

# FRBSF: Western Econ. Dev. (08/97)

## Western Economic Developments

August 1997

### [Executive Summary](#)

### [District Update](#)

- [Nonagricultural Payroll Employment Chart](#)
- [District Employment by State Chart](#)
- [District Manufacturing and Construction Indicators Chart](#)
- [District Employment by Industry Chart](#)

### [California's Economic Expansion](#)

### [Financial Conditions](#)

### [Alaska, Oregon, and Washington](#)

- [Nonagricultural Payroll Employment Chart](#)
- [Non-residential Construction Awards Chart](#)
- [Residential Construction Permits Chart](#)
- [Employment Table](#)

### [Arizona, California, and Hawaii](#)

- [Nonagricultural Payroll Employment Chart](#)
- [Non-residential Construction Awards Chart](#)
- [Residential Construction Permits Chart](#)
- [Employment Table](#)

### [Idaho, Nevada, and Utah](#)

- [Nonagricultural Payroll Employment Chart](#)
  - [Non-residential Construction Awards Chart](#)
  - [Residential Construction Permits Chart](#)
  - [Employment Table](#)
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## **Executive Summary**

*The District's economic expansion has been rapid and stable during 1996 and the first half of 1997, with payroll employment growth hovering near a 3 1/2 percent annual rate throughout the period.*

*During the second quarter of 1997, the District economy was led by accelerating employment growth in manufacturing and construction.*

*California's economy is thriving, and boom conditions are continuing in Nevada, Utah, Arizona, Oregon, and Washington.*

*Loan data for large banks headquartered in the District revealed solid overall growth in the second quarter, particularly for business and commercial real estate loans.*

*California's sustained economic expansion has produced a strong fiscal position for the state government and corresponding strength in other state economic indicators.*

## **District Update**

The Twelfth District economy continued on a rapid growth path during the second quarter of 1997. Nonfarm payroll employment expanded by 3.2 percent at an annual rate during the period. The District's overall economic expansion has been stable throughout 1996 and the first half of 1997, with yearly employment growth hovering at about 3 1/2 percent. This far outpaces the national growth rate and has led to substantial tightening in area labor markets; the District unemployment rate fell 1.2 percentage points over the past 18 months. Vigorous economic activity is evident in almost all areas, and the District contains 6 of the 9 fastest growing states in the nation.

The California economy is ranked ninth nationwide in its rate of job creation, and it has been a key source of the District's steady economic expansion. Although the rate of job growth in the state slowed between the first and second quarters of this year, other indicators point to a continuation of the state's strong growth trend. For example, the unemployment rate has fallen steadily this year, and the pool of unemployed is shifting away from job losers and towards entrants who have been lured into the labor market by persistently favorable conditions. Figures on personal income, taxable sales, and state government revenues also point to continued robust performance in 1997. Among other states in the District, the Washington economy has accelerated further in recent months, and boom conditions continued in Nevada, Utah, Arizona, and Oregon. Although growth in Idaho has slowed to a moderate pace in 1997, economic fundamentals in the state remain sound. The Alaskan economy picked up slightly in recent months, but conditions in Hawaii softened further.

Expansion of District manufacturing activities was rapid during the first half of 1997. Boeing's stepped-up production schedules continued to create new jobs at a fast pace in aerospace and related industries, and the company's recent merger with McDonnell Douglas will further stimulate aerospace production activities in Washington, Southern California, and other areas of the District. The aerospace expansion has combined with a resurgence in the Pacific Northwest wood products industries and continued vigor in the high-tech manufacturing sector. These factors spurred an acceleration in durable manufacturing employment growth to 4.1 percent at an annual rate during the second quarter. Construction employment growth also accelerated in the second quarter, despite a slowdown in California. District service-producing industries have continued on a strong growth path or accelerated in recent months.

For most states in the District, sustained stellar economic performance has produced strong growth in personal income and favorable fiscal conditions. In the first quarter of 1997, personal income for District residents was 7.7 percent above its level from a year earlier. Due largely to strong growth in personal and business income taxes, estimated revenues for fiscal year 1997 are high in most states. Most states plan to use their added revenues to support items--such as tax cuts, education, and highway and water supply infrastructure--that should further boost District economic growth in both the short and long terms.

### **California's Economic Expansion**

After accelerating substantially during 1994-96, the California economy has settled onto a strong and stable growth path in 1997. Sustained growth has considerably improved the state fiscal situation by generating substantial revenue increases over the past several years, and state expenditure plans should help to maintain growth in the near term. Several other indicators also point to continuation of the state's strong expansion.

### ***State Government Finances***

Most discretionary revenue and expenditure activity by the California state government takes place through the General Fund. As an illustration of the structure of the General Fund, [Table 1](#) shows projected revenues and expenditures by broad category from the Governor's proposed 1997-98 budget (as revised in May 1997).

