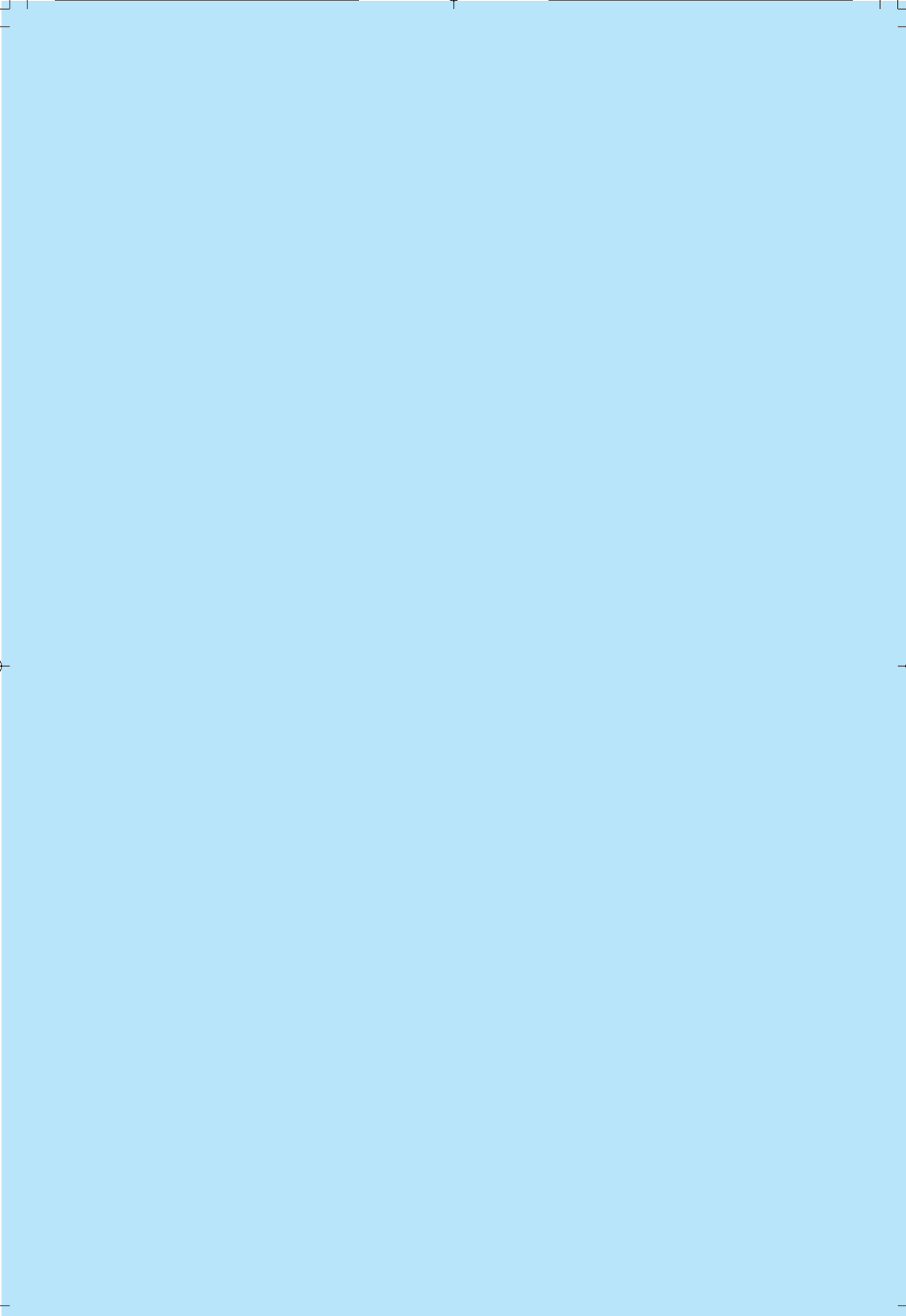




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# II

## PERSPECTIVES ON THE ECONOMY AND DEMOGRAPHICS





## *Perspectives on the Economy and Demographics*



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Economics and demographics play important roles in the outlook for California's budget. For example, revenue collections from the sales and use tax, personal income tax, and bank and corporation tax are significantly affected by the level of retail spending, personal income, and corporate profits in a given year. Similarly, population and economic developments within California have significant impacts on many of the state government's key programs in such areas as education, health and social services, and youth and adult corrections.

California's severe recession contributed to the major budgetary shortfalls confronting policy makers in the early 1990s. More recently, healthy economic expansion provided funds for both increased spending and tax relief in each of the past two budgets. The Governor's proposed budget for 1999-00 assumes that economic growth will continue in 1999 and 2000, but at a more subdued pace than in the past two years.

In this part, we review recent economic and demographic developments, discuss the forecasts contained in the *1999-00 Governor's Budget*, and provide our own perspective on California's economic and demographic outlook.

## THE ECONOMIC OUTLOOK

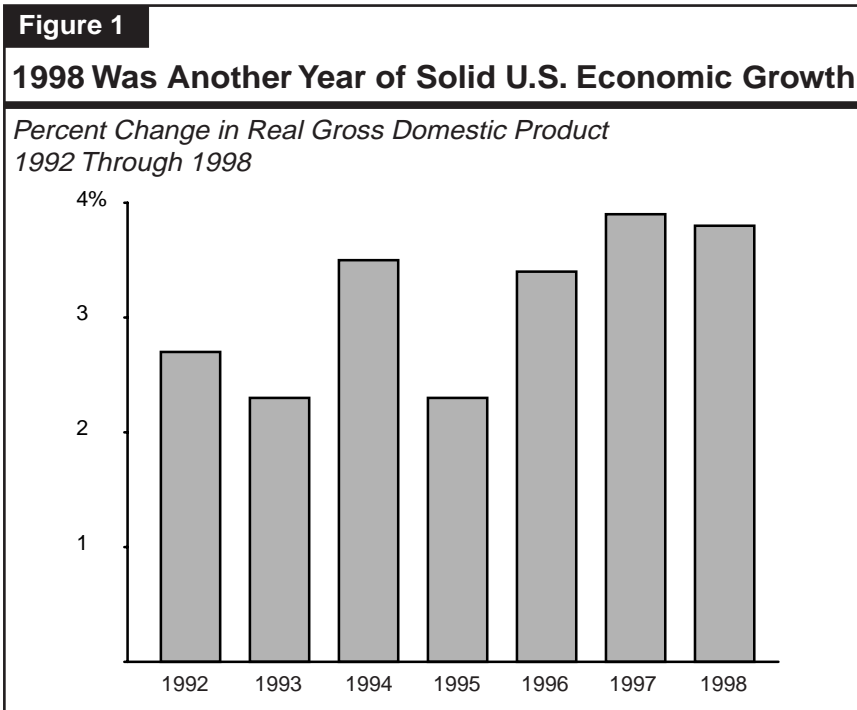
### Recent Developments

Despite concerns about the adverse impacts of Asia's economic and financial problems, both the U.S. and California economies experienced a year of healthy economic growth and low inflation in 1998. The positive trends continued through year-end, and 1999 is beginning with both the national and state economies in good shape.

#### National Developments

The U.S. economic expansion entered its eighth year in 1998, and is showing no signs of faltering. As shown in Figure 1, real gross domestic product (GDP) increased by 3.8 percent in 1998, the fourth year in the past five that growth in U.S. economic output has exceeded 3 percent. Growth in 1998 significantly exceeded the consensus of forecasts made at the beginning of the year (which called for a 2.5 percent increase).

Asia's economic problems resulted in a deterioration in the U.S. trade balance during the year. However, weakness in this sector was offset by



surprisingly strong growth in other sectors—particularly consumer spending on durable goods, home construction, and business investment—which benefitted from low inflation and interest rates. Specifically:

- *Personal consumption expenditures* increased by nearly 5 percent in inflation-adjusted terms, reflecting particularly large increases in sales of autos, home furnishings, and other durable goods.
- *Housing starts* reached 1.6 million units nationally in 1998, the highest level of the decade. With inventories of new homes at near all-time lows, the near-term outlook for home construction remains strong.
- *Business investment* in capital equipment grew by 16 percent in inflation-adjusted terms during the year. The overall increase was driven by a more than 50 percent increase in real expenditures on computers and office equipment.

The international trade sector weakened in 1998, as expected, due primarily to Asia's economic problems. During the year, exports were flat, while imports jumped by over 10 percent. This caused the trade deficit to increase from \$93 billion in 1997 to \$162 billion in 1998, subtracting nearly 1 percentage point from overall 1998 GDP growth.

***Inflation and Interest Rates Declined.*** Two of the more positive developments in 1998 were the unexpected declines in both inflation and interest rates—very unusual occurrences for the eighth year of an economic expansion. The increase in the Consumer Price Index (CPI) fell from 2.3 percent in 1997 to 1.6 percent last year, while the growth rate in the U.S. GDP implicit price deflator fell from 1.9 percent to 1 percent. These declines were brought about by lower international prices of oil, agricultural products, raw materials, and other commodities, caused in part by weak demand in Asia. These declines offset the effects of higher labor-related wage and benefit costs on U.S. product prices.

The combination of low inflation, monetary easing by the Federal Reserve Bank, and a federal budget surplus, contributed to a decline in interest rates in 1998. For example, the interest yield on 30-year Treasury bonds fell from slightly over 6 percent in the fourth quarter of 1997 to slightly over 5 percent by the fourth quarter of 1998.

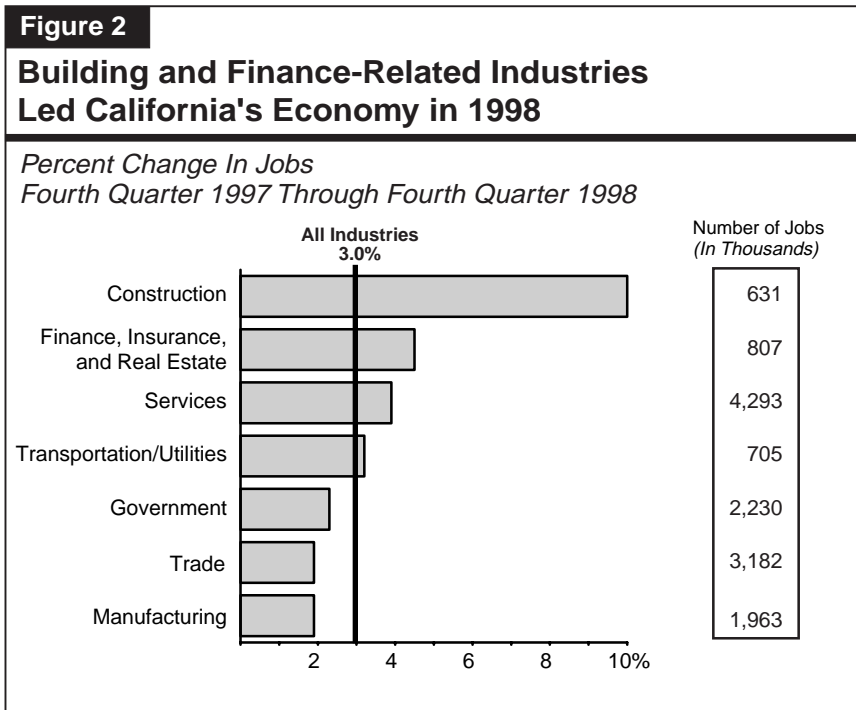
Low inflation contributed to gains in the purchasing power of U.S. households, which in turn helped boost consumer spending during the year. Similarly, the drop in interest rates contributed to increases in home sales and construction spending in 1998.

