

Dispelling Myths About The Bay Area Economy

**Robert T. Parry
President
Federal Reserve Bank of San Francisco**

**Bay Area Council
Outlook Conference**

**San Francisco
January 13, 1989**

Good morning, ladies and gentlemen. I appreciate the opportunity to share my views on the outlook for the Bay Area economy with such a distinguished group today. As a relative newcomer to the Bay Area, I have been impressed by this region's many strengths: its sheer physical beauty, its vitality, and its economic, cultural, ethnic, and even climatic diversity. After all, where else in the world does the local weather report give a range for maximum daytime temperatures of 55 to 100 degrees in the summer?

My task today, however, is not to extol the Bay Area's virtues, but to identify the key strengths and weaknesses that are shaping its economic outlook. I believe the key to the Bay Area's future will be its ability to adapt to rapid changes in technology and in the world economy. In this regard, the Bay Area excels. Our region boasts an intellectual and financial climate that thrives on creativity and innovation. In fact, the changes we're seeing in the region's industrial composition towards greater reliance on high tech industries are clear indications of our economy's adaptability.

But there are challenges. We must be able to continue to attract and retain the highly-skilled population that will enable our region to adapt to change. Thus, it is essential that we address the serious structural problems that threaten the quality of life of Bay Area residents.

I'll begin by dispelling some myths about the Bay Area's economy. Then, I'll discuss changes in our area's industrial structure. Finally, I'll discuss my outlook for the region and draw some conclusions. I'll keep my remarks brief to leave time for your questions and comments.

Myths About the Bay Area's Economy

There is a popular perception that the Bay Area economy has not fared well; that it is a weak sister to the southern part of the State. Reports that our region is losing its stature as a corporate headquarters location help to confirm this view. Likewise, many worry about the health of the region's high-tech sector since the semiconductor industry is said to be losing ground to foreign competitors. And everyone's pet fear is that the high cost of land and the high level of wages are pricing the Bay Area right out of future growth opportunities.

I'd like to dispute some of these assertions. First, over the past 15 years, the Bay Area's economy has been stronger than that of the rest of the state and of the nation as a whole. As a result of the restructuring that took place over this period, employment in the Bay Area grew at an incredibly strong average annual rate of 4.3 percent, outpacing the respectable 2.3 percent rate for the nation and the 2.9 percent rate for the rest of California. Admittedly, growth has slowed in the last few years.

Second, the Bay Area is not losing ground as a headquarters location. Although San Francisco itself has lost several major corporate headquarters in recent years, many of these firms merely relocated their headquarters elsewhere in the Bay Area. In fact, the number of Fortune 500 firms headquartered in the Bay Area actually remained pretty constant between 1977 and 1986, and increased from 18 to 22 in 1987, largely because indigenous firms grew to that size during this period.

Even that statistic understates our region's strength, however. The Bay Area is a fertile ground for new enterprises which, by definition, are not measured by Fortune 500 statistics. In 1987, for example, only 10 of the largest 50 cities in the United States reported increases in business starts. Three of those ten cities were San Jose, San Francisco, and Oakland. By the way, none of the others were in California. So, while the names and addresses within the region may be changing, the Bay Area's position as a home for corporations does not appear to be in jeopardy.

My third point concerns the high-tech industry, properly considered a kingpin industry in the Bay Area economy. Although lower-priced competition for commodity-type chip products is a real concern to the region's semiconductor industry, it poses relatively little threat to our position as a leader in high-tech development generally. The Bay Area continues to provide an excellent environment for the innovations that yield growth in such technology-related sectors as software development, data processing, and biotechnology. In fact, biotech first emerged in our region, and we continue to dominate this industry. Twenty-five percent of the nation's biotech firms are in California, and the two largest firms -- Cetus and Genentech -- are headquartered in the Bay Area.

Fourth, many cite the region's high labor and land costs as the harbinger of a slowing Bay Area economy. To be sure, average wages in this region are high. But wages are high partly because we have a highly-skilled, highly-educated population. Nearly 25 percent of the population has four or more years of college, compared with only 16 percent nationally. It is this high quality "human capital" that allows our economy to respond to technological and economic change.

Similarly, high land costs actually reflect the growing strength of the region, both as a place to do business and as a place to live. Surveys show that housing certainly is more affordable elsewhere. But the most affordable housing is in metropolitan areas such as St. Louis, Detroit, and Cleveland -- places whose economies lack the vibrancy we have here. The least affordable home prices are in Boston, New York, Washington, and San Francisco -- areas with high incomes and strong economies.

The final myth I'll tackle concerns the so-called demise of our traditional manufacturing base and our central cities. Broadly speaking, it is true that the Bay Area economy is coming to rely less on traditional manufacturing. Indeed, the share of total Bay Area jobs provided by manufacturing fell during the past 15 years. Moreover, the outlying counties are growing much faster than are the central cities. The relative declines of manufacturing and of the city centers are trends that are likely to continue. However, they are not unique to the Bay Area; these declines are typical of other cities throughout the U.S.

Nonetheless, some observers have seen these changes in our industrial composition as a problem to be solved. While I think it is important not to adopt policies that artificially encourage these trends, I'd like to point out that the patterns of growth we have observed can be viewed in a more positive light: they are manifestations of an evolving and flexible economy. The Bay Area has prospered in recent years precisely because its economy has become

more and more oriented toward businesses that can take full advantage of the region's human capital, amenities, and location. As such, it would be a mistake to stand in the way of this kind of industrial restructuring.