Nearly half of the \$52 billion in state General Fund revenues are projected to come from personal income taxes, with most of the remainder coming from sales and use taxes. On the expenditure side, the General Fund primarily is used for educational purposes, with about 43 percent going to K-12 education and another 13 percent going to higher education. Most of the rest goes to health and welfare programs.

[Figure 1](#) shows yearly percentage growth in General Fund revenues for the years 1980-98 (deflated using the national CPI, and assuming a constant inflation rate during 1996-98). There were substantial real declines in state General Fund revenues during each of FY 1989-90 through 1993-94, except for FY 1991-92. The increased revenues in FY 1991-92 were due to increases in state income and sales tax rates rather than an improvement in state economic conditions. In contrast, General Fund revenue growth has been strong since FY 1993-94. The Governor's budget forecasts that revenue growth over the previous budget year will average about 3 percent in real terms during FY 1996-97 and 1997-98.

The 1997-98 budget figures reflect an increase in projected revenues of approximately \$2.3 billion between the Governor's initial estimates (January) and the latest estimates (May). This total increase in revenues available in 1997-98 is divided into \$1 billion for FY 1996-97 and another \$1.3 billion for FY 1997-98. The upward revision is based on an excess of state revenue receipts over projections for the 1996-97 fiscal year through April, with a related upward adjustment applied to estimates of expected revenues through the end of FY 1997-98. Over 95 percent of the net two-year upward revision is attributable to state income tax receipts that exceeded prior forecasts. Because state income taxes are highly elastic with respect to economic conditions, this figure suggests that the state economy has been performing even better than suggested by the traditional indicators used to form the state's revenue forecast.

On the expenditure side, the 1997-98 budget projects General Fund expenditures of \$51.7 billion, which represents an inflation-adjusted increase of 2.1 percent compared with the previous year; the corresponding real increase for 1996-97 was 5.3 percent. In addition to the upward adjustment to estimated available revenues, the May budget revision included a \$1.1 billion reduction in expenditure commitments, due primarily to reductions in health and welfare caseloads. Expenditures on each of the state's principal entitlement programs Medi-Cal, SSI/SSP, and AFDC/TANF have been revised downward for the current and budget years. For example, the Governor's revised budget assumes that AFDC/TANF caseloads will decline by 5.9 percent in 1996-97 and 10.1 percent in 1997-98. In contrast, the state Legislative Analyst's Office projects that the 1997-98 caseload reduction will be smaller (5.4 percent).

The funds freed up by declining entitlement expenditures are available for use in other programs. Combined, the May budget revision's increased revenue estimate (\$2.3 billion) and reduced expenditure commitments (\$1.1 billion) imply \$3.4 billion in total additional funds available for FY 1997-98. Of these additional funds, \$2.2 billion is intended for Proposition 98 spending on K-14 education programs.

In recent weeks, the state's executive and legislative branches engaged in additional negotiations to reach a final compromise budget plan. These negotiations were affected by the Governor's decision to

repay immediately \$1.36 billion that had been borrowed from the state employee retirement system in 1992 and 1993, rather than spread repayment over a 10-year period. The Governor's decision to repay the loan at this time necessitated that the May revision's spending proposals be cut by a significant amount in the final plan.

### ***Fund Balance and Debt***

Rising revenues during the past few years have substantially improved the state's General Fund balance and debt situation. [Figure 2](#) depicts the state government General Fund balance (actual or projected) for the fiscal years 1981-1998. The state government accumulated considerable operating deficits during the fiscal years (FY) 1989-90, 1990-91, and 1991-92 (the 1992-93 bar in the figure is indistinguishable from zero). These deficits were financed through rapid depletion of the state Special Fund for Economic Uncertainties, followed by several billion dollars worth of short-term loans. Since then, however, the state budget situation has improved considerably. The General Fund has been in surplus since 1993-94. These surpluses enabled the state to pay off the short-term debt financing by the middle of 1996. Since remaining surpluses are carried over to the next fiscal year, elimination of this debt burden freed up substantial resources in the FY 1996-97 and proposed FY 1997-98 budgets.

### ***Personal Income and Taxable Sales***

The strong growth in state revenues primarily reflects strong growth in personal income for California residents, along with increasing sales tax collections. [Figure 3](#) shows year-over-year growth rates for these two items. Substantial acceleration is evident after 1993-94. Although growth in taxable sales slowed in the first quarter of 1997, it is likely to return to its previous trend in the remainder of the year. Growth in personal income picked up recently. The quarter-to-quarter growth rate between 1996Q4 and 1997Q1 was 7.9 percent on an annual basis, which compares favorably to recent growth in personal income for the nation as a whole.

