

Bifurcated No More?

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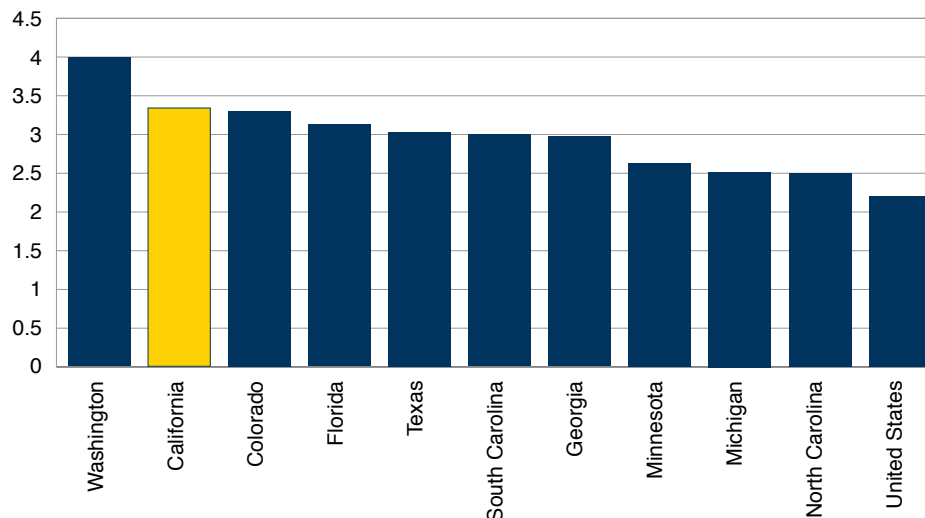
To describe how the two powerhouse states in the current economic cycle, California and Texas, came to be that way one need only answer “it has been all about tech and energy respectively.” With the fall in energy prices Texas growth slowed, but has now returned. California, however, kept zooming ahead. But as we move into the latter part of this business expansion these two states still dominate, but it is no longer about tech and energy. The landscape of the expansion has changed and this has some important implications for the California economic outlook.

Interestingly enough, that might change again in the coming year. The Keynesian stimulus of don’t tax and spend coming out of Washington will be sending demand California’s way and it will be felt most in the tech-centric coastal cities. In this California report, we reveal the why of it and extend our current forecast one year, to 2020.

Though California made a temporary tax more or less permanent, experienced record high cost of living, and has been prone to being characterized (both inside and outside of the State) as one of the most business un-friendly states in the nation, it has done remarkably well. Among the states with over 5 million in population, California GDP has grown consistently and over the period 2013 to 2017 is the 2nd fastest growing state after Washington (Chart 1). To be sure, The Golden State might have grown faster if taxes were low and if unfettered development induced in-migration rivaling the decades of the 60’s, and 70’s had been the norm, but No. 2 is not bad. Within the State this strong growth has been powered by the western Bay Area from Marin to Silicon Valley as those counties rode a tech wave felt all across the country. Drilling down to understand how current growth differs, we first examine the latest 3 and 12 months statewide, regionally and by sector.

Chart 1

Average Quarterly GDP Growth (2013 to 2017)



Source: BEA.gov

Employment Retrospective

California employment hit an all-time record high in January 2018. Non-Farm Payroll employment, which measures the number of jobs, is now over 16 million and it is 9.9 percent higher than its pre-recession peak. It is also 20.2 percent higher than at the depth of the recession. Total employment, which measures the number of people employed and includes farm workers and non-farm non-payroll sole proprietors is also at an all-time high at 9.0 percent above its previous peak and 16.3 percent above its recession low (Chart 2).

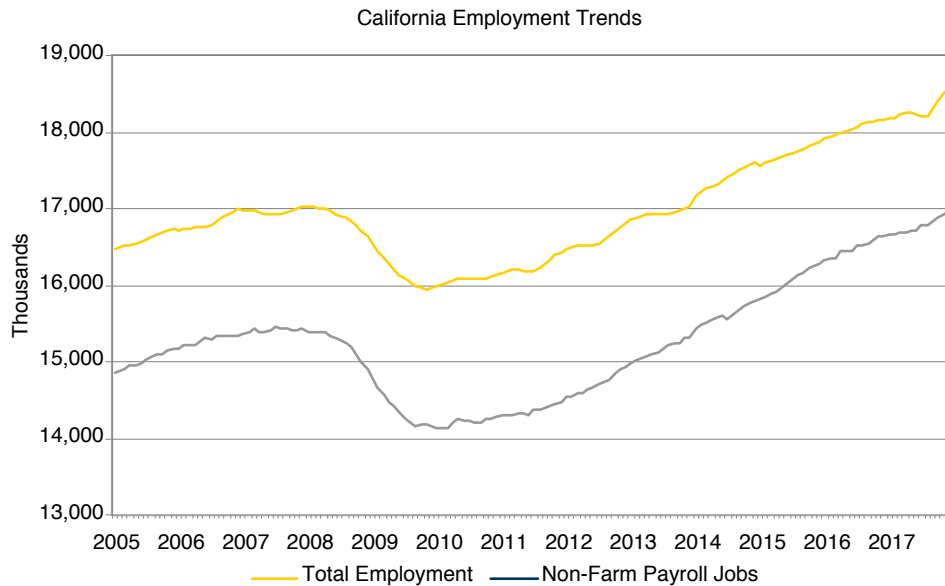
The important trend reversal can be seen in Silicon Valley, San Francisco and The North Bay. Earlier in the expansions they were growing much more rapidly than the U.S. and more rapidly than other parts of California. Now, on an annual basis, growth has slowed significantly. In San Francisco the high cost of housing and limited office space has undoubtedly taken its toll. This has also been the case in Silicon Valley, though to a lesser extent. In the North Bay it wasn't an economic event, but the tragic and devastating

wild fires that led to a setback in the latter part of the year (Chart 3 and Chart 4).

In spite of this slowdown, California continued to lead the nation in job growth with the slack in net new jobs in the Bay Area in 2017 being taken up by The Inland Empire, San Joaquin Valley, and Sacramento and the Delta. Over the last three months of 2017, employment growth accelerated in most of the State, with Inland regions outpacing some of the heretofore faster growing tech dependent regions. This time each year, one has to view the numbers with some skepticism as they will all be revised, perhaps substantially, on March 7, the day of the Forecast release. The history of the annual benchmark suggests caution. However, the relative changes revealed by the data today ought not to change.

With other parts of California now leading the employment growth charge, we expect to see a change in the composition of new jobs. Though the expected changes in the mix of jobs is there in the most recent data, the sectors that are dominating suggest this might be short lived. First, the health care and social services sector and the leisure and

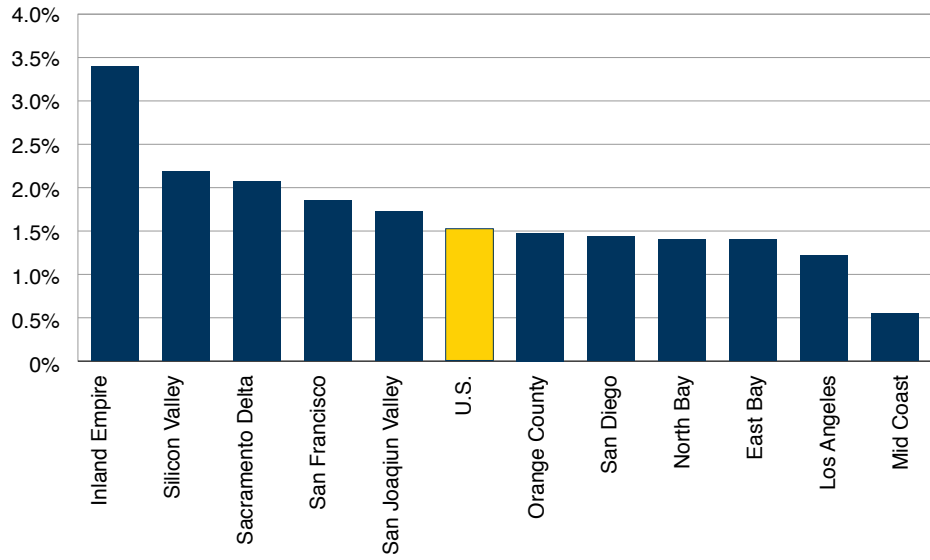
Chart 2



Source: www.edd.ca.gov

Chart 3

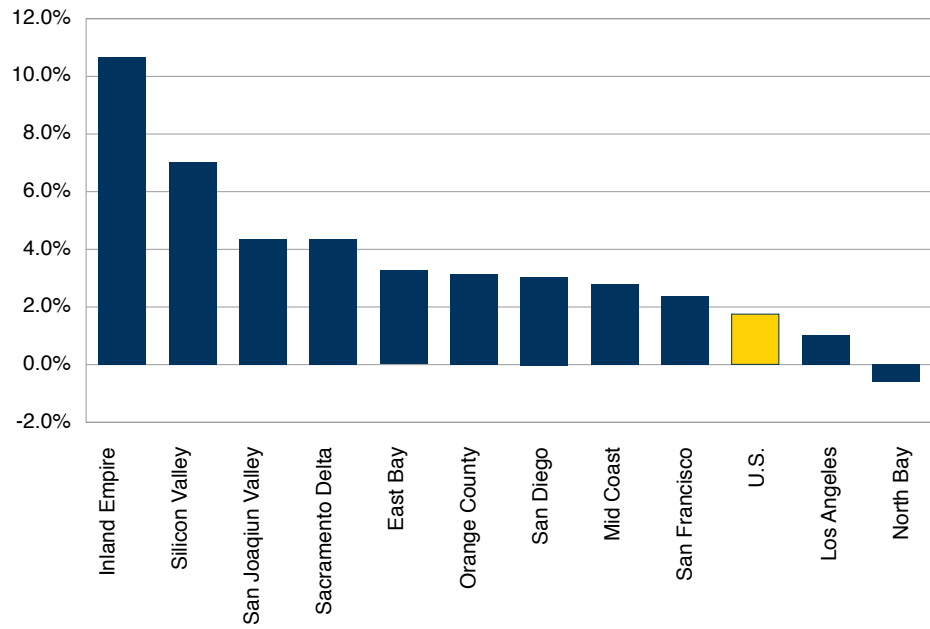
California Regional Job Gain
(Dec. 2016 to Dec. 2017, SA)



Source: www.edd.ca.gov

Chart 4

California Regional Job Gain
(Sept. 2017 to Dec. 2017, SA)



Source: www.edd.ca.gov

hospitality sector continue to lead in the number of jobs added. These are driven by income growth, public health policy and demographics, all of which have been favorable to this point.

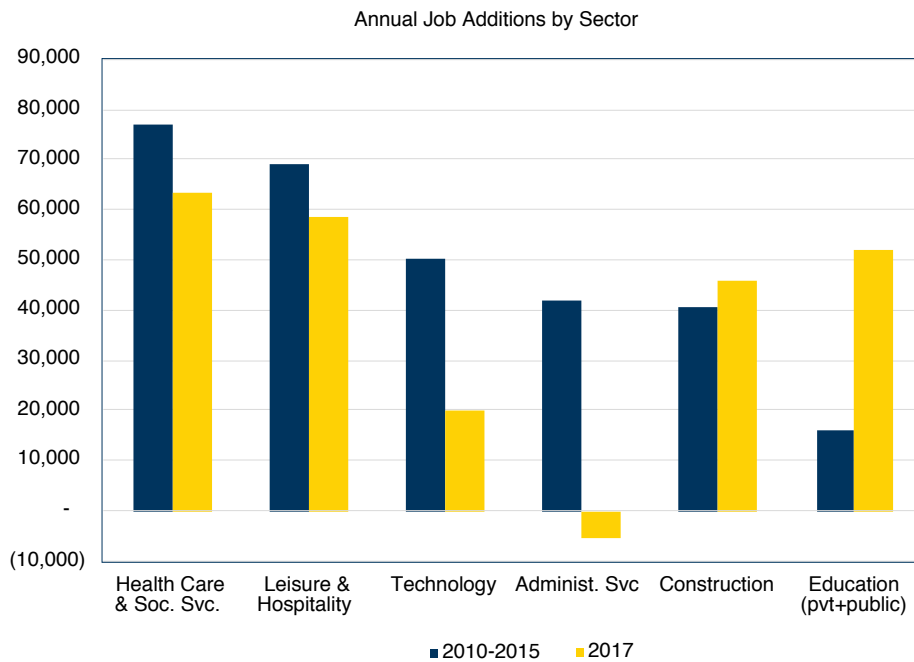
However, tech and administrative services which combined were a major contributor to job growth have now become only minor ones. Tech is defined as business, technical and scientific services and information. This has been an important source of wealth and income growth as well as employment. The administrative services sector includes consultants and temp workers. Temps are no longer being added in any significant numbers, further confirmation that job markets are tight and that potential employees can more easily sign on for payroll jobs with firms. In 2017 the number of consultants in California declined. This may also a sign of a tight job market with firms now investing in moving consultants and 1099 workers into payroll employees.