### California's Economic Performance

Like the nation, California's economy experienced healthy economic growth in 1998—despite the adverse impacts of Asia's economic and financial problems on key industries and geographic regions within the state:

- *Wage and salary employment* increased 3.2 percent, matching the gains in 1997. While employment declined in the state's high-tech industries, such declines were largely offset by healthy increases in the construction, finance, and services sectors of the state's economy.
- *Retail spending* increased at a solid pace in 1998. Inflation-adjusted taxable sales rose by 5.2 percent during the year, the largest "real" increase in over a decade.
- *Real estate activity* was very strong, with home sales reaching all-time highs, and construction activity climbing during the year.

**Job Performance By Industry.** Figure 2 shows that all major employment categories increased between the fourth quarter of 1997 and the fourth quarter of 1998. The fastest growing sectors were construction,



finance, and services, reflecting increases in consumer spending and real estate activity. More modest gains were posted by the transportation/utilities, trade, government, and manufacturing sectors.

## Asia—Recent Developments and Near-Term Outlook

Over the past 12 months, the major risk facing the U.S. and California economic expansions has been the potential adverse impacts of the financial and economic problems in Asia. A key concern was that the crisis would lead to a substantial slowdown in the U.S. economy, caused by major U.S. overseas investment losses, slowing exports, and rising imports from abroad. California was thought to be particularly vulnerable to Asia's problems, given that nearly one-half of the state's exports are to that region. An additional concern was that Asia's problems would spread to other global regions, including such emerging economies as Russia and those in Latin America.

Developments over the past year indicate that the worst fears regarding Asia's problems have not materialized. While Asia's problems have hurt high technology industries, the damage has thus far been largely offset by the positive effects on other sectors of lower interest rates and inflation.

### Export-Related Industries Have Suffered

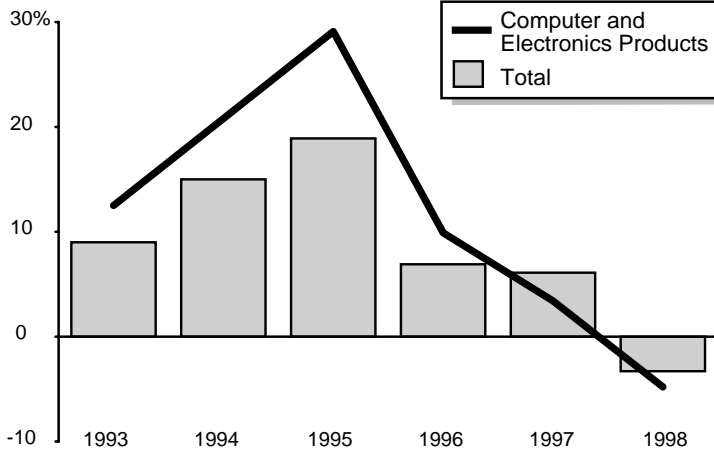
Growth in California exports was a key factor behind the early stages of California's current economic expansion. As shown in Figure 3 (see next page), total exports of California-produced goods increased by as much as 19 percent in 1995, led by major increases in computer and electronics shipments abroad. More recently, however, computer and electronics exports have slowed sharply, reflecting significant declines in sales to Asian countries. This led to a 3 percent decline in total California exports during the first three quarters of 1998 compared to the same period of the prior year.

The slowdown in computer and electronic exports has clearly had a negative effect on the state's high-tech industries. As shown in Figure 4 (see next page), employment growth in California's computer and electronics industries, which had been strong between 1995 and 1997, subsided beginning in early 1998, and turned negative during the fourth quarter of the year.

**Figure 3**

**California's Exports Falling**

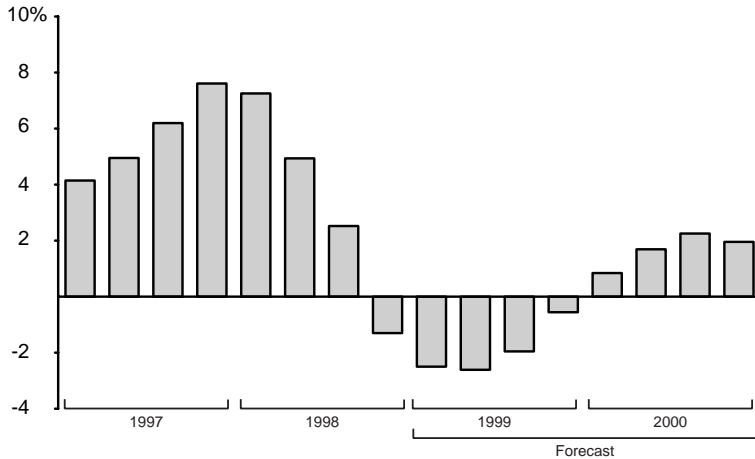
*Percent Change in California-Made Exports  
1993 Through 1998*



**Figure 4**

**Falling Exports to Asia  
Hurting California's High-Tech Industries**

*Year-Over-Year Percent Change in  
Computer and Electronic Manufacturing Jobs, by Quarter*



