CENTER FOR CONTINUING STUDY OF THE CALIFORNIA ECONOMY

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California Economy Update

Prepared for:

The California Economic Summit on May 11, 2012

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Introduction

This report was prepared by the Center for Continuing Study of the California Economy (CCSCE) at the request of the management team as background for the California Economic Summit to be held on May 11, 2012.

The findings illustrate **that there is no single California economy but, rather, what we call the California economy is best understood as a collection of industries and regions.** Industry structure explains why California performed poorly in the recession but also why the state has a strong economic base that can be the foundation for competitiveness and future prosperity for residents.

The performance of key sectors including construction, technology, foreign trade, agriculture and tourism explains the job trends and future prospects and challenges for the state's many and diverse regions and California still leads in applying creativity and innovation to the development of new goods and services.

CCSCE's analysis supports the regional forum findings that there are many strategies best worked out and implemented at the regional level including many strategies related to workforce and infrastructure priorities and coordinated business outreach and permitting policies. At the same time, industries and residents face challenges that require state and federal action such as funding and access to higher education, state and national infrastructure planning, review of regulations, immigration and policies in support of research and foreign trade.

California competes for both entrepreneurs and talented workers and their families. This means that strategies must focus on making California a great place to work **and, at the same time,** a great place to live.

This decade will bring continuing and substantial demographic change.

Compared to the past 20 years, there will be no growth in the family age (35-54) groups. Most population growth will be in the 55 and above age groups and in the number of young adults. The baby boomers are moving out of the 35-54 age groups and beginning to move into retirement with implications for workforce--replacing the retiring baby boomers--and housing--where will young adults and aging baby boomers want to live and in what kind of housing.

And the state's ethnic composition will continue to change with most population growth coming in Hispanic and Asian groups with a mixture of continuing immigration and births.

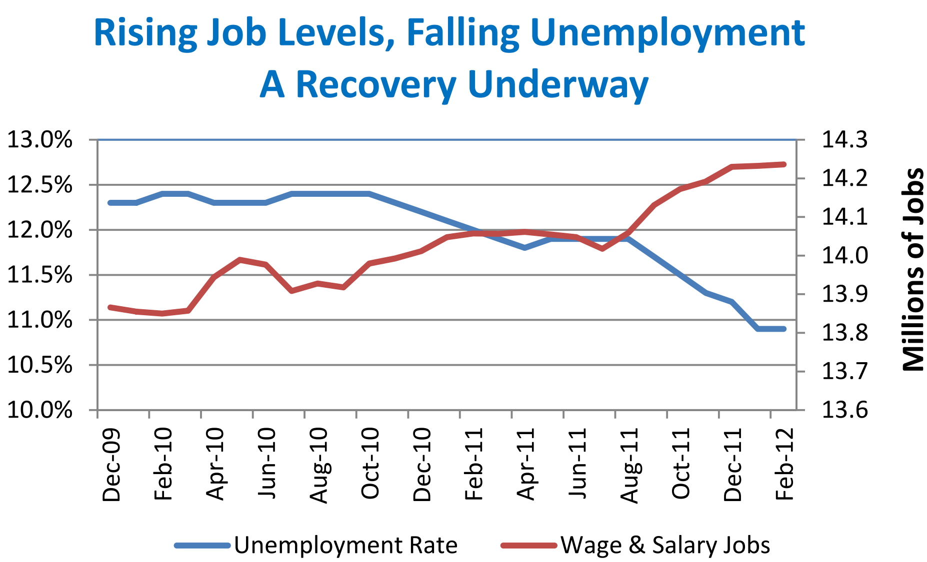
The purpose of this report is to provide an information background on the economy's current situation and futue prospects and challenges as a foundation for the Summit discussion of strategies and solutions.

California Economy Update

The performance of the California economy during the recession and the current recovery can be traced to trends in the state's key industry sectors. The state's economic regions have different industry structures and, as a result, job trends were and are different depending on which region we look at. Both from an analytical and policy perspective, it is helpful to think of the California economy as an economy of industries and regions.

An Economy in Recovery

Between December 2009 and February 2012 the state experienced a gain of 370,000 payroll jobs and a decline in the unemployment rate from 12.3% to 10.9%. Though the state and national economy are not producing growth strong enough to quickly bring unemployment rates down, the economy has **moved from recession to recovery.**

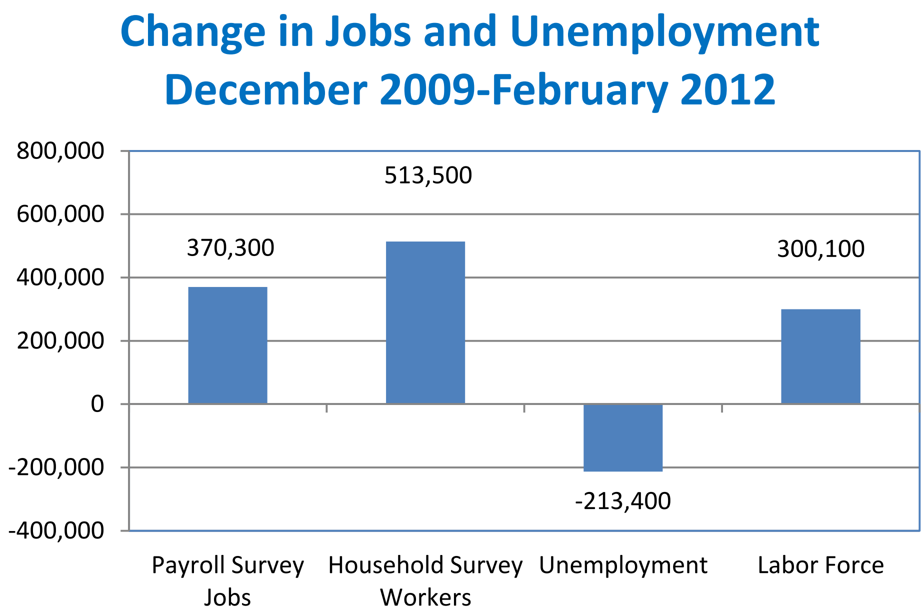


The state and nation job gains share two important characteristics:

1) The gains came despite job losses in the government sector and no substantial uptick in construction

2) The added jobs and reduction in unemployment were a small percentage of the recession losses and leave unemployment rates high though recent months brought some declines

The recovery looks stronger using the household survey data that is collected to determine the unemployment rate. The household survey shows a gain of 513,000 jobs compared to 370,000 in the survey of firms and it also shows that the unemployment rate went down during a time when the labor force grew by 300,000 residents. One explanation is that the household survey is capturing a gain in self employment and jobs at new firms that are not in the payroll jobs survey, which has happened in previous recoveries. The fact that people are returning to the labor force and finding jobs is encouraging though it is also true that 2 million residents remain unemployed, some for a long period of time.

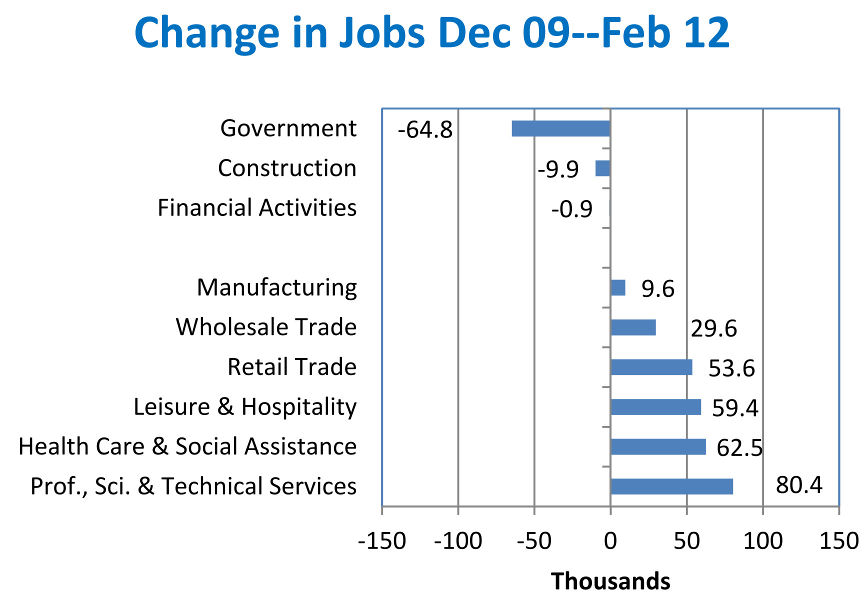


The Pattern of Industry Recovery

The state's economic recovery is being led by technology sectors along with industries related to foreign trade and tourism. In addition agricultural sales and exports set records in 2010 and employment has risen slowly in 2010 and 2011.

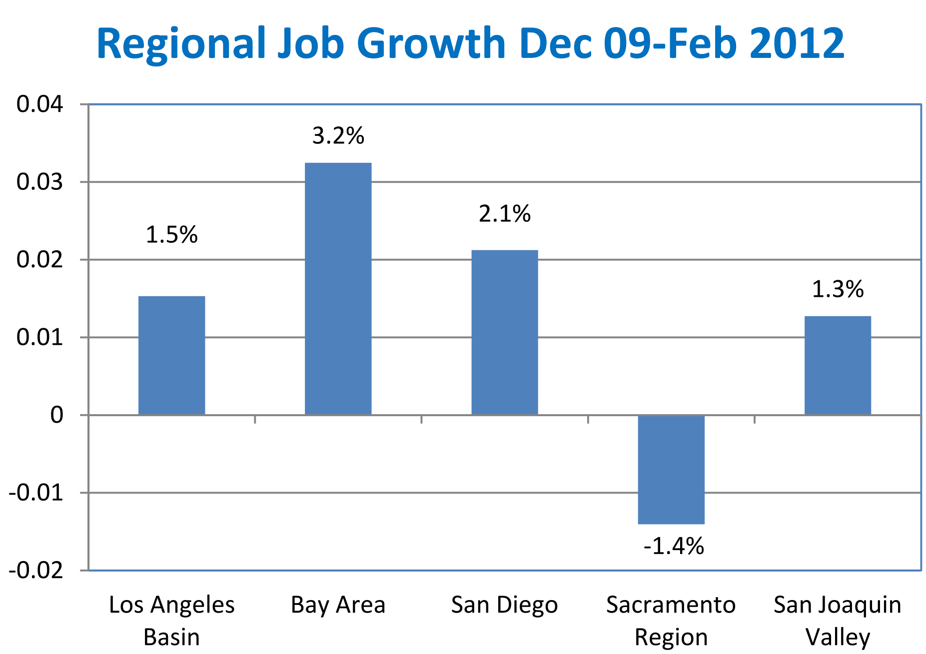
The largest major sector job growth was in the high wage professional, scientific and technical services sector that includes computer, management, scientific R&D and architectural & engineering services—a gain of 80,400 jobs since December 2009. Health care posted the next largest gain followed by leisure and hospitality serving both residents and tourists. Wholesale trade jobs posted one of the largest percentage job gains as exports and trade volumes picked up.

The Information sector had no net job growth but large gains in software and Internet services were recorded but were offset by losses in newspapers and telecommunications. In contrast Government jobs fell by nearly 65,000 with most losses in local government and education and the construction and finance sectors showed no recovery adding small additional job losses. Manufacturing added 9,600 jobs.



Industry Trends Determine Regional Growth Trends

With technology leading the recovery along with trade and tourism, it is no surprise that the Bay Area posted the largest regional job growth rate in the recovery so far. The San Diego region also has a favorable industry mix with strength in technology, trade and tourism. In contrast, the Sacramento region lost jobs as it has the highest concentration in government jobs and was a major region for new home building, which has shown no recovery as yet.



Within regions the sub-regional markets experienced very different rates of recovery. In the Bay Area the job growth is concentrated in the San Jose and

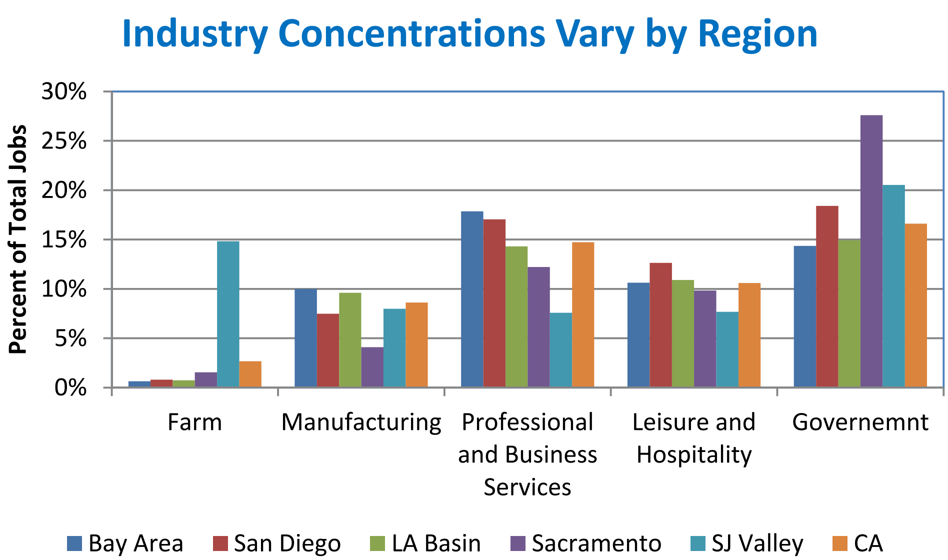
San Francisco metro areas where the technology surge occurred but is slower in other parts of the region. In the Los Angeles Basin the recovery leaders were Orange County with technology, trade and tourism and the Inland Empire despite continuing declines in construction and finance jobs. The Los Angeles and Ventura metro areas are having a slower job recovery.

In the San Joaquin Valley most of the job growth since December 2009 has been in Kern County with gains in the oil and agricultural sectors while other parts of the region remain constrained by losses in construction and government.

Job trends during the recession and recovery are an important reminder that California is an economy of regions and industries with considerable variation in the concentration of industries by region. For example the San Joaquin Valley has a high concentration of agricultural and government jobs while government is the major sector in the Sacramento region. Professional and Business Services is the largest sector in the Bay Area and second in San Diego behind government aided by the navy bases. Manufacturing has the highest concentration in the Bay Area and Los Angeles Basin

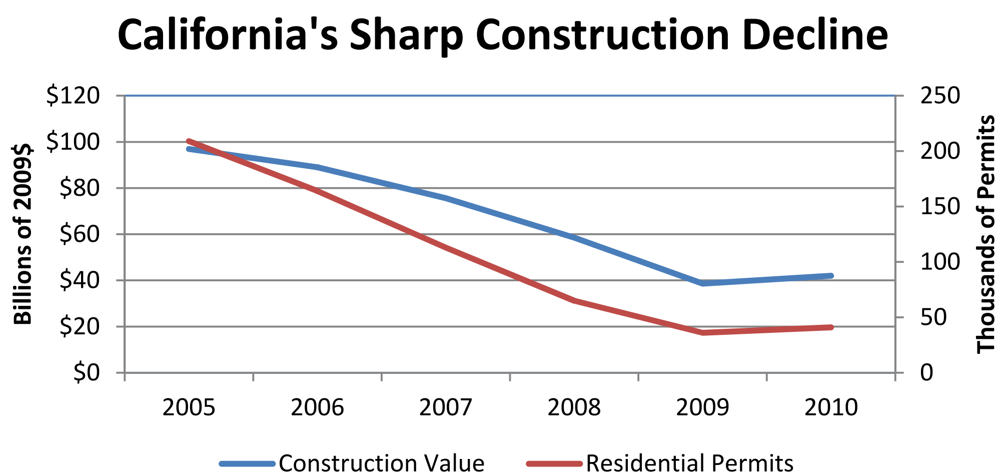
On the other hand the Valley trails in Professional and Business Services and Leisure and Hospitality while the Sacramento region trails in Manufacturing and Professional and Business Services.

Within regions there are industry concentrations such as motion pictures, port activity and aerospace in Los Angeles County, Internet and Software in Santa Clara and San Francisco counties, oil in Kern County and tourism in Orange and central coast counties including Monterey, Santa Barbