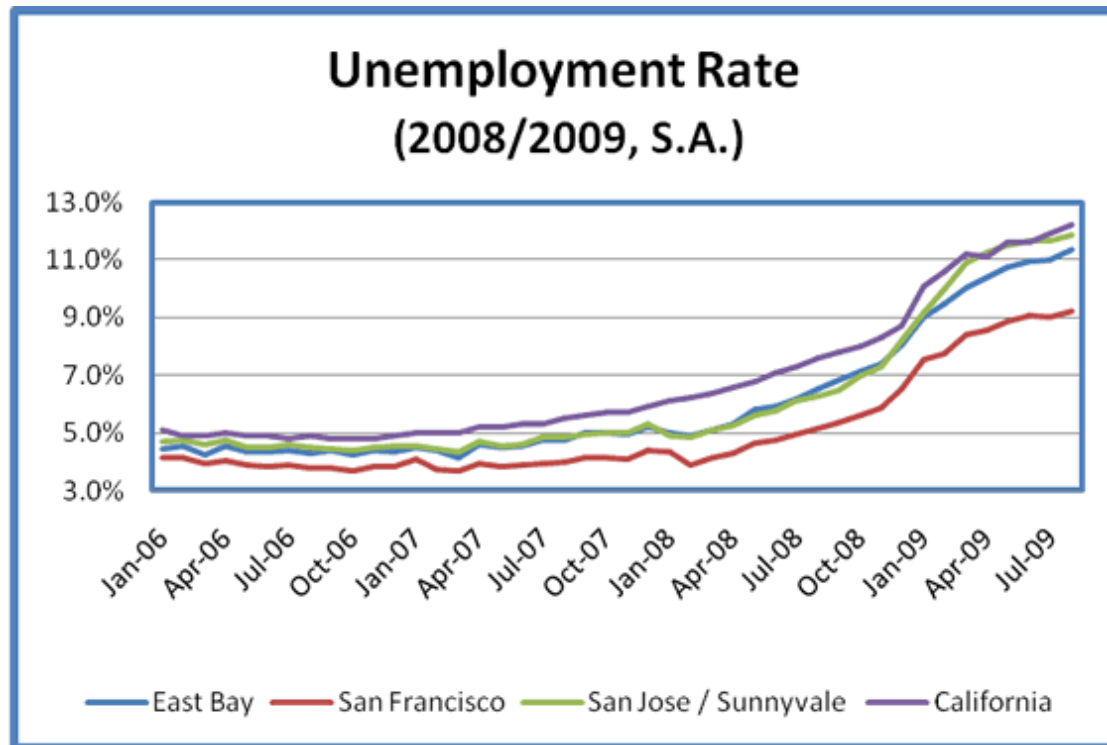
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# PRIVATE SECTOR EMPLOYMENT TRENDS

Looking back over the last 21 months, the East Bay, once thought to be the weak sister of the three Bay Area sub-regions, has been pretty average. Throughout the Bay Area unemployment rates have been rising steadily since the summer of '08. In the East Bay unemployment rates remain higher than San Francisco and lower than the Silicon Valley, and they remain nearly a full percentage point below the state unemployment rate. While that is little comfort to the 11.4% of the labor force which is out of work, it is a commentary on the diversity of the East Bay economy. What should be of some comfort is that the trends in employment, with the exception of government, are all in the right direction. So, while unemployment is destined to get worse in the coming months, the seeds of a recovery in job creation are being sowed right now.



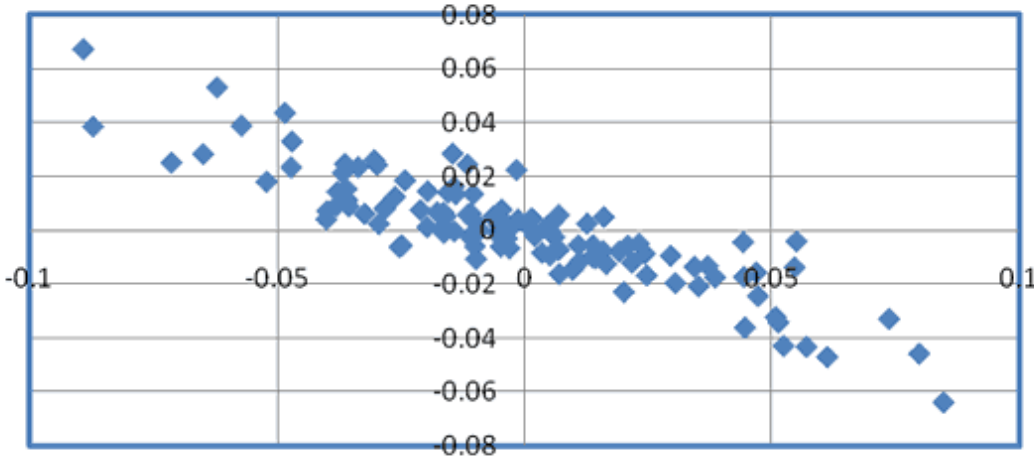
## THE BEDROOM EFFECT

One needs only to cross the Bay Bridge or depart from the San Leandro Bart station in the morning to see that a significant number of East Bay residents commute to San Francisco for work each day. This is visual evidence of why it is not possible to completely separate out the evolution of East Bay employment and housing from the wider economic activity of the Bay Area. In particular, unemployment may be generated by a loss of jobs in the East Bay, or a loss of jobs in San Francisco and Silicon Valley, or both. To understand the monthly unemployment numbers we need to understand that these numbers come from a survey, the Current Population Survey (CPS), which measures employment and unemployment by the residence of the survey respondent. So a resident of Oakland who was laid off from a job in San Francisco is counted as part of Oakland's unemployment and not as part of San Francisco's unemployment. But if the same person decides to move in with a friend across the Bay, that person is counted as part of San Francisco's unemployment and is deleted from the unemployment count in the East Bay. Sorting out the commuting portion of employment is more than an academic exercise as the economic forces which are part of the domicile location decision are constantly moving during a recession and they ultimately affect the demand for housing, public services, and consumer goods.