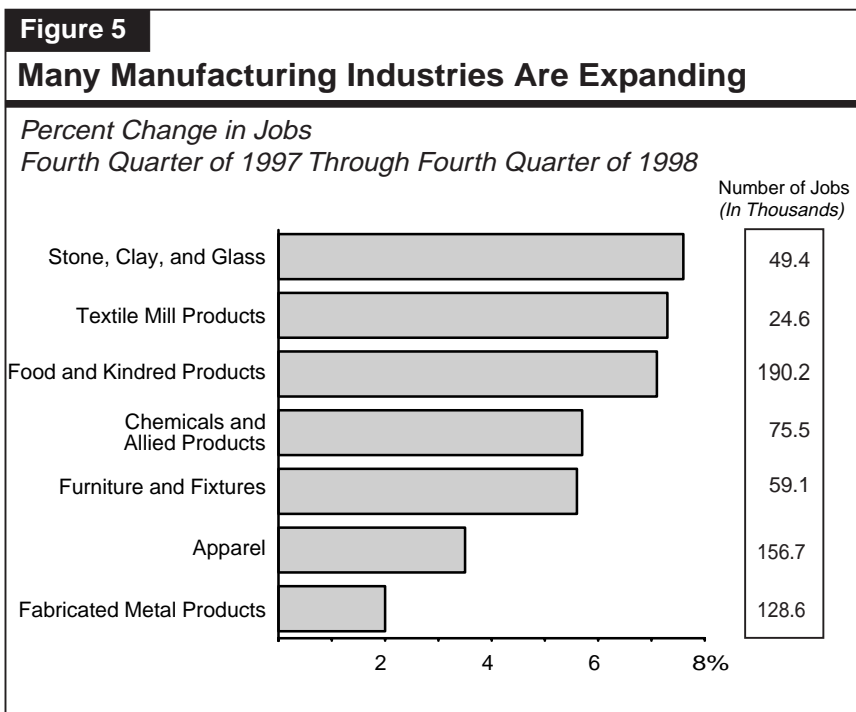


### But Other Industries Have Fared Better

Outside of high-tech and a few other industries directly affected by falling exports to Asia, the picture has been much brighter. As indicated above, both falling interest rates and low inflation have boosted consumption and real estate activity nationally and in California. Industries benefitting from these developments are experiencing healthy employment gains.

Even within the manufacturing sector there was a notable split between the performance of the high-tech category and other industry categories during the year. In terms of jobs, the declines in high-tech manufacturing were offset by increases in a number of other sectors. Such building-related sectors as stone-clay-glass and furniture-fixtures posted healthy gains during 1998 (see Figure 5).

Taking into account these positive and negative factors, Asia's impact on overall economic growth thus far has been a "mixed bag," with some industries suffering, and others actually benefitting from lower interest rates and inflation.





## Outlook For Asia Remains Important

While the effects of Asia's crisis have so far been muted by other factors, the state and the nation remain vulnerable to potential further negative developments abroad. For example, further steep declines in exports to Asia could deepen and thus exacerbate the current downturn in California's high-tech industries, thereby undercutting consumer and business confidence in the state's economy. Thus, the outlook for Asia is very important. The key issue is the extent to which Asia's problems will continue to pull down U.S. and California economic growth in the future.

At this point, there are encouraging signs that the Asian economic region as a whole is nearing the bottom of its "down" cycle, and that a recovery could begin late this year. However, the outlook remains fraught with risk, and serious problems could remain well into next year.

With regard to Japan (which is California's largest trading partner), analysts generally expect that the major fiscal stimulus package adopted by the Japanese government last year will help ease that country's recession, and eventually lead to a rebound. According to the "consensus" estimate of international forecasts, real GDP in that country is projected to decline by less than 1 percent in 1999 (compared to a 2.7 percent decline in 1998), before growing by 1 percent in 2000.

Other Asian countries are also showing signs that their economies are approaching the bottom of their economic cycles. The rates of decline in economic activity have been diminishing in many countries. In addition, inflation is stabilizing, and reforms adopted over the past year are beginning to take effect. Finally, stock markets in the region have stabilized and there are signs that foreign investment is slowly returning to the region.

While the region continues to face challenges associated with large loan losses and other factors, even a mild improvement will help stabilize the recent decline in California exports. This should, in turn, permit some recovery in the state's high-tech industries by late this year (see Figure 4 earlier).

## THE GOVERNOR'S BUDGET ECONOMIC OUTLOOK

The Governor's budget assumes that the U.S. and California economies will slow significantly in 1999 relative to their recent performances, before rebounding slightly in 2000. As shown in Figure 6, real GDP is projected to increase 1.9 percent in 1999, or slightly more than one-half the rate of 1998. In California, wage and salary employment is projected to increase 2.1 percent this year and 2.4 percent in 2000, compared to



**Figure 6**

**Summary of Budget's Economic Outlook**

	Projected		
	1998	1999	2000
<b>United States Forecast</b>			
Percent change in:			
Real GDP	3.6%	1.9%	2.2%
Pretax corporate profits	-3.1	-5.2	0.5
Unemployment rate (%)	4.5	4.8	5.1
Federal funds interest rate (%)	5.4	4.6	4.3
<b>California Forecast</b>			
Percent change in:			
Personal income	6.3%	5.1%	5.5%
Wage and salary jobs	3.2	2.1	2.4
Taxable sales	5.6	5.4	5.4
Consumer Price Index	1.9	2.4	3.0
Unemployment rate (%)	5.8	5.8	5.8
New housing permits (000)	126	152	166

3.2 percent in 1998, while personal income growth is projected to increase by 5.1 percent and 5.5 percent during 1999 and 2000, respectively, compared to 6.3 percent in 1998.

Key factors cited for the expected national slowdown include more-moderate gains in consumer spending and business investment, along with continued weakness in the international sector. California's economy is expected to slow in line with the nation's, reflecting the continued effects of Asia's problems on the state's high-tech sector. The budget assumes that state employment and income growth will continue to exceed the nation's in both 1998 and 1999, due to continued growth in California's building sectors.

While the budget forecast is consistent with other economic forecasts made last fall, strong year-end economic data, coupled with the rebound in the stock market, has prompted many forecasters to significantly raise their projections for 1999. As one example, Standard & Poor's DRI, which is among the largest of the national economic consulting firms, raised its forecast of real GDP growth from 1.9 percent as of November to 2.7 percent as of January. While this renewed optimism could be undercut by further negative developments abroad or by a sustained drop in the

U.S. stock market, it is nevertheless the case that the administration's forecast for both the nation and California is currently on the conservative side of the "economic consensus" of projections.

