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- I. Thank you very much. I'm here today to talk to you about California, and as you know, the news isn't good.
 - A. We're still reeling from the civil disorders in L. A.
 - B. And we've had a series of natural disasters: earthquakes, fires, floods, droughts—even pestilence.
 - C. The economic news isn't much better.
 1. In most recessions, the worst you hear about California is that its economy has "paused."
 2. But this time, we're dealing with an outright contraction,
 - a. and an unemployment rate that has been higher than the nation's for most of the downturn.
 - D. In the face of all this grim news, I think it's easy to ignore the basic strengths and resilience of the state.
 1. So today I want to give you a broad perspective on the California economy,
 2. and I've prepared a few handouts to help tell the story.
- II. Let me start with some highlights about the state. **[Chart 1]**
 - A. California is the seventh biggest economy in the world, and a very important part of the nation's economy.
 1. 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.
 2. Its ports handle 20 percent of the nation's imports and 17 percent of its exports.

3. And the state produces 15 percent of the nation's exports.
 - a. Over half of the exports are high-tech products such as computers, electronic equipment, and scientific instruments.
 - b. Another 14 percent is transportation equipment—primarily aircraft and parts.

III. But California is in its longest and deepest recession since World War II, and the first since 1970 in which it's done worse than the nation. [Chart 2]

- A. The state has lost over half a million jobs since employment peaked in May of 1990.
- B. Real estate and construction are weak.
 1. A quarter of the construction jobs that existed two years ago are gone today.
 2. And the value of new nonresidential construction awards in 1991 was less than half the 1986 peak.
- C. Banks in California have seen profits plunge, as they've taken loan losses and built up loan loss reserves.
 1. In the fourth quarter of 1991, the California banking industry lost \$384 million.
 2. And 7.0 percent of total loans outstanding are now "problem loans;"
 - a. the national number is only 6.1 percent.
- D. The defense sector has been hit hard by cutbacks.
 1. Real defense spending in California has fallen more than 13 percent since its 1988 peak.
 2. And aerospace employment has fallen 18 percent during the last two years—a loss of 44,000 jobs.

- E. Complaints about the state's business climate have grown to a loud chorus.
 - 1. In addition to the perennial problems of traffic, smog, and crime,
 - 2. the list now includes the high cost of worker's compensation coverage, a deteriorating educational system, and sometimes onerous smog abatement regulations.
 - 3. And the upheaval in Los Angeles has underscored the severity of that city's urban distress.

- F. Finally, the state budget is in trouble.
 - a. Last year, it took some last-minute maneuvering to close a \$14 billion shortfall.
 - b. According to recent estimates, we're looking at an \$11 to \$12 billion budget gap that needs to be closed by June 30.
 - c. And dealing with recent civil and natural disasters will put a further burden on state coffers.

IV. It's no wonder that some observers say that California is in for some fundamental—and negative—change.

- A. But before we write off California's future,
 - 1. I think it's worth putting each of these problems into perspective,
 - 2. to get a sense of how seriously they threaten the longer-term health of California's economy.

V. Let me look first at real estate and construction.

- A. The percentage job losses in construction have been much less severe in California than in New England. **[Chart 3]**
 - 1. Actually, it's about comparable with the percentage decline here in New York.

- B. And, although we've seen dramatic declines in commercial real estate and in high-end residential values in some coastal areas,
1. home values overall have held steady.
 2. Statewide, the median home price has been within the \$195-200,000 range for most of the past three years.
- C. California has weathered similar construction-related downturns in the past.
1. This cycle is the fourth in the past 30 years in which construction employment in California has fallen by more than 20 percent. **[Chart 4]**
 2. In fact, the loss of construction jobs and the decline in home building activity were just as deep during the early 1980s as in the current downturn.
 - a. And in the middle and late 1980s California real estate boomed.
- D. I wouldn't want to predict a boom in California real estate or construction during the next few years,
1. mainly because the commercial real estate sector suffers from serious overbuilding.
 2. For example, just last year, about 9 million square feet of new office space came on line in the Los Angeles area,
 - a. This raised the office vacancy rate to 22 percent, from 19 percent in 1990,
 - b. and depressed lease rates and property values.
 - c. And projects already under way assure the problem will get worse before it gets better.
- E. But I *do* think there are fairly promising signs on the residential side.