Important Differences

Our patterns of growth have differed dramatically from those of other metropolitan areas. It is here, in these differences, that I think our fundamental strengths are revealed.

One major distinguishing feature of the Bay Area's economy has been its orientation toward high technology and business services activity. Our region's high-tech revolution began with the semiconductor industry, which has doubled in employment during the past 15 years. Now, semiconductors, together with such other high-tech industries as computers, software, data processing services, and biotechnology, employ nine percent of the Bay Area's work force. Between 1974 and 1986, high technology alone contributed around 13 percent of the region's employment growth. This does not count all of the jobs created by derivative and support industries.

The business services area also has been a hallmark of the Bay Area. Services such as personnel placement, public relations, advertising, word processing, and other office services added 90 thousand jobs, contributing nearly 11 percent of the area's employment growth. Now, about 6 1/2 percent of the Bay Area's work force is employed in this sector.

Thus, technology and business services together have been responsible for about a quarter of the jobs created here during the past 15 years -- a much higher proportion than the 17 percent seen nationally. This is not surprising, given the specific strengths of the Bay Area.

There are many factors that explain the rapid growth of technology and business services. First, high tech and business services are industries that need the highly-educated work force that the Bay Area has to offer. Moreover, the region's world-class universities provide an important springboard for research and development. And finally, the region has the necessary venture capital for start-up firms and new projects. In fact, the Bay Area is a strong magnet for investable funds. Twenty-one of the top 100 venture capital firms in the U.S. are headquartered here in the Bay Area.

Restructuring in the Semiconductor Industry

These are all factors that contribute to the adaptability of the Bay Area economy. This adaptability will be tested within the region's semiconductor industry. During the past 20 years, the semiconductor industry has progressed from infancy towards maturity and, in the process, has enjoyed incredible productivity and income growth. But now that the industry is more mature, gains from new innovations will be harder and more expensive to come by.

In fact, if semiconductors follow the pattern of product development observed following other types of technological breakthroughs, most future productivity gains will be in manufacturing, not in new product design and

development. This could mean trouble for the Bay Area's semiconductor industry, because its highly-skilled and highly-paid work force is more suited to new product development.

Does this potential restructuring in the semiconductor industry spell disaster for high-tech in the Bay Area and for its economy generally? I think the answer is no on both counts. The semiconductor industry's impact on the region's economy has been important in the past, but it is not decisive for the future. We need to recognize that while semiconductor development was a major source of growth in the last 20 years, the Bay Area's most important contributions were in research, development, and entrepreneurship. Similar opportunities for rapid growth will come from breakthrough developments in emerging high-tech areas of superconductivity and biotechnology -- areas in which the Bay Area can assume a leadership role.

Outlook and Policy Challenges

Let me offer now the specifics of my outlook for the region. The region's economy looks solid. Population growth should remain around one percent annually for the region, and range from virtually no growth in San Francisco County to three to four percent growth in the outlying counties. I expect employment growth to slow somewhat to around 1 1/2 to 2 percent, largely because the level of employment in the region already is so high. The proposed closures of the Presidio and other Bay Area military facilities would diminish employment opportunities in the short run, but it's still too early to predict their long-run impact until we know more about how these valuable properties will be used.

Over the longer term, our economy's continued dependence on technological developments poses a challenge. For one thing, income growth will depend in part on the creativity and inventiveness of the Bay Area's people. But more importantly, expectations about the region's future potential will be based largely on the outlook for the region's key high-tech and service industries. If the outlook is bright, the region will attract the capital and innovative minds that will foster further growth.

In this regard, I do have some concerns which I think many of you share. There are serious structural problems that degrade the quality of life of Bay Area residents -- problems that threaten their creative and innovative potential. Anyone who has attempted to cross any of the Bay's bridges at rush hour knows that the existing transportation system is frustrating and inadequate. And further growth will only worsen the problem. Estimates show that even a two percent increase in employment can decrease travel speeds by eight percent at our current level of congestion.

In addition, while high real estate prices reflect our economy's strength, they also deter some individuals and firms from locating here. Moreover, even the modest increase in population growth I expect will cause real housing costs to outpace real income growth this year. Unless the supply of housing becomes more responsive than it has been in the past, I wouldn't be surprised to see housing costs rise at least five percent faster than inflation in 1989. This will strengthen the tendency for traditional manufacturing firms and jobs to move out of the area.

Finally, declining educational attainment at the elementary and secondary levels threatens to restrict the future availability of the skilled labor necessary for continued expansion. It also makes it harder to "import" the highly-educated young talent we need from other regions since these young workers are also parents who worry about educating their children.

Addressing these problems of transportation, housing affordability, and education at the local level cannot possibly yield sensible solutions for the region as a whole. For example, construction of moderately-priced homes is taking place primarily in the outlying counties within our region. As the residents of these areas attempt to commute to their jobs many miles away, an enormous burden is placed on our transportation infrastructure. Clearly, residential development and transportation policies are linked together within the region as a whole.

Fortunately, there is a growing consensus among academics, business leaders, and elected officials that we must begin to formulate regional policies. As a matter of fact, the Bay Area Economic Forum recently has been formed to help bring a regional perspective to the policy process. I am also heartened by the willingness of Bay Area residents to do more than talk about these problems; for example, the recently-enacted increases in bridge tolls and sales taxes signal a commitment to solving our region's transportation problems.

If our major problems are addressed effectively, the Bay Area should continue to attract and retain "the best and the brightest." In so doing, we will be able to meet the challenges posed by a rapidly changing technological and economic environment.