## THE LAO'S ECONOMIC FORECAST

Reflecting recent positive developments, the LAO's revised economic forecast calls for higher rates of growth in the U.S. and California economy than does the budget forecast. Our national and state projections are summarized in Figure 7.

### National Forecast

We assume that real GDP will slow from 3.8 percent last year to 2.6 percent in the current year, and then taper a bit more to 2.1 percent in 2000. Our projections assume that Asia's problems will continue to have a negative effect on net exports through most of 1999, and that both consumer and business spending will slow some in 1999 relative

**Figure 7**

### Summary of LAO's Economic Outlook

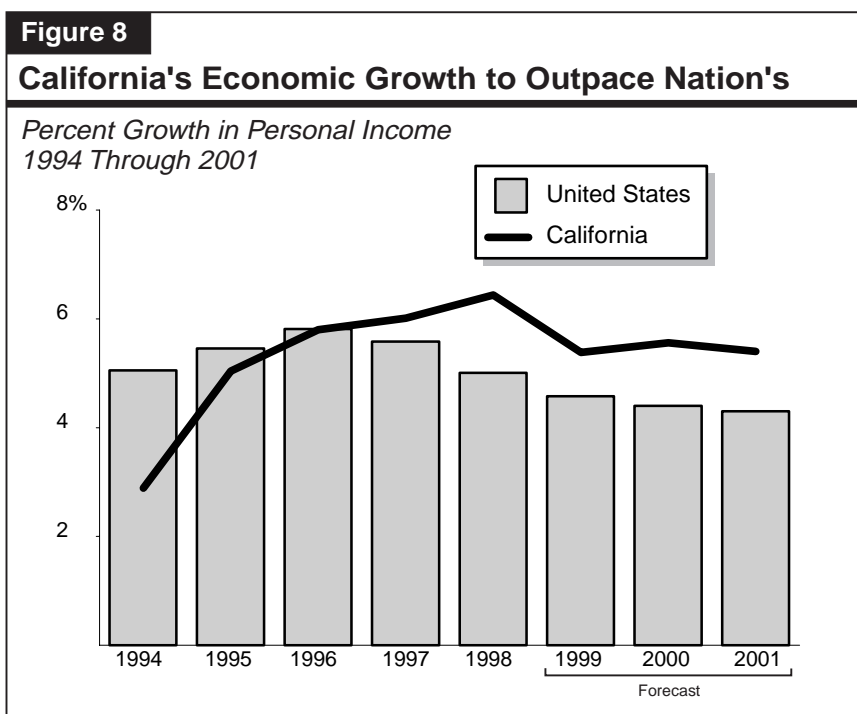
	Forecast			
	1998	1999	2000	2001
<b>United States Forecast</b>				
Percent change in:				
Real GDP	3.8%	2.6%	2.1%	2.0%
Personal income	5.0	4.6	4.4	4.3
Wage and salary jobs	2.5	1.7	1.6	1.4
Consumer Price Index	1.6	2.2	2.4	2.5
Unemployment rate (%)	4.5	4.5	4.6	4.9
Housing Starts (000)	1,614	1,585	1,500	1,480
<b>California Forecast</b>				
Percent change in:				
Personal income	6.4%	5.4%	5.6%	5.4%
Wage and salary jobs	3.2	2.4	2.6	2.4
Taxable sales	5.8	5.5	5.4	5.2
Consumer Price Index	2.0	2.4	2.7	2.9
Unemployment rate (%)	5.9	5.8	5.5	5.6
New housing permits (000)	125	144	172	175

to their above-average rates in 1998. Even with these slowdowns, however, we expect that the pace of economic expansion will remain moderate. Positive near-term factors include: high levels of consumer wealth, confidence, and real incomes; continued low interest rates; and continued strong business fixed investment, driven by businesses' need to modernize and increase output per worker in a tight labor environment.

Our forecast assumes that inflation will increase modestly over the next two years, with growth in the CPI rising from 1.6 percent last year, to 2.2 percent this year, and to 2.4 percent in 2000.

### California Forecast

We forecast that economic growth in California will subside this year, yet continue to expand at a moderate pace. We forecast that personal income will increase by 5.4 percent in 1999 and 5.6 percent in 2000, compared to 6.4 percent in the prior year. Our projections assume that California employment and personal income will grow faster than for the nation as a whole throughout the forecast period (see Figure 8), reflecting the relatively positive outlook for the state's construction, finance, and services industries.



### Characteristics of California’s Expansion Changing

The past year marked a change in the forces behind, and characteristics of, California’s economic expansion. The key elements of this change (depicted in Figure 9) include shifts in leading industries and regional growth patterns within California.

**Leading Industries.** The earlier stage of this expansion was led by booming growth in the high-tech and international trade-related industries, while the current phase is being led by *internally-driven* factors, such as rising population, wealth, and income within the state. These have caused a shift in the nature of the job growth that is occurring. Namely, the earlier expansion in high technology-related employment is being replaced, in part, by increases in construction, finance, services, and a variety of manufacturing industries outside of the high-tech categories.

**Regional Patterns.** With these industry changes has come a shift in employment growth patterns between the major geographic economic regions of the state. Year-over-year growth in jobs has subsided in the San Francisco Bay Area, due largely to an abrupt slowdown in employment in Silicon Valley. Offsetting this slowdown, however, has been a pickup in job growth in Southern California. We expect these trends to remain in effect through the forecast period.

Reflecting these changes, we expect that the fastest growing job sectors in 1999 will continue to be those most directly related to growth in population, income, and wealth—namely, construction, services, finance, and various manufacturing industries outside of the high technology sector.

