

FRBSF WEEKLY LETTER

Number 92-24, June 19, 1992

Perspective on California

California has received a spate of bad news recently, ranging from the unrest in Los Angeles to a series of natural disasters: earthquakes, fires, floods, droughts—even pestilence.

The economic news is not much better. Most recessions are milder in California than they are nationally. But this time, California is in worse shape than many other regions, and its unemployment rate has been higher than the nation's for most of the downturn.

This *Weekly Letter* examines some of the issues that are important to California's economy. It concludes that improvement in the national economy should bring a recovery to California, although the problems California faces are serious ones that will delay and restrain the recovery.

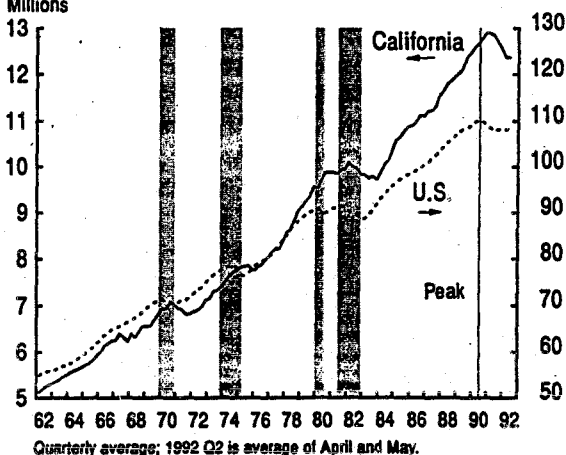
The importance of California

California is the seventh biggest economy in the world, and an important component of the nation's economy. It accounts for 12 percent of the U.S. population, 11 percent of national payroll employment, and 13 percent of the nation's personal income. Its ports handle 20 percent of the nation's imports and 17 percent of its exports, and the state produces 15 percent of the nation's exports. Over half of the exports are high-tech products such as computers, electronic equipment, and scientific instruments. Another 14 percent are transportation equipment, primarily aircraft and parts, while 6½ percent are food products.

A severe recession

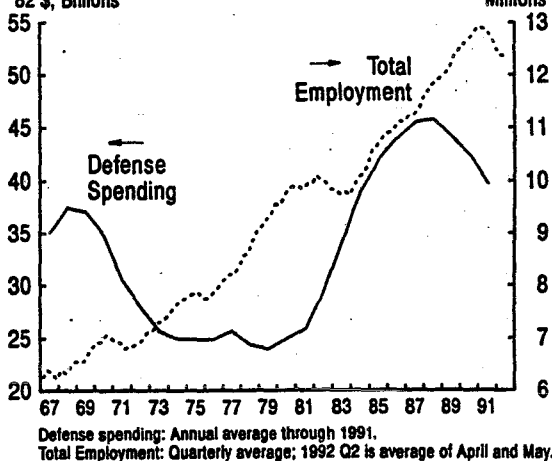
Currently, California is in its longest and deepest recession since World War II, and the first since 1970 in which it has done worse than the nation. The state has lost over half a million jobs since employment peaked in May of 1990 (Chart 1). Part of the state's problem is that the defense sector has been hit hard by cutbacks. Real defense spending in California has fallen more than 13 percent since its 1988 peak. And aerospace employment has fallen by about 20 percent during the last two years—a loss of over 50,000 jobs.

Chart 1
Nonagricultural Employment
Millions



While there is little good news to report in the California defense sector, some analysts have overemphasized its role in California's economy. The coincidence of defense cuts and national recession brings to mind the 1970 recession that was accompanied by the cutbacks related to winding down the Vietnam War (Chart 2). In that episode, cutbacks in California's defense spending continued until 1975. Yet California began its

Chart 2
California Defense Spending and Total Employment
'82 \$, Billions



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recovery in 1971. At that time, defense accounted for 11½ percent of the state's production, much more than the 7 percent defense provides today. This suggests that California could recover smartly from the most recent recession—even in the midst of defense cutbacks—if the rest of the economy is sufficiently robust.

Real estate and construction

The real estate and construction sectors provide an additional source of weakness. Almost a quarter of the construction jobs that existed early in 1990 are gone today. The value of new nonresidential construction awards in 1991 was less than half the 1986 peak. And the number of housing permits in 1991 was the lowest since 1982, at a third of the 1986 peak.