### ***Real Estate Markets***

Construction employment growth has been very rapid in California over the past year. Until recently, most of the growth in construction activity had been focused on private nonresidential and government infrastructure construction rather than new home building. Reflecting the softness in residential real estate markets, California median home prices declined from the middle of 1991 through 1996, as shown in [Figure 4](#). However, prices in the first half of 1997 finally increased a bit for the state, which suggests that the previous downward price trend may be reversing. This follows substantial increases that occurred in many parts of the San Francisco Bay Area during 1996. Although Southern California continues to lag behind the Bay Area, the 1997 figures for the state as a whole suggest that residential real estate markets may have turned the corner. Residential construction permits also have risen substantially: during the first half of 1997, the number of residential permits was running 16 percent above the 1996 pace.

## ***Summary***

The state's fiscal picture reflects steady recovery over the past several years, and strong economic performance during 1995-97 produced state revenues that exceeded initial budgetary forecasts. The resulting revenue windfall will be spent in a variety of potentially productive ways, with most focused on education; this should help state growth in the long-term, and perhaps stimulate short-term growth as well. Other indicators of the state economic picture such as income growth, taxable sales, and housing prices also point to continuing strong growth.

## **Financial Conditions**

Large banks headquartered in the District outside of California reported strong growth in total loans outstanding in the second quarter. Loan growth accelerated, following slowdowns in the two preceding quarters. The strength in overall lending reflected healthy growth in the business, real estate, and consumer categories.

Business lending at large banks headquartered in California slowed somewhat in the second quarter, but remained solid. Led by strong commercial real estate lending, total real estate loans grew modestly, reversing declines in outstanding loans for the two preceding quarters.

## **Alaska, Oregon, and Washington**

**Alaska's** sluggish economy strengthened slightly in the second quarter of 1997, with most major sectors posting employment gains. The recent pickup in employment reduced the state unemployment rate to 6.9 percent in June, nearly a percentage point below its average during the first quarter. The largest employment gains were in the retail and wholesale trade, services, and transportation sectors. Although the state is behind most others in its yearly rate of employment growth, Alaskans have benefited from excellent investment performance by Alaska's Permanent Fund; this performance generated a \$700 million deposit to the Fund's principal, and large return checks soon will be mailed to Alaska citizens.

Other economic news in the state is mixed. A recent federal ruling opened Alaska's air cargo market to most foreign airlines; substantial expansion of air cargo transfer operations now is planned at the Anchorage International Airport. However, Alaska's fishing and seafood processing industries have been hurt by a poor yield and falling prices, prompting the Governor to declare some fishing dependent regions in the state economic disaster areas.

After easing early in 1997, employment growth in **Oregon** returned to its previous trend pace-- about 4 percent annually--during the second quarter. Strong employment gains have combined with slower labor force growth to reduce the state unemployment rate by 0.8 percentage point over the past year, to 5.1 percent in June. Construction job expansion has slowed compared with the double-digit pace of

1994-96, but it continued to be very rapid, with employment growth averaging 9.5 percent at an annual rate during the first half of the year. Solid job gains were posted by all major industrial sectors except for the federal and state government sectors, which both shrank.

The manufacturing sector has been one of the key contributors to Oregon's economic expansion. Since December, over 5,300 jobs have been created in manufacturing; this represents about 20 percent of total net job creation. Over 90 percent of the new jobs have been in durable goods manufacturing, fueled in part by a resurgence of the lumber and wood products industry and by the continued expansion of high-tech manufacturing activities.

Economic growth in Washington has been vigorous, and it accelerated further in recent months. Payroll employment increased at a 5.0 percent annual pace during the second quarter, boosting employment growth to just over 4 percent at an annual pace during the first half of 1997. During the second quarter, the pace of employment growth in construction, trade, services, and government exceeded growth during the preceding five quarters. Strong employment growth has kept the state unemployment rate below 5.0 percent for the past two months.

The state's durable manufacturing sector has benefited from increased activity at Boeing, and the aircraft maker continues to gain strength. Recent approval by the Federal Trade Commission and the European Commission for the Boeing-McDonnell Douglas merger cleared the way for the companies to join forces by the end of August. Although employment growth at Boeing slowed slightly in recent months, the company estimates that it will need an additional 5,000 to 6,000 employees to meet scheduled production increases in 1998 and 1999.

### **Arizona, California, and Hawaii**

**Arizona's** already rapid economic expansion picked up a bit in recent months. Payroll employment increased at roughly a 5 percent average annual pace in the second quarter, after slowing to a 3 1/2 percent average annual pace in late 1996 and early 1997. Accelerating job growth in the construction, business services, and government sectors accounted for much of the recent pick up. The construction sector accounted for about 3,000 jobs out of the roughly 43,000 jobs added in Arizona during the first half of this year. The business services and government sectors each added about 5,000 jobs over this period. Arizona's economic expansion has been very broad-based, as sizeable gains also were posted in manufacturing, finance, and wholesale and retail trade.

Other indicators of economic activity point to solid economic conditions in Arizona during the past year. Through the first eleven months of the state fiscal year ending in June, retail sales were up 5 percent relative to a year earlier. During the same period, state general fund revenues were running 10 1/2 percent above their year earlier level, largely reflecting gains in individual and corporate income tax collections.

Although overall employment growth in **California** moderated slightly in the second quarter and July, most economic indicators point to a continuation of the underlying trend of rapid growth. Payroll employment increased by 2.3 percent at an annual pace during the past 4 months, down from the 3.3 percent average annual pace in late 1996 and early 1997. Construction employment jumped sharply near the beginning of the year and has remained high but was not followed by additional large increases in the second quarter. Also, the round of public school teacher hiring which boosted the local government job count in the first quarter was not repeated in the second quarter; however, additional teacher hiring is planned for the new school year. Several key sectors with smaller seasonal influences--such as manufacturing and business services--continued to exhibit rapid job growth during the second quarter.

Other California labor market indicators continued to be favorable in recent months. The state unemployment rate fell to 6.1 percent in July, down from 6.5 percent in April and a full percentage point below a year earlier. Furthermore, the fraction of the unemployed who are job losers continued to trend down through June; increasingly, the unemployed are new entrants or re-entrants to the labor force. Consistent with the declining share of job losers among the unemployed, initial claims for unemployment insurance in the state continued to trend down through June.

**Hawaii's** economy remains slack. Payroll employment edged down in the second quarter, after little change in late 1996 and early 1997. In recent months a decline in private sector jobs was partly offset by increased state and local government employment.

The Hawaiian fiscal situation is mixed. State general fund revenues bottomed out in fiscal year 1994-95, increased in 1995-96, and remained near the higher level in 1996-97. The state anticipates increased general fund revenues in the 1997-98 fiscal year and has approved multi-billion dollar infrastructure projects. However, bond rating agencies appear concerned about the state's ability to meet its financing targets. Furthermore, county governments have been hurt by reductions in their property tax base.

### **Idaho, Nevada, and Utah**

**Idaho's** economy has settled onto a moderate growth path in 1997. Payroll employment expanded at approximately a 2 percent annual pace during each of the first two quarters of this year, compared to 3 percent during 1995-96. However, in contrast to a flat 1996, construction employment has surged in recent months. Manufacturing employment gains also have been solid in 1997, led by strong recent gains in high-tech manufacturing employment. In contrast, weak demand for Idaho potato products has slowed food processing expansion in recent months, and the retail trade and financial sectors have shrunk in recent months. Despite moderated growth, the state unemployment rate has stayed down around 5 percent this year.



Preliminary data on Idaho's fiscal performance for the year ending in June suggest substantial continued strength in the state economy. State general fund revenues for the year were \$17.9 million dollars above the state's December forecast. This excess represents about 1 percent of total revenues for the year. About half of the revenue surprise came from corporate income tax payments, which combined with strong individual income tax payments to more than offset softness in sales tax revenues.

**Nevada's** booming economy picked up steam in recent months. Payroll employment grew about 7 percent at an annual pace during the second quarter of this year, compared with about 6 percent during the preceding two quarters. The recent uptick was led by a surge in construction employment growth, which was concentrated outside the state's major urban areas (Las Vegas and Reno). Growth in retail employment also picked up in recent months, and growth in local government payrolls has been particularly rapid in 1997, with a huge surge in June.

Nevada still ranks first among the states in its pace of annual job creation, well ahead of its closest rival, and the state unemployment rate continued to hover around 4.5 percent in recent months. Available indicators point to continuation of the state's sizzling growth streak. Nevada's bustling construction sector should be further stimulated in the months ahead by a recent sharp increase in nonresidential construction awards, and the state government has an estimated budget surplus equal to 16.8 percent of its general revenues for fiscal year 1997.

Economic growth in **Utah** accelerated in the second quarter of 1997, keeping the state on a very rapid growth track. Payroll employment growth had fallen below 3 percent at an annual pace in the first quarter, but it increased to 6 percent in the second quarter. Construction payrolls soared in May and June due to the start of a major state highway improvement project. Manufacturing activity also accelerated in the second quarter, with substantial employment gains recorded in both the durable and nondurable sectors. Most other sectors expanded at a good clip in recent months, and the state still boasts the District's lowest unemployment rate (3.1 percent in June).

Due to its strong economic performance over the past year, Utah has an estimated budget surplus equal to 10.1 percent of its 1997 general revenues. This increase occurred in spite of the cumulative impact of several years of state tax cuts, which has forced the government to make careful spending decisions; for example, a 1996 legislative measure earmarks a large chunk of state funds for local road projects and development of water supplies.