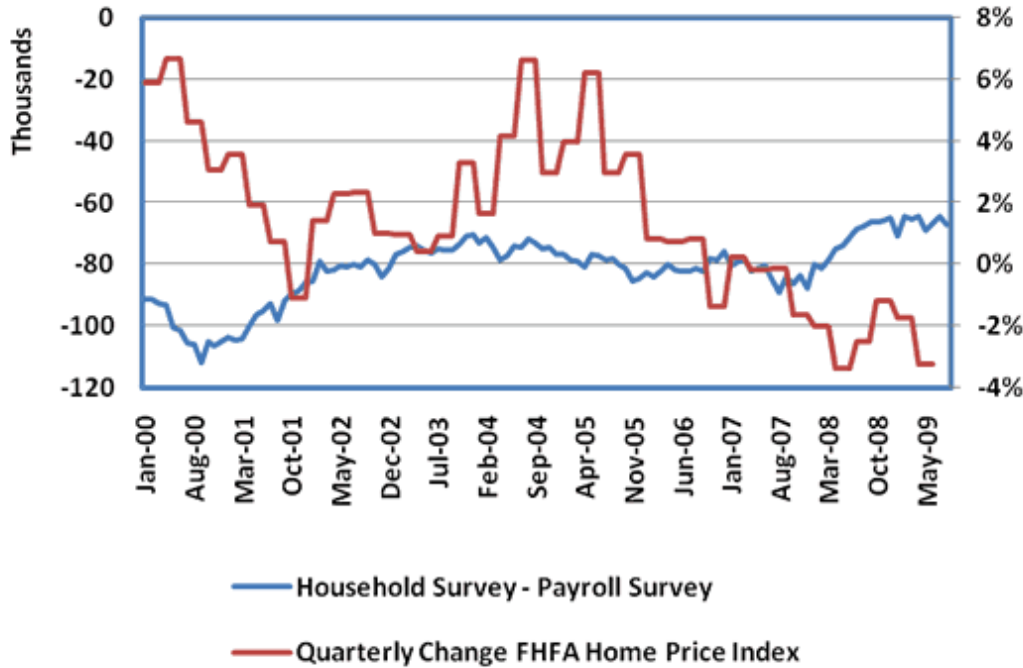
There are two surveys that we use to understand employment and unemployment. Aside from the aforementioned CPS there is the Current Employment Statistics (CES). The CES measures payroll employment by the location of employment. The CPS and CES differ in other ways. The CPS sample size is smaller and the CES does not include those who are self employed, independent contractors, and those who are unpaid employees of family owned businesses. On top of all of those differences are the commuters. None of these differences are culled out separately, but if commuters are a major part of the difference between the CPS and the CES, then changes in the difference can reflect changes in living and work patterns between the sub-regions. As it turns out that is the case for the East Bay and San Francisco, but not for the East Bay and Silicon Valley.

The relationship between the two regions is surprisingly regular. From 2000 to 2009 whenever the number in the domicile survey (CPS) for San Francisco went down relative to the CES, the opposite was true for the East Bay. An important reason for this is the cost of housing in San Francisco. When home price appreciation abated in the early part of the decade, the proportion of people both working and domiciled in San Francisco increased. When home prices skyrocketed in 2004 and 2005 this proportion declined, and today, with home prices depreciating, the proportion is increasing once again. What this means is that there is sufficient housing in San Francisco at a price that makes sense relative to the cost of housing in the East Bay (and the cost of commuting across the Bay) that new hires in San Francisco are more likely to be residents of the city as well. Thus recovery in the bedroom community portion of the East Bay economy will not be leading the way until San Francisco employment turns the

## Employment Survey Differentials (San Francisco vs. East Bay)



## San Francisco Employment Survey Differentials vs. Home Price Change

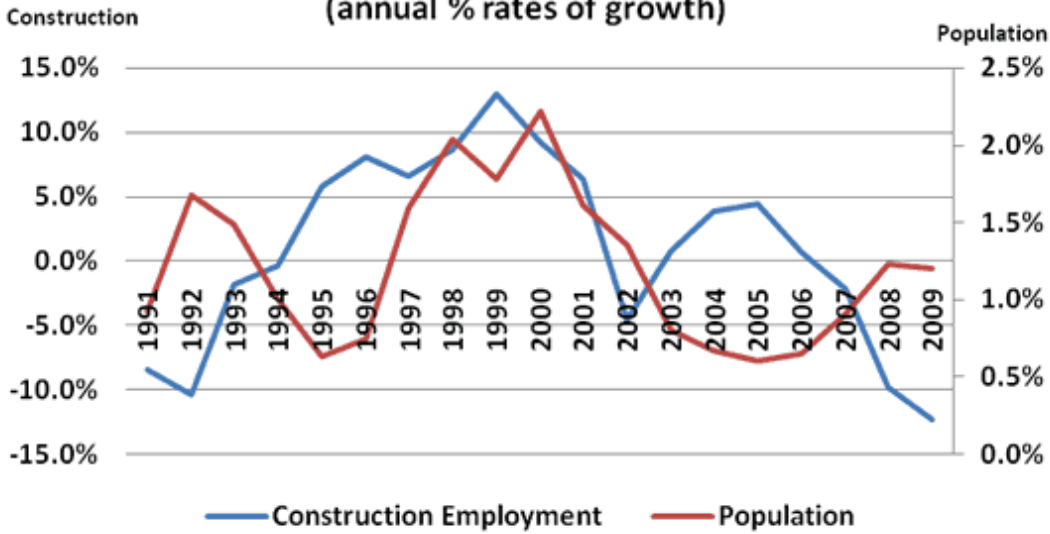


### **BOOM INDUCED BULGES IN EMPLOYMENT AND RECESSION JOB LOSS**

The construction sector is one of the most important sectors for the East Bay. Over the last decade it has averaged about 6% of all payroll jobs. Though the average has been relatively stable, employment has not been. Through the 90's, the growth in construction employment was more or less in step with the growth in population. Population growth preceded construction employment growth during the 1990 recession, and shortly thereafter the two were in tandem. This was not the pattern coming out of the 2001 recession. Even though population growth slowed down with the shrinkage of the dot com/internet industry, construction employment kept growing. Easy money and rising home prices provided an incentive to build more houses than were justified by replacement and actual or expected population growth. But clearly this was not sustainable. With the crash in housing demand, the number of jobs in the construction trades plummeted. This is evidenced by the fact that the number of construction jobs lost in this recession amounted to about 23% of all jobs lost and the sector has been the largest driver of unemployment in the East Bay.

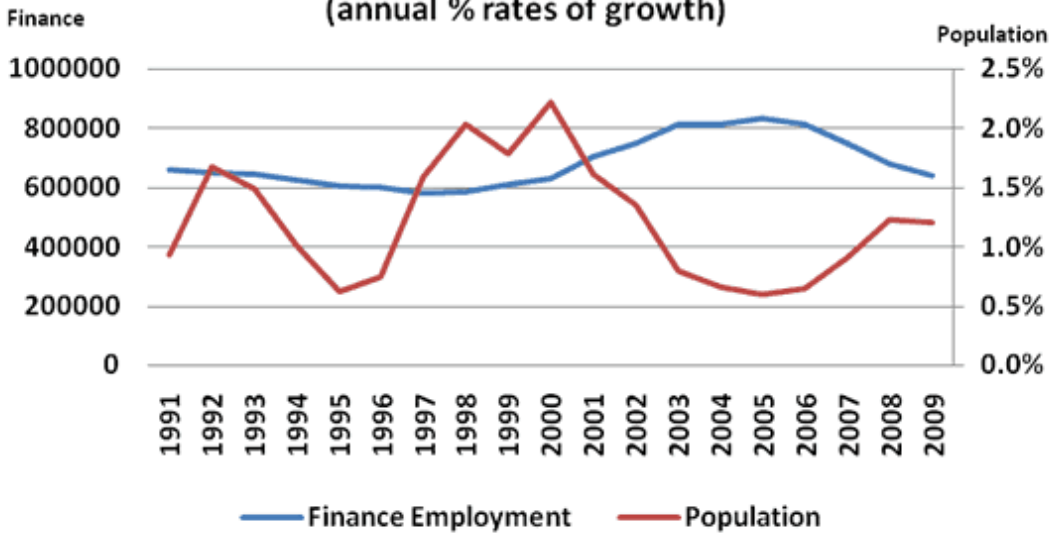
## Construction Employment and Population