1. Lower interest rates in the last few months are breathing some life into residential sales.
 - a. The number of home sales in the state is 5 percent higher than it was a year ago.
 - b. And the pieces are starting to fall into place for some improvement in residential construction.
 - (1) Though the number of housing permits issued has been flat since a sharp drop in 1990,
 - (2) the 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.
- F. Overall, since nonresidential building accounts for only about 30 percent of total statewide building, I think we've seen the worst of this construction cycle,
1. and I don't expect much more deterioration in measures of overall activity, such as construction employment.
 2. In fact, I wouldn't be surprised to see improvement before the end of this year.

VI. Now let me turn to banking.

- A. It's going to take some time to work through the problem loans, particularly in business and construction, even if construction activity improves.
- B. Troubled loans are declining as a percentage of loans outstanding nationally.
 1. And in this cycle, California banks seem to be following the national trend with about a one-year lag.
- C. But despite this, some California banks are reporting increases in first quarter profits over the first quarter of last year.

- a. This suggests that earnings for the California banking industry probably were positive for the first quarter, despite large losses at a few banks.

VII. The defense sector in California will probably get worse before it gets better. But I think it's a mistake to overemphasize its role in California's economy.

A. The role of defense cuts in this recession brings to mind the 1970 recession that was accompanied by the cutbacks related to winding down the Vietnam war. [Chart 5]

- 1. In that episode, cutbacks in California's defense spending continued until 1975.

B. Yet California began its recovery in 1971.

- 1. At that time, defense accounted for 11 1/2 percent of the state's production, much more than the 7 percent defense provides today.

C. So, even without a pick-up—or a leveling off—in defense spending, California managed to stage a robust recovery.

D. This suggests that California could recover smartly—even in the midst of defense cutbacks—if the rest of the economy is sufficiently robust.

VIII. Despite slurs against the state's business climate, there *is* some good news to report.

A. For example, 44 of the Fortune 500 companies are headquartered in California, an *increase* from 38 five years ago.

B. And 17 percent of Inc. Magazine's 500 fastest-growing companies of 1991 also are California-based.

C. These statistics make it clear that, in spite of its very real problems, some companies still find California a good place to do business.

IX. Finally, as the recovery takes hold in the state,

- A. the improvement in the general economy will go a long way toward resolving the budget crisis.

X. So where does California stand?

- A. I think a number of the signs are positive.

- 1. The national economy looks like it's finally back on a solid, if moderate, growth path, and that's good news for California.
 - a. Research at our Bank suggests that about three-quarters of fluctuations in California's economy are associated with changes in the national economy.
- 2. And most forecasts of California's economy anticipate some noticeable improvement by the end of the year.
 - a. In fact, employment seems to have stopped deteriorating last December.
- 3. It's also worth keeping in mind that California is a large—and wealthy—market that's still attractive to many businesses.
 - a. Even though net migration from other states dropped to around 35,000 in 1991,
 - b. natural increase and some 250,000 foreign immigrants led to a 670,000 net gain in population.
 - c. The energy and initiative these new residents bring to the state's economy provide a continuing source of new businesses and entrepreneurship.

- B. But there's no denying the plethora of serious economic, social, and natural problems the state faces.

- 1. Improvements in the defense and commercial real estate sectors are still at least a couple of years away.
- 2. And the state government is going to have to face some hard

issues,

- a. made even harder by the budget crunch
 - b. and a political environment that has been hostile to paying for government-provided services.
3. If there is a ray of hope, it's that the magnitude of these problems is changing what had been a fairly complacent attitude among some of the state's leaders and is generating some momentum to deal with them effectively.
- a. For example, a Governor's Commission headed by Peter Ueberroth recently proposed sweeping changes to improve California's business climate, including
 - (1) modifying workers' compensation laws,
 - (2) increasing the time children spend in school,
 - (3) and toughening the sanctions for bringing frivolous lawsuits.
 - b. In fact, Ueberroth was picked again to spearhead the rebuilding of South Central L.A.
4. But it will take a strong political will to address the most important item on the agenda—and that is providing the funds for investing in the state's future—both its infrastructure and its people.

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