<b>Figure 9</b>		
<b>Contrasts in California’s Economic Expansion</b>		
<i>1995 Through 1997 Versus 1998 Through 2000</i>		
	<b>1995 Through 1997</b>	<b>1998 Through 2000</b>
<b>General Features</b>	High technology and export-driven gains in computer hardware and software industries.	More diffuse and internally driven growth, related to population, income, and wealth.
<b>Leading Industries</b>	High-tech manufacturing and services.	Construction finance, retail trade, and varied services and manufacturing activities.
<b>Regional Aspects</b>	Focused in north.	Focused in south.

## Outlook By Sector

We believe that the industry growth patterns evident in 1998 (shown earlier in Figure 2) will remain in place through the forecast period. In particular, we expect that healthy gains will be experienced in construction, services, and finance industries, with more-moderate gains in retail trade, utilities and transportation, manufacturing, and government. Within the state's large services industry, we expect continued strength in business services—partly related to growth in software design—as well as in the areas of health care, engineering, architectural design, engineering, and management.

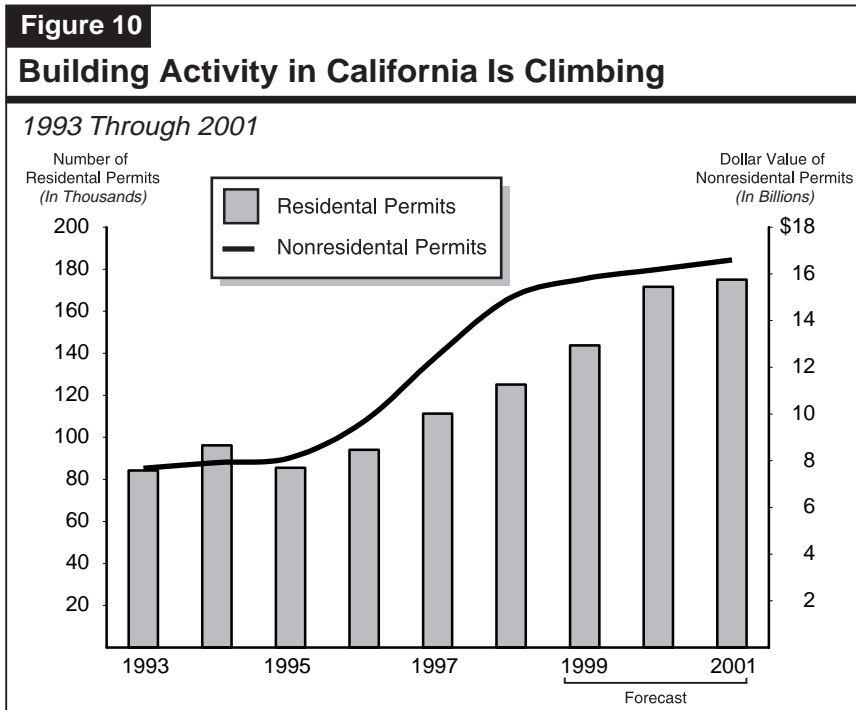
Subsectors within the manufacturing sector will continue to experience divergent performances. As indicated earlier, we expect that the state's computer and electronics industries will continue to experience job losses through most of 1999 before recovering in 2000. In addition, we expect that employment in the aerospace industry will fall over the next two years, reflecting announced job reductions by Boeing, Northrop-Grumman, Raytheon, and other aerospace companies. Employment in manufacturing industries outside these high-tech areas should experience moderate gains over the next two years.

## Real Estate Market to Remain Strong

A key to California's economic outlook is the continued growth in the real estate sectors. These sectors were very strong in 1998, characterized by record-high home sales, rising home prices, and substantial increases in both residential and nonresidential construction activity. Sales of single-family detached homes increased 13 percent to over 650,000 units (annual rate) in the third quarter of 1998, the highest quarter on record. The median price of homes sold reached \$206,000 during the same period, up 9 percent from the prior year.

The increase in housing activity has translated into higher building rates. Permits for new construction climbed to over 130,000 in the second half of 1998, the highest level since 1990. Nonresidential construction activity also was up sharply in 1998, reflecting an over 50 percent increase in industrial building, and a 16 percent increase in office building. All major geographic regions were up sharply during the year, except for the Bay Area. Particularly large gains occurred in Southern California, which posted over 60 percent gains in industrial building and a 75 percent gain in office buildings.

As indicated in Figure 10 (see next page), we expect that both residential and nonresidential construction activity will continue to climb in 1999 and 2000. Low inventories of new and existing homes, coupled with rising levels of population, employment, and personal income,



suggest that residential home construction will continue to increase. Nonresidential construction will continue to be led by new construction of industrial buildings, warehouses, and office space—particularly in Southern California. Low interest rates are also a positive factor in the outlook for both residential and nonresidential building. Despite these gains, the level of building is forecast to remain well below the levels achieved in the 1980s.

The projected increase in real estate sales and construction activity is a key element behind our forecasts for continued gains in the finance, construction, and various manufacturing sectors in the state.

### Key Risks to the Outlook

Last fall, some leading national forecasters rated the risk of a recession in 1999 as high as 50 percent. Since then the risks of a *near-term* economic downturn have faded significantly, due to the current momentum in the U.S. economy and the rebound in the U.S. stock market. In fact, as this report went to press, the performance of the national economy was continuing to exceed expectations. Nevertheless, both the U.S. and California economies continue to face signifi-



cant threats in late 1999 or in 2000, primarily related to a possible worsening of the global financial and economic situation. A second, and potentially related, risk is that the U.S. stock market will experience a steep and sustained drop in value, leading to a significant erosion in U.S. consumer wealth, confidence, and spending.

Most economists believe that if a recession were to occur, it would be relatively mild by historical standards, with the Federal Reserve Bank being able to blunt the impact of the downturn through reductions in interest rates.

### Comparison of Recent Forecasts

Figure 11 (see next page) compares our current economic forecasts for the nation and California to our November 1998 forecasts (see *California's Fiscal Outlook: The LAO's Economic and Budget Projections*, November 1998). It also compares them to those of the University of California, Los Angeles (UCLA) made in December 1998, and the Governor's January 1999 budget forecast.

Compared to both our November forecast and the administration's January forecast (which was prepared late in 1998), we see significantly stronger U.S. growth and modestly stronger California growth in 1999. The improvement reflects the greater near-term momentum in both the national and state economies, particularly in many of the interest-sensitive sectors. It also reflects the rapid recovery in the stock market at the end of 1998, which has added to household wealth and confidence levels.

## CALIFORNIA'S DEMOGRAPHIC OUTLOOK

California's population is highly dynamic along a variety of dimensions—including its growth properties, age composition, ethnic and racial mix, foreign and domestic migration trends, and intrastate mobility patterns. These factors significantly affect, both directly and indirectly, the state's economy, its revenue collections, and its expenditure levels. Consequently, the state's demographic outlook is an important element in assessing and projecting its budgetary situation.

### Population Growth Rate Increases

We project that California's population will grow at an average annual rate of 1.7 percent during the next three years, reaching 35.2 million by the year 2001. In numerical terms, California will gain about 1.8 million new residents—a population slightly larger than the Silicon Valley. We expect California's population growth to outpace the nation's in

**Figure 11**

**Recent Economic Forecast Comparisons<sup>a</sup>**

*Percent Changes*

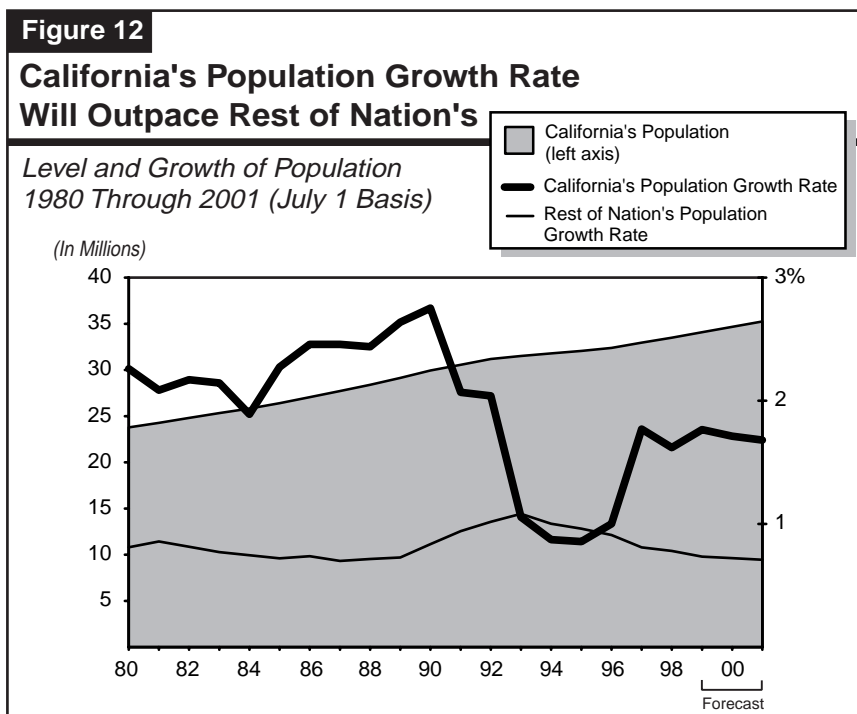
	1998	Forecast	
		1999	2000
<b>United States Real GDP:</b>			
LAO November	3.5%	1.9%	2.4%
UCLA December	3.7	2.5	2.8
DOF January	3.6	1.9	2.2
LAO February	3.8	2.6	2.1
<b>California Wage and Salary Jobs:</b>			
LAO November	2.9%	2.2%	2.5%
UCLA December	3.2	2.4	2.6
DOF January	3.2	2.1	2.4
LAO February	3.2	2.4	2.6
<b>California Personal Income:</b>			
LAO November	6.8%	5.2%	5.6%
UCLA December	6.6	5.3	5.6
DOF January	6.3	5.1	5.5
LAO February	6.4	5.4	5.6
<b>California Taxable Sales:</b>			
LAO November	6.1%	5.2%	5.6%
UCLA December	5.5	6.2	5.8
DOF January	5.6	5.4	5.4
LAO February	5.8	5.5	5.4

<sup>a</sup> Acronyms used apply to Legislative Analyst's Office (LAO); University of California, Los Angeles (UCLA); and Department of Finance (DOF).

each of the next three years. This is illustrated in Figure 12, which compares recent and forecasted population growth for California and the rest of the nation. As the figure indicates, the state's population growth rate fell below the rest of the nation's during the first half of the 1990s. However, we project that California's population growth rate will be more than double that of the rest of the nation by the end of the decade.

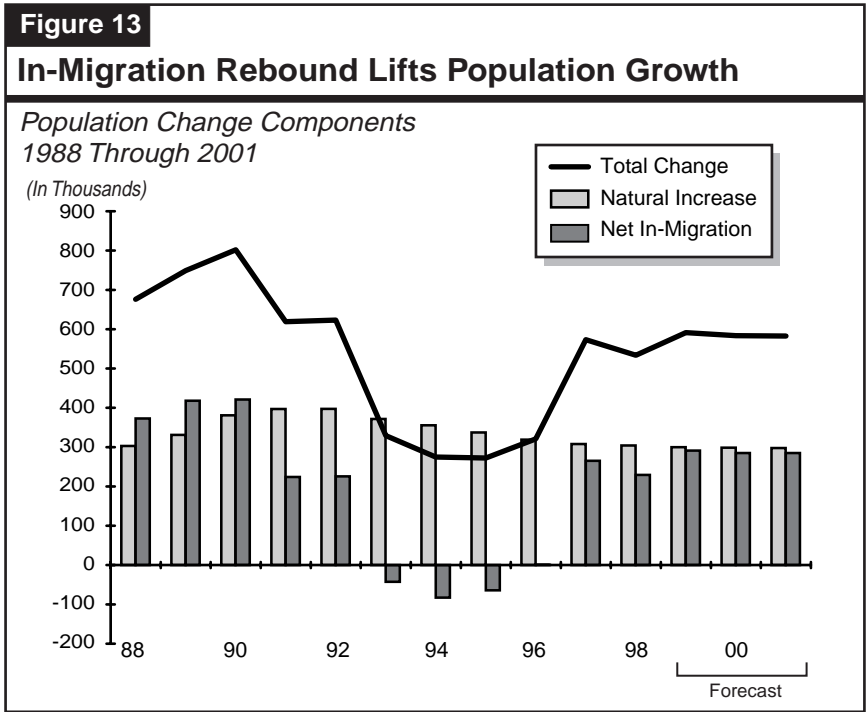
**In-Migration Helps Drive Population Growth**

There are two components to population growth—*natural increase* (the excess of births over deaths) and *net in-migration* (the difference between the number of people who migrate to California and the number that



leave). Figure 13 (see next page) shows the state's annual population change since 1988, and documents the contributions of each component. It shows that a sharp decline (and actual outflow in three of the years) in net in-migration is responsible for the slower state population growth in the early 1990s. Indeed, while natural increase remained relatively stable, net in-migration to California plunged in concert with California's extremely severe recession. That is, the state's severe recession discouraged people from coming to California who otherwise would have migrated to the state in search of economic opportunities.

**Migration Behavior.** In-migration itself can be broken down into two categories: *domestic* (population movements between California and the other 49 states) and *foreign* (movements between California and other countries). Substantial numbers of both domestic and foreign migrants made their way to California during the 1980s. California continued to experience a sizable in-flow of residents from other countries during the first half of the 1990s, but this gain was offset by a large-scale net out-migration of Californians to other states. Now that economic conditions have improved in the state, net in-migration has resumed; we expect net in-migration to add an average of 287,000 persons annually between 1998 and 2001.

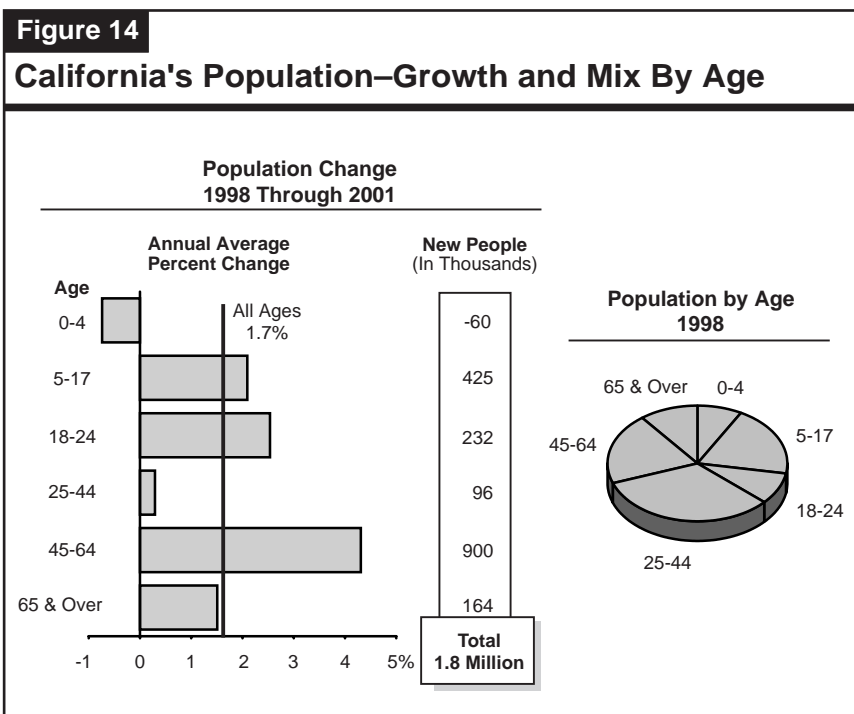


**Changes in California’s Age Profile**

Rapid changes are also taking place in the age distribution of California’s population. Figure 14 shows California’s age distribution as of 1998 and how its mix of age groups will change during the next three years. California’s workforce will grow older as the baby boomers enter their late 40s and 50s. Indeed, the 25-to-44 age group will stay relatively flat, as the baby boom cohort ages into the next older group. Growth in the K-12 school-age population and the 18-24 age cohort will be somewhat higher than that of the general population. Conversely, the number of preschoolers is projected to decline, while the elderly population is expected to grow moderately.

**What Effects Will These Trends Have?**

Demographic trends occurring in the state are key determinants of both state revenues and expenditures. In the case of expenditures, for example, program needs are influenced by caseloads, which are a function of such demographic factors as overall population growth and the age characteristics of the population. Likewise, revenues depend on such economic factors as income and job growth, which in turn are influenced by demographic variables such as the size of the labor force and the



number of people needing the various goods and services which businesses produce. Similarly, the housing market is affected by the population's age mix and household characteristics.

The rapid changes in the size and composition of California's population will have many implications for the future course of California's economy, and for the volume and mix of public services that will be needed in the budget year and beyond. For instance:

- Continued population growth will lead to both increased economic activity and additional strain on the state's infrastructure.
- Growth in the school age and young adult population will place greater demands on K-12 and higher education, job training programs, and possibly the criminal justice and correctional systems.
- The increasing diversity of the state's population will mean that many public institutions, especially schools, will have to serve a public that speaks a multitude of languages, and that has a wide range of cultural backgrounds.