(annual % rates of growth)



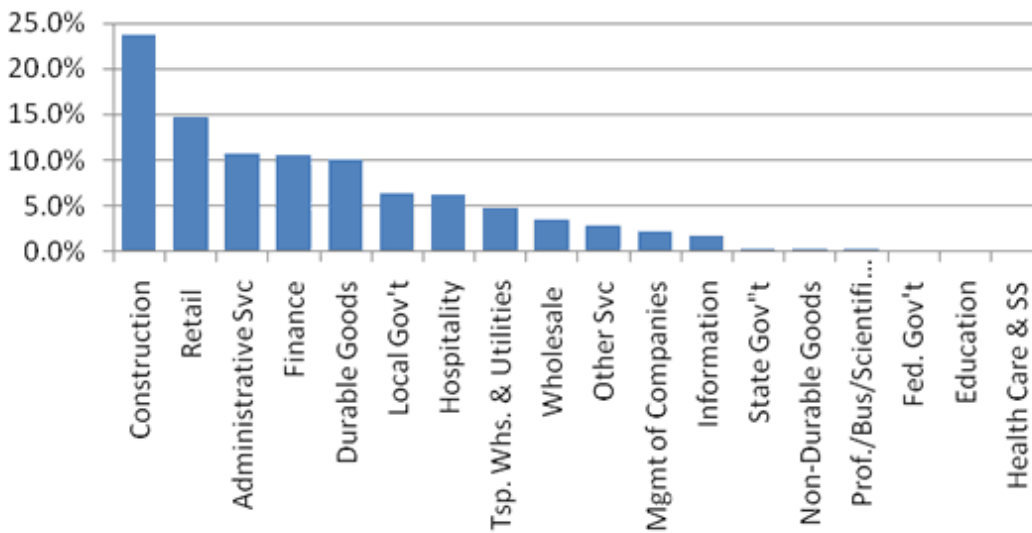
## Finance Employment and Population

(annual % rates of growth)



The finance sector shows a similar pattern. It grew rapidly during the housing boom to keep up with the explosive demand for money generated by the significant growth in the issuance of sub-prime and other creative mortgage instruments. Nearly 20,000 new jobs were added between 2001 and 2006 to support the hyperactive real estate industry. The failure of mortgage institutions, the consolidation of banks and the lower level of transactions to be supported have resulted in lost jobs in the finance sector. This sector, which accounts for only 5% of all payroll jobs in the East Bay, contributed 10% of the recession job loss.

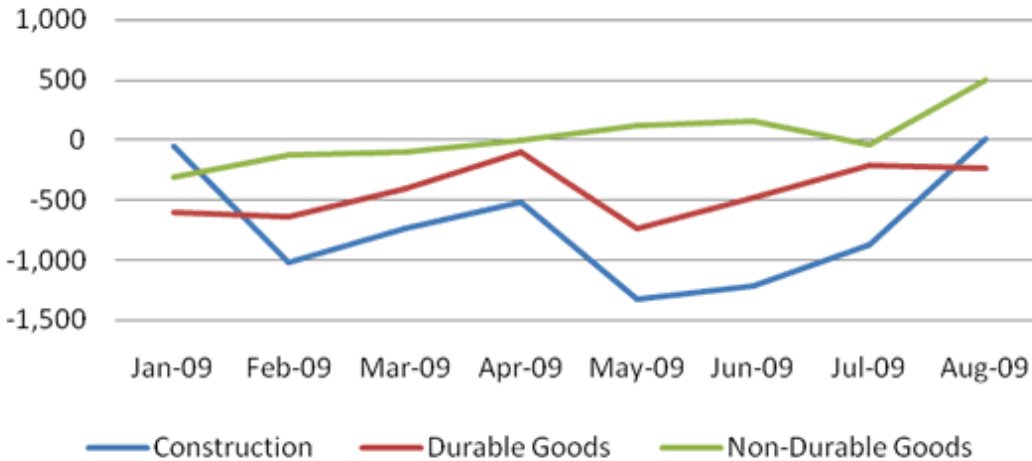
## Contribution To Job Loss Dec '07 to Aug '08



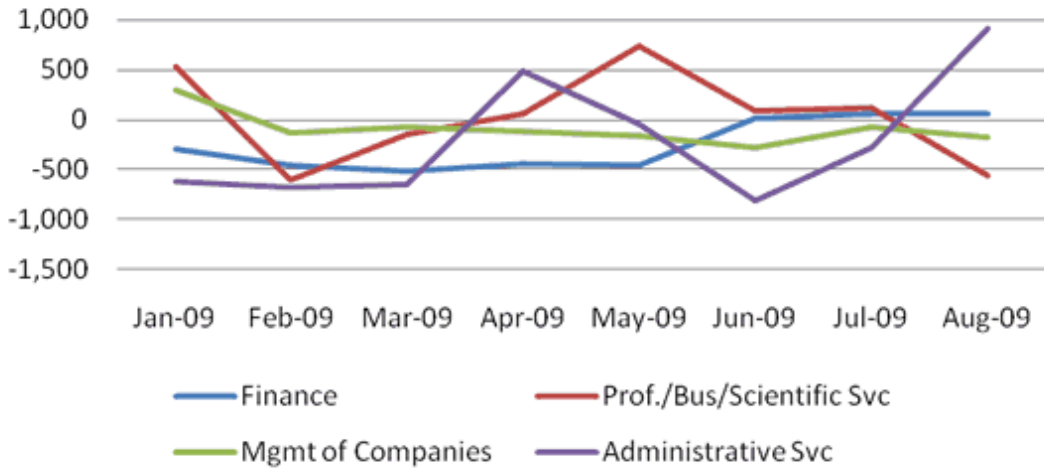
### A TURN IN JOB LOSS

Throughout California payroll employment job loss has begun to abate . Similar trends are evident in the East Bay. Of the goods producing sectors (construction, durable goods manufacturing and non-durable goods manufacturing) only durable goods lost jobs in August. In Consumer services, only health care and social service, which had been adding jobs during the recession, lost jobs in August. In business services demand is still weak, but the trends remain favorable. The administrative services sector which contains temporary employees saw an uptick in demand in August, the first sign of expansion in the employment base. In short, the private sectors of the economy are all moving towards, if not already into job creation.