Replacing tech and consultants as a significant job creator is education. While more educators rather than fewer is clearly desirable as workforce development is one of the key issues of the 21st Century, one should be cautious about the implications for future growth. Non-education government was the fifth largest job generator in 2017. Of

the top five sectors in job growth last year three, health care, education and non-education government, are now dependent on tax revenues. Given the nature of these sectors – not being driven by demand generated innovations nor the economist’s perfect competition, one cannot expect California’s growth to maintain the pace it has experienced earlier in the expansion absent a comeback of manufacturing or tech, or a significant acceleration of construction. Indeed, this is the expected in-fill as the California economy drives ahead at full employment.

But the expected might have changed at the beginning of this year. There is now a budget resolution calling for a significant increase in the purchase of sophisticated defense durable goods. That will increase the demand for manufacturing and engineering in Southern California and technological developments throughout the State. Accompanying this is a Keynesian tax bill designed to stimulate investment spending. New capital goods are going to be labor savings and will employ equipment and software, fields that California is disproportionately heavy in. To achieve this more labor will be needed and wages will have to increase to draw the labor in, either from the sidelines or from outside the State.

Chart 5



Source: www.edd.ca.gov

The implication of the change in the mix of jobs and the regions where they are being generated are good for the State. Growth is now more balanced and the diversification of employment makes the State less vulnerable to one sector imploding. To be sure, if tech imploded as in 2001, it would be a serious blow to the State, but unlike 2001, the more balanced growth of today would focus the pain in one region rather than more generally. But the good news is that is not likely to happen anytime soon. Rather we expect the opposite for 2018 and though full employment will slow growth thereafter, California ought to continue to outperform the U.S.

The Forecast

Our current forecast changes the quarterly pattern of growth from that in the December forecast. This reflects a pulling forward in time investments that might have been made in 2019 but for the expensing of capital investment in the tax overhaul. Our national forecast has an otherwise overheated economy tamed by increases in interest rates and more restrictive monetary policy. This will dampen the growth of investment and consumer debt financed autos, housing and credit card purchases. That will, of course, free up resources, particularly labor, to meet the increased demand for defense, tech and export goods and services produced in the State.

We expect California's average unemployment rate to have its normal differential to the U.S. rate at 4.3% in 2020. While the overall forecast is not much different from

that released in December 2017, some economic activity has been pulled forward into 2018 due to changed fiscal policy. This results in a weaker 2020 than was implied by our previous forecast.

Our forecast for 2018, 2019 and 2020 total employment growth is 2.2%, 01.7% and 0.9% respectively. Payrolls will grow at about the same rate over the forecast horizon. Real personal income growth is forecast to be 3.1%, 3.6% and 2.8% in 2018, 2019 and 2020 respectively. Homebuilding will accelerate to about 138,000 units per year by the end of the forecast horizon 2020.

The risks to the forecast remain elevated. The increase in the Federal deficit will put pressure on the international trade deficit. That increases the likelihood of trade actions that would depress California's logistics and export industries. The forecast builds in increased investment from the incentives provided in the new tax law. Were the tax savings to go into dividends, stock buy-backs and mergers and acquisitions in a significantly greater way than we have predicted, demand for California made technologically advanced equipment and software will be less strong than currently expected. The third important risk is the assumption in our forecast that State and local governments will continue to facilitate more home building in an effort to mitigate California's housing shortage. If this were to abate in 2019 or 2020, the forecast would be too optimistic. On the upside, we are not assuming a significant increase in visas for tech agricultural workers. Were this to change it would increase California's workforce and our forecast would be too low.

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