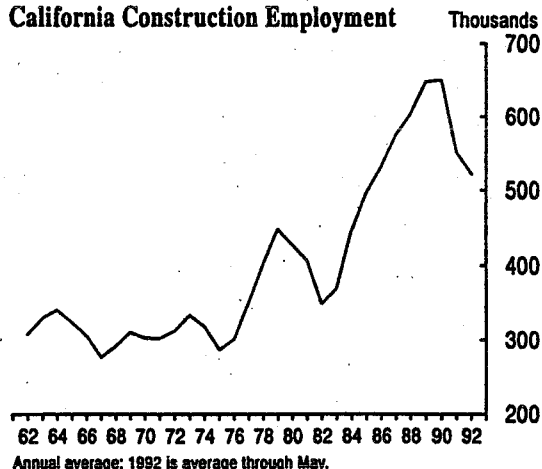
By most measures, California's current situation is comparable to other areas that have had real estate and construction downturns. California lost 27 percent of its construction jobs between the peak in March 1990 and the low point reached in February. By way of comparison, Texas lost 29 percent of its construction jobs during the mid-1980s, while New York State has lost 27 percent during its current episode. In contrast, New England has suffered a much larger decline in construction jobs, of 48 percent.

While there have been dramatic declines in commercial real estate values and in high-end residential values in some coastal areas, home values overall have held steady. Statewide, the median home price has been within the \$195,000 to \$200,000 range for most of the past three years.

California has weathered similar construction-related downturns in the past. This cycle is the fourth in the past 30 years in which construction employment in California has fallen by more than 20 percent (Chart 3). In fact, the percentage loss of construction jobs and the decline in home-building activity were just as deep during the early 1980s as in the current downturn. And in the middle and late 1980s California real estate boomed.

Of course, a boom in California real estate or construction is not likely during the next few years, mainly because the commercial real estate sector suffers from substantial over-building. For example, just last year, about 9 million square feet of new office space came on line in the Los

Chart 3
California Construction Employment



Angeles area. This raised the office vacancy rate to 22 percent, from 19 percent in 1990, and further depressed lease rates and property values. Projects under way assure the problem will get worse before it gets better.

But there are some promising signs on the residential side. Lower interest rates have been breathing some life into residential sales, and also bode well for an improvement in home-building activity. Though the number of housing permits has not yet picked up, the Western Blue Chip consensus forecast is that the number will be almost 20 percent higher in 1992 than it was in 1991, with an additional 35 percent pick-up expected in 1993.

Banking

Banks in California have seen profits plunge, as they have taken loan losses and built up loan loss reserves. In the fourth quarter of 1991, the California banking industry lost \$384 million. At the end of the fourth quarter, 7.0 percent of total loans outstanding were "problem loans;" the national number was only 6.1 percent.

It will take some time to work through the problem loans, particularly business and construction loans, even if construction activity improves. Even so, some California banks are reporting increased profits in the first quarter of this year compared with the first quarter of last year. This suggests that earnings for the California banking industry as a whole probably were positive for the first quarter, despite large losses at a few banks.

Business climate

Complaints about the state's business climate have grown to a loud chorus. In addition to the perennial problems of traffic, smog, and crime, the list now includes the high cost of workers' compensation coverage, a deteriorating public education system, and sometimes onerous smog abatement regulations. Moreover, the violence in Los Angeles has underscored the severity of that city's urban distress.

Despite slurs against the state's business climate, there is some good news. For example, 44 of the Fortune 500 companies are headquartered in California, an increase from 38 five years ago. And 17 percent of Inc. Magazine's 500 fastest-growing companies of 1991 also are California-based. These statistics make it clear that, in spite of its very real problems, many companies still find California a good place to do business.

Fiscal problems

Finally, the state budget is in trouble. A year ago, it took some last-minute maneuvering to close a \$14 billion shortfall. Current estimates of the budget shortfall for Fiscal Year 1992-93 range up to \$11 billion, including carryovers from FY 1991-92.

Improvement in the state's economy would provide a much-needed shot in the arm for revenues. But it is unlikely that the economy would improve enough to rescue the state's budget. A more realistic hope is that a modest recovery in California might reduce the severity of the state's budget problems somewhat.

Prospects

There is no denying the plethora of serious economic, social, and natural problems the state faces. Problems in the defense and commercial real estate sectors are likely to persist for at least a couple of years. And the state government is going to have to face some hard issues, made even harder by the budget crunch and a political environment that has been hostile to paying for government-provided services.

Nevertheless, some signs are positive. The national economy looks like it is finally back on a solid, if moderate, growth path, and that is good news for California. Research at this Federal Reserve Bank suggests that about three-quarters of fluctuations in California's economy are associated with changes in the national economy. Most forecasts of California's economy anticipate some noticeable improvement by the end of the year. In fact, currently available data suggest that employment stopped deteriorating last December.

It also is worth keeping in mind that California is a large—and wealthy—market that is still attractive to many businesses. Even though net migration from other states has dropped sharply in recent years, natural increase and some 250,000 foreign immigrants led to a 670,000 net gain in population during 1991. The energy and initiative these new residents bring to the state's economy provide a continuing source of new businesses and entrepreneurship.

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