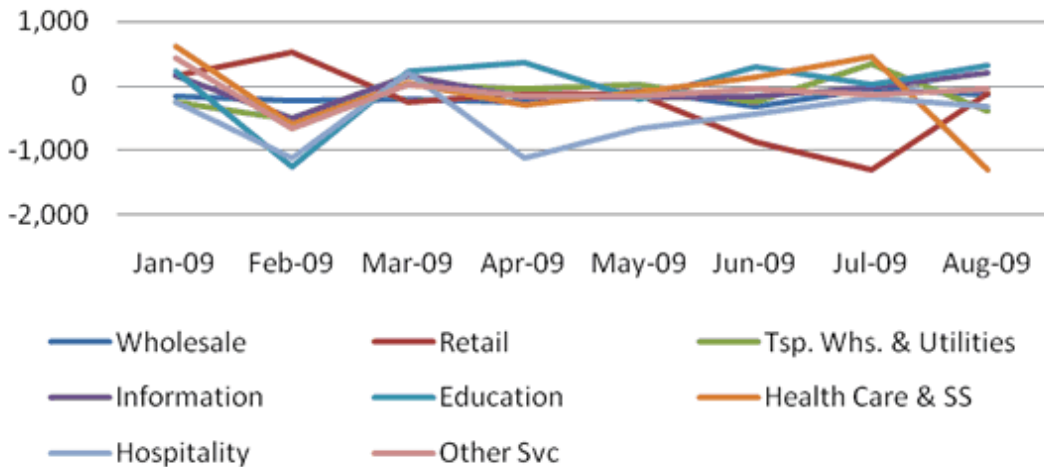
## East Bay Job Loss/Gain (S.A. Goods Producing Sectors)



## East Bay Job Loss/Gain (S.A. business Oriented Services)



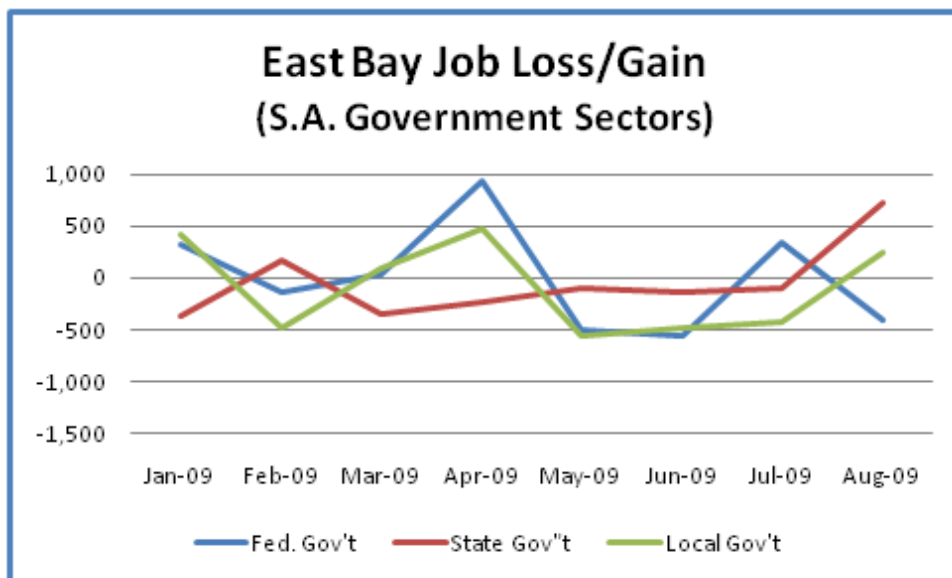
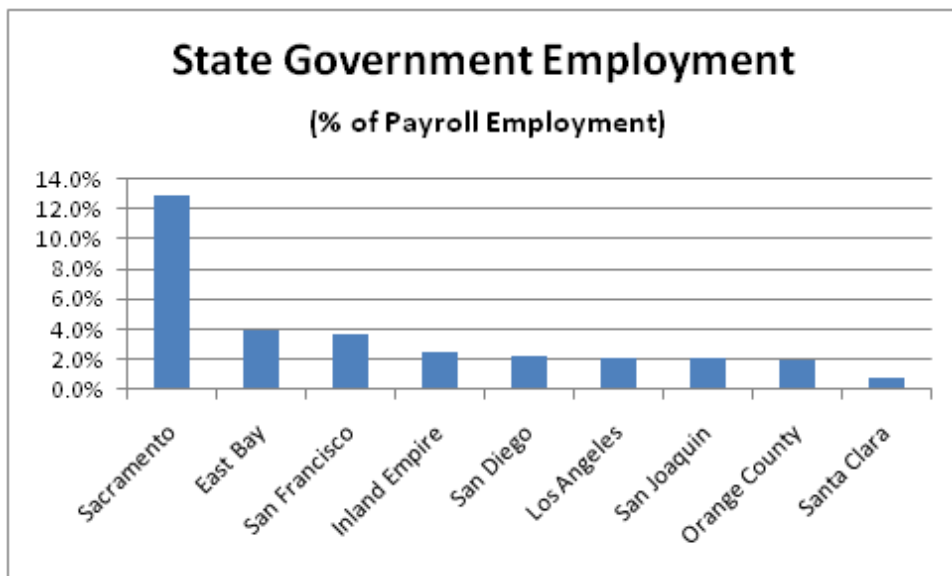
## East Bay Job Loss/Gain (S.A. Consumer Oriented Services)



# THE PUBLIC SECTOR: HINTS OF THINGS TO COME

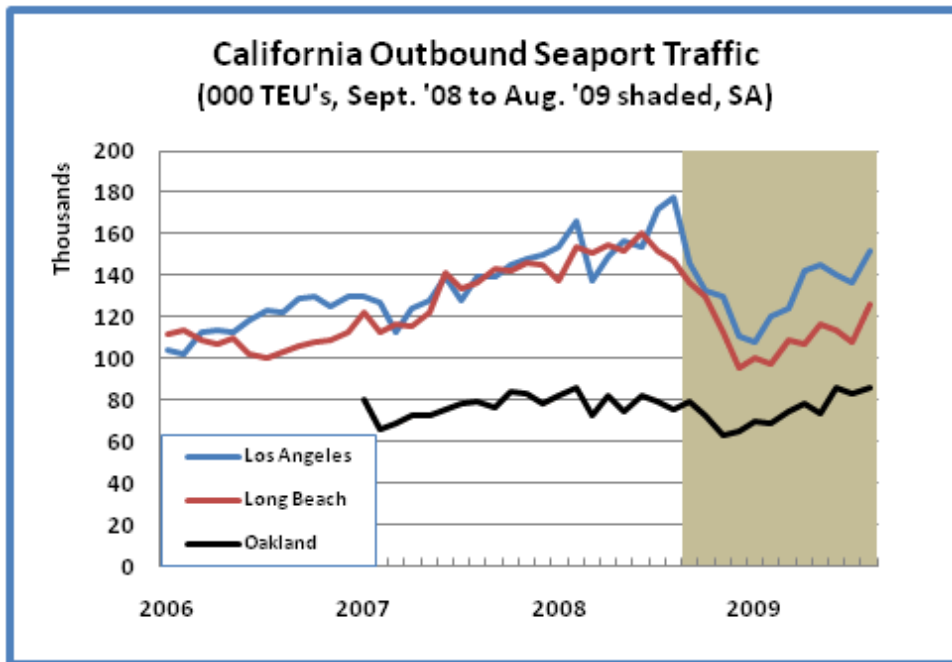
The drama of Sacramento coming to terms with falling tax revenues and an irate electorate is over, at least for this year. Between the February and July budget agreements the state has been able to close the gap between planned expenditures and tax revenues. To do so required a series of tax increases, asset sales, one time transfers, creative accounting and serious spending cuts. The spending cuts will take general fund supported expenditures from \$103 Billion in the 2007 fiscal year to an inflation adjusted \$83.3 Billion for the current fiscal year. This is a 19% cut in state general fund spending and this will engender program closures and concomitant job loss. Typically the public sector does not shed jobs proportional to expenditure cuts, and the design of the current cutbacks seeks to preserve as many jobs as possible. Furloughs and pay cuts, a kind of unemployment sharing, will take up some of the slack in revenues. But this time the shortfall yields far too large a reduction in state expenditures to avoid a significant impact on public sector employment. That is not good news for the East Bay. Outside of Sacramento, the East Bay has a larger proportion of state government sector jobs than any other major population center in California.

Even though expenditure cuts were clearly going to occur, the state sector has yet to experience any net reduction in force. What that means is that the reductions, whether direct or indirect are still on the way. As the new budget plays out with cuts in programs, hiring freezes and reduced consumer demand from furloughed employees, we can expect a reduction in state, local and derivative sector employment. At present we don't know the geography of these cuts. To gain some insight into the impact on the East Bay, we will assume that they are imposed in the same proportion as fiscal year 2007 employment in the state government sector. This translates to a reduction in East Bay payroll employment in the current fiscal year of 0.36%. If the same proportion of jobs are lost in the local government sector the reduction is 1.47% of payroll employment. In fact, the number will be something between the two and probably closer to the state-only reduction. Nevertheless these are big numbers. The dot com/Internet implosion - which has had a decade long impact on aggregate employment in the Bay Area - totaled 2.3% of Bay Area payroll employment. So while the number in this instance is smaller, the impact on the East Bay as it grows out of the recession is significant; and importantly, until this is behind us, the East Bay can expect little-to-negative net employment growth.



# TRADE & MANUFACTURING: UP FROM THE BOTTOM

The most encouraging sign of the end of the recession in the Bay Area comes from international trade. Previously we reported that the IMF and other international agencies did not expect our trading partners to come out of recession before the U.S. It is California's good fortune that the forecast was wrong. Japan emerged from recession in the 2nd quarter and grew at a 2.3% rate, and China, which had a slowdown in growth to near 6% during last year, has picked up and is growing in the 8% range once again. In Europe, the French and German economies are the first out of the recession registering 1.2% annual rate growth rates in the 2nd quarter. These turnarounds are due in no small part to huge domestic inventory adjustments. As firms around the globe confronted collapsing economies and "trash talk" of great depressions they postponed new investments and they liquidated inventories as fast as they could. Once inventories fell below optimal levels for the new, lower demands from the marketplace and a realization set in that the downturn was not bottomless, inventory orders began to be placed once again. Even though our largest trading partners, Canada, the U.K. and Mexico are not out of the woods yet, the surprising turnaround in Asia and Europe has been enough to get California's exports growing once again.

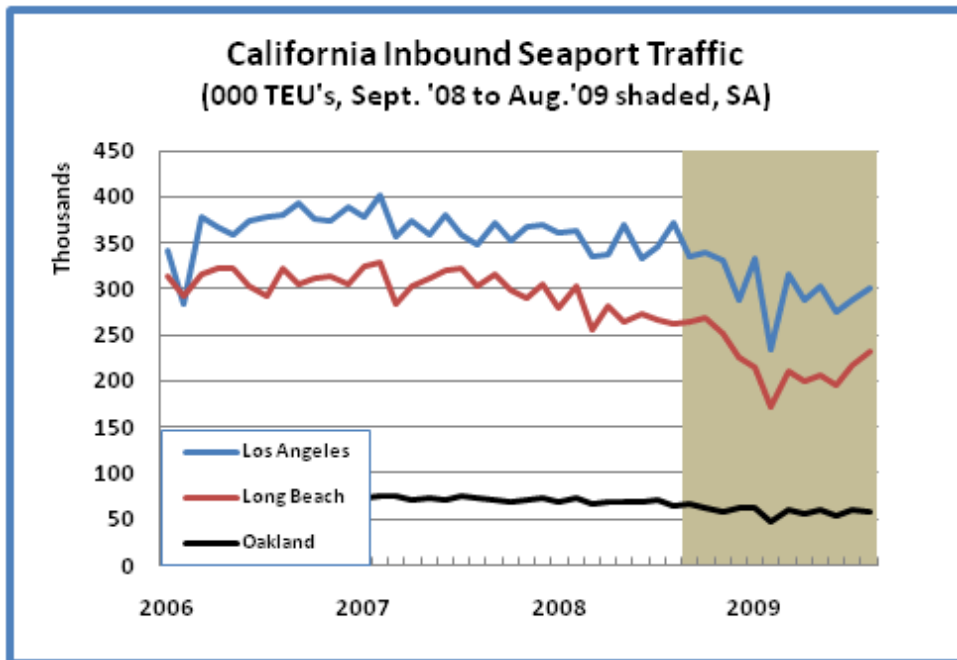
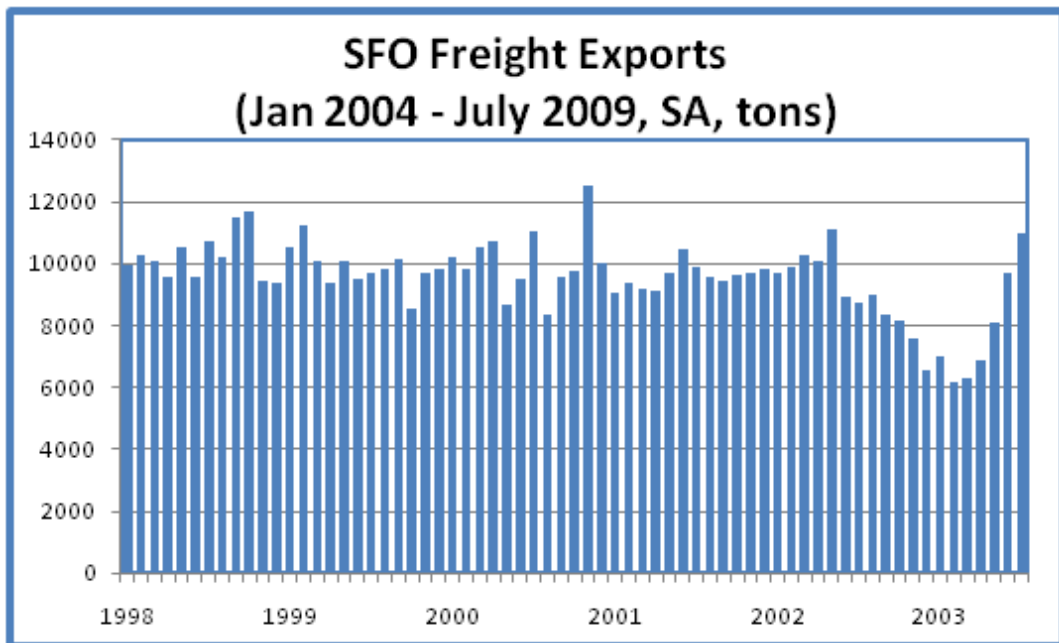


Growth of exports through California's seaports has been relatively steady since they hit a trough in the 1st quarter of 2009. The Port of Oakland, which is a conduit for exports of raw and processed food, raw materials, and forest products from the Central Valley and North Coast as well as machinery from Bay Area factories, has seen a steady rise of traffic and has returned to pre-recession levels of activity. Higher valued goods from Bay Area and Northern California factories and perishable and time sensitive exports typically travel by air cargo through SFO. At SFO exports climbed in the 2nd quarter and as of July, 2009 air cargo export tonnage was back to pre-recession levels. While the employment impact of this export growth has yet to be seen in the transportation, warehousing and durable goods manufacturing sectors, this increased activity bodes well for these sectors being the leaders in the early part of the recovery.

Manufacturing is particularly interesting in this context. Employment in manufacturing has been declining for some time. This is part of a transformation of the California economy from a final assembly manufacturing state to a knowledge based manufacturing state. The 2001 recession, the reduction of multi-lateral trade barriers and China's 2001 admission to the WTO all sped the process of this transformation. The current recession will undoubtedly take this one step further. Graphic local evidence is seen in the planned closing of NUMMI, California's last major auto assembly plant located in the East Bay city of Fremont. Though the loss of about 4,500 to 5,000 jobs in the East Bay is not welcomed, it is not unexpected either. The auto industry has been struggling for several years and GM, one of the two joint venture partners, was unlikely to be able to continue production, while Toyota, the other partner, with excess capacity of its own, would have been an unlikely savior. But the closing brings opportunities as well. California manufacturing is ready to grow again with the expansion of new technology manufacturing. This is illustrated in the East Bay by the examples of Tesla considering sites, including the NUMMI plant, for its new electric sedan factory, Solyndra expanding with a new plant in Fremont employing up to 2,000, and Mobius of Fremont developing cutting edge battery technology for hybrid and electric cars. While it is too early to tell how these and other new technologies will play out in terms of jobs, this kind of activity replicates the replacement of repetitive final assembly manufacturing with knowledge based design, development and manufacturing which has been occurring throughout California these past two decades. So the key issue with respect to the impact of the closure of NUMMI is the speed with which new job creation provides opportunities.

On the import side the picture is quite different. American consumers are not buying and the level of demand for imported manufactured goods from Asia's factories remains flat. In our national forecast we have very sluggish growth in U.S. consumption. While that helps both the U.S. consumer's personal balance sheet and the national balance of trade, it means that

the jobs associated with the importation and distribution of goods are not going to be returning to the East Bay in the near term.



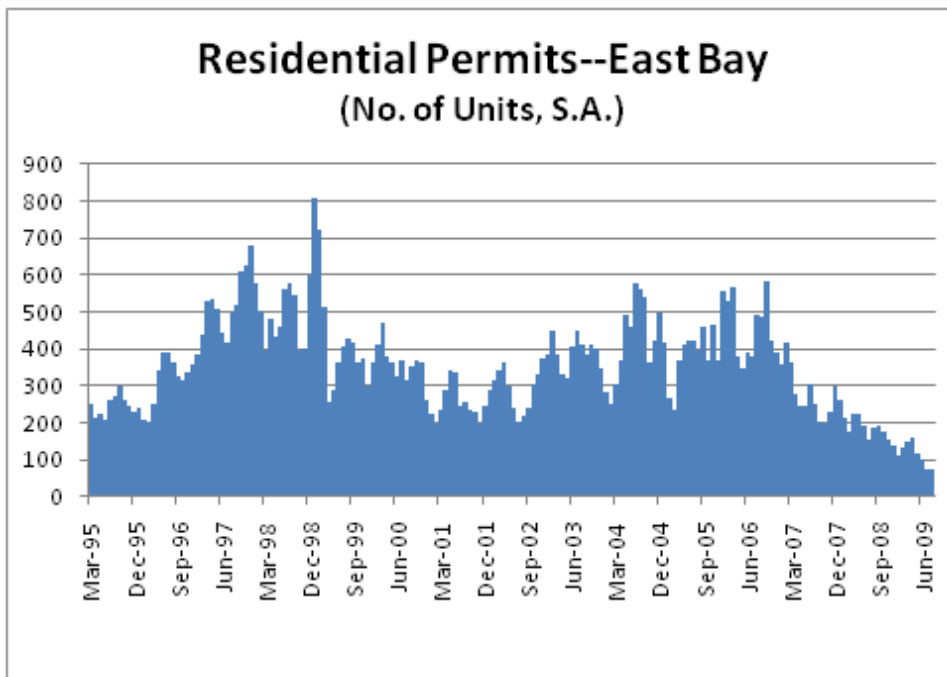
# THE HOUSING MARKET: ARE WE REALLY SEEING AN END TO THE DOWNTURN?

Another hopeful sign of a turn in the East Bay economy is found in housing markets. Almost four years have passed since housing prices peaked and home sales began to plummet. Builders were a little slow to respond to falling demand, but by the beginning of 2007 applications for new residential building permits had fallen off a cliff. Over the past year residential construction has been lower than at any time during the last three housing cycles. Picking a turning point in residential construction is always a risky proposition, and the data are not yet admitting of a clear signal that East Bay housing is in the throes of an incipient recovery. Hanging over this market is the potential for reductions in government employment in the near term. Nevertheless, there are a couple of hopeful signs that we may be at the bottom.

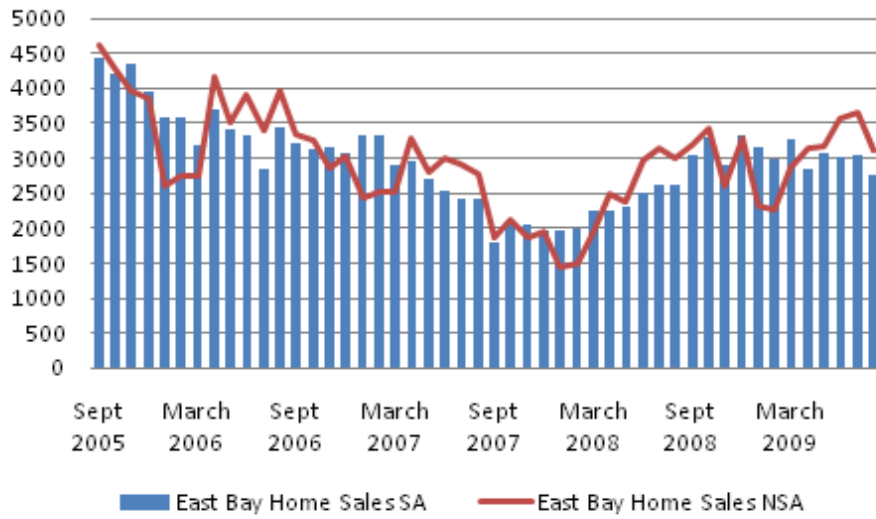
First, the 2004-2006 exuberance in housing markets drove prices to unsustainable heights above fundamental norms. Housing is an investment and therefore must carry a positive return. After adjusting for inflation, the historical return in the East Bay (1975-1995) was about 0.6% per quarter. If the return is calculated through 2002 it is slightly higher. Sustained appreciation above those returns is only possible if immigration adds substantial incremental demand to the housing market. The 2004-2006 incremental demand was not from a larger population, but from speculative purchases based on anticipated continued appreciation. The subsequent wave of foreclosures resulted in an unprecedented decline in home prices in the East Bay. This leads us to our first sign of a turn in the market. If one invested in a home in the East Bay in 1975 and sold it today, the home would have earned almost exactly the 1975-1995 average rate of return and less than the 1975-2002 average rate of return. In other words, all of the excess in price appreciation from the speculative bubble has now been wrung out of the market.

Second, home sales are picking up. Sales were at a low in the first quarter of 2009 and have since climbed back to 2006-2007 levels. They are not robust, and the trend is not clearly up, but the last three months has seen more home sales activity. Clearly prices, interest rates and incentive programs are helping, particularly with first time home buyers. What is encouraging though is the reduction in inventory. There are various estimates of inventory available, but the best estimates all suggest that inventories in the coastal areas of California are now at very low levels. So, low inventories, buyers in the market, little new construction coming onto the market, and prices which now make East Bay housing affordable once again all bode well for a near term turn in real estate and residential construction.

There is one important caveat to this optimism about East Bay housing. In the eastern portion of the region and further into the Central Valley housing was constructed for those who could not afford to live close to their work and who were willing to pay the price of long commutes for home ownership. These communities find themselves with substantial inventory and it is unlikely that residential construction will begin to recover during the early part of the incipient economic expansion.

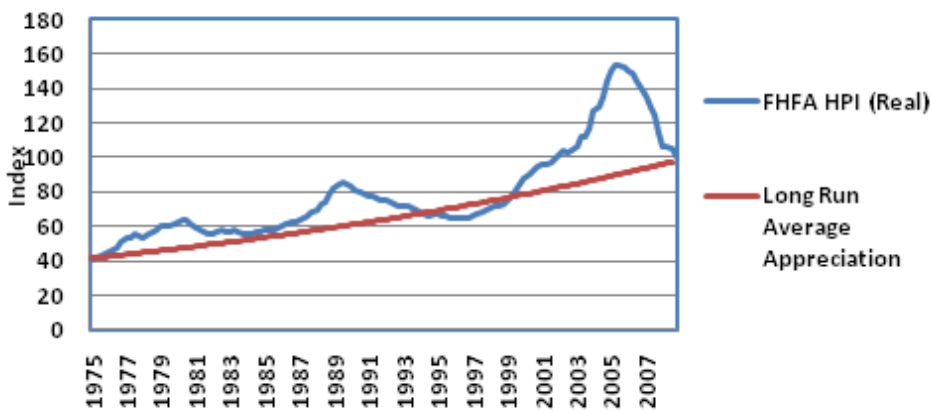


## Monthly Home Sales -- East Bay



## East Bay Home Appreciation

(adjusted for inflation)



# EAST BAY OUTLOOK

In the last East Bay outlook we were optimistic about the potential for export trade to turn around and lead the East Bay recovery. Exports continue to grow and employment in manufacturing, the source of 10% of job loss during the recession, is growing once again. With the IMF predicting an earlier and faster recovery of more of California's trading partners, we expect these positive trends to continue. The balance of the trade sectors will begin to see some growth induced by the last quarter inventory correction in the U.S., but robust growth in these sectors will not return until and unless consumers start spending again.

Layered on top of growth in trade and manufacturing will be the beginnings of a recovery in residential construction and the ultimate infusion of investment in renewable energy products, health care and infrastructure. None of these will happen quickly, but they are clearly on the way. The first allocation of research funds from the Department of Energy saw 20% go to Bay Area firms and the first allocation of \$5B of medical research and technology funds resulted in over \$200M in grants to Bay Area research projects. These funds were for storage technologies, CO2 scrubbing technologies, and transmission technologies, and for primary research in to disease prevention and control. Infrastructure funds, which make up a large part of the Obama National Recovery Act, are typically slow to arrive. Engineering, EIR's, land assemblage, public input and legal wrangling must all be put to bed before contracts are let and workers are hired. But the process has begun. Venture capital is still struggling with existing investments but 2nd quarter investments in California were up. Venture Capital is now beginning to place resources more heavily into medical technology, medical software and alternative energy, all strengths of Bay Area firms.

Our optimism is tempered however by the recognition that until the East Bay adjusts to a smaller government sector, there will remain a drag on the economy. Now that we know the magnitude of the overall contraction in general fund expenditures, the impact on the East Bay during the balance of the fiscal year has the potential for aggregate growth to be in the negative range and cut off the recovery in housing before it begins. For decades it was an advantage to have a large government sector with well paying, stable jobs. The lesson of this decade is that it is now a disadvantage. Until California decides to deal with periodic massive shortfalls in state revenue, or to downsize government to such an extent that it can fund itself through existing taxes in a recession, these supersized swings in government expenditure will occur. The East Bay's growth sectors, trade, technology, manufacturing, and health care are Henry J. Kaiser's "opportunities." The evolution of the East Bay economy to be less dependent on government will be painful, but will ultimately contribute to increased stability in employment, income, and the local tax base.

Our national forecast is for slow growth from the current quarter through the end of 2010 as U.S. consumers align their personal balance sheets with today's reality and as energy, autos, and finance adjust to a new, larger role for the Federal Government. The state forecast is more muted as the contraction in state expenditures through the middle of 2010 will provide a drag on state growth. This will be felt more heavily in the East Bay than in many other parts of California and we are expecting little to no growth in East Bay income and employment through the next few quarters. Thereafter, California should grow faster than the U.S. led by all three sub-regions of the Bay Area, Los Angeles and Orange Counties.

# Will California Watch the Take-Off From the Tarmac Once Again?

## The Answer Seems To Be, At Least Initially, Yes

Jerry Nickelsburg  
Senior Economist  
UCLA Anderson Forecast

This recession has been deep and wide. From housing and finance to retail, logistics and manufacturing, California has seen economic activity diminish. Now that there are signs of the end of the recession in the U.S., the focus turns to California, which initially led, but now lags the nation in the current cycle. The difficulty we have to go through before joining the recovery is the incipient contraction of state and local government. Comprising 16% of all payroll jobs, this sector alone will dampen the impact of the forces of recovery for the balance of the fiscal year. But the news is not all bad, though our takeoff will be delayed, we will ultimately get off the tarmac and take wing once again.

The good news comes from outside of Sacramento. The housing market is beginning to pick up. Now that prices in the coast cities have adjusted to levels which make existing homes more affordable, sales are increasing and conditions are becoming ripe for new residential construction. Already we have seen a jump above the trend levels of the 2003-05 housing boom in recent construction and finance jobs. In trade and manufacturing, there is fresh evidence that demand for California's export goods is beginning to increase. Though the consumer goods and services sectors remain very weak, consumer confidence surveys and the response to the "cash for clunkers" program provide indicators that consumer demand may be on the verge of recovery and the implosion of hospitality, retail, wholesale and transportation employment may be coming to an end.

The downside is unemployment. The numbers are ugly to say the least and will remain so for some time. More rapid growth than can be expected over the next twelve months would be required to bring the unemployment rate down. The overall outlook is not much changed from our June forecast. We are expecting little growth through the middle of 2010 and a take-off towards the latter part of next year.

## What Does The End of A Recession Look Like?

We are now in that phase of the recession where the downturn is slowing and the economy is ready to turn around. In terms of magnitude, the reduction in government jobs, the government section being the last to make major cuts in this downturn, does not rise to the level of the reduction in aerospace jobs in 1991 nor to that of internet job loss in 2001. But, it will have a larger impact than the disappearance of the sub-prime mortgage finance industry in Orange County in 2006. So it is a minor earthquake, felt statewide, but without too much damage. With increasing state revenues in fiscal 2010, the adjustment to a smaller government is expected to be over by mid-year 2010.

In 2011, things change dramatically. Government will not longer be cutting programs. The stimulus money from Washington will finally be flowing in significant amounts and California, with its technology advantage stands to get a greater proportion of the energy, infrastructure and medical innovation research monies than the rest of the U.S. So while 2010 will look a lot like the structural change years of 1970, 1991, and 2002, the subsequent year will look more like the early 1980s with California growing faster than the U.S.

## Conclusion

Overall, the outlook for the balance of the year is for little to no growth. The economy will begin to pick up some tail winds towards the end of 2010 and by the beginning of 2011 we will get off the tarmac and begin to grow at more normal levels. The keys to California's recovery remain a recovery in U.S. consumption which increases the demand for Asian imports and for products from California's factories, increased public works construction, and increased investment in business equipment and software. On an annual basis, our expectation is that total employment will contract by -3.7% in 2009 and will barely grow at a 0.2% rate in 2010. Once growth returns in 2011, employment will begin to grow faster than the labor force at a 1.9% rate and the unemployment rate will begin to fall. Real personal income growth will be -1.5% in 2009 and then return positive growth at 0.5% and 3.4% in 2010 and 2011 respectively.

# The Long Goodbye<sup>1</sup>

## Recession Over, But Recovery Very Sluggish

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Although the worst recession in seven decades likely ended in the current quarter, its negative effects will linger well into the next decade. As we noted previously, the recession had its origins not so much in imbalances in the real economy, but rather in the over-indebtedness of consumers and businesses that will take time to cure. Simply put it was a balance sheet recession.

That said, after four quarters of decline, economic growth is resuming. A lion's share of near-term growth will come from a dramatic reversal in inventories. After plunging at a revised annual rate of \$159 billion in the second quarter, real inventories are forecast to increase by \$12 billion in the fourth quarter accounting for almost 1 1/2% of real GDP. However, once the big swing in inventories is spent, growth will remain very modest for most of 2010. Two other important swing factors are the recovery in exports and the long awaited rebound in residential construction.

And so, if our view of sluggish overall growth is close to the mark, the unemployment rate will be above 10% well into next year. Also adding to the subdued recovery is our belief that after a two decade consumer spending binge based initially on rising stock prices and then on rising home prices fueled by extraordinarily easy credit has ended. Now consumers seeking to accumulate assets will have to do it the old fashioned way, by directly increasing savings through a reduction in consumption.

## Fiscal Collateral Damage

Starting with the Bush Administration's \$168 billion stimulus package in 2008 and ending with the Obama Administration's \$787 billion package in 2009, the federal government has gone all out in attempting to mitigate the effects of the recession and to engender economic recovery. Whether or not the programs work as intended will take time to sort out, but it appears that the increase in spending and tax cuts may have put a floor under last winter's decidedly weak economy.

However, the stimulus spending along with an increase in baseline spending and the effects of the recession have caused a decided worsening in the long-term fiscal outlook. The administration is now projecting cumulative federal deficits of \$9 trillion over the next 10 years. To call this collateral damage is to put it mildly; it looks more like a fiscal train wreck that international holders of large dollar balances might seek to avoid thereby triggering a significant devaluation of the currency. Given the fiscal outlook, sooner or later President Obama is going to have to give-up on a host of domestic programs and/or go against his campaign pledge not to increase taxes on households earning less than \$250,000 a year.

## Whither the Fed?

Now that Federal Reserve Chairman Ben Bernanke has been re-nominated, the focus will return to the substance of Fed policy. As difficult as it might have been for both the Fed and the Treasury to engage in their unprecedented interventions in the economy, the hard part is now ahead of them. It is one thing to intervene with the goal of saving the economy and restoring growth, it is quite another to take back the monetary stimulus to fight an incipient inflation in an environment of high unemployment. Market participants know full well that there is more than enough liquidity in the system to ignite a persistent inflation; not today but perhaps within a few years.

In order to deal with this threat we believe that the Fed will gradually shrink its balance sheet and begin to slowly move away from its zero interest rate policy in the third quarter of 2010. To be sure unemployment will still be around 10%, but the economy will have been growing, albeit slowly, for about a year by then. The argument for modest rate hikes will be that the financial emergency is over and that modest rate increases would have a minimal effect on the economy. In fact it could be viewed as a sign of strength in light of the fact the financial markets by that time would have returned to normal.

Bottom line: despite the weak outlook, we are no longer looking into an abyss.

[1] With apologies to Raymond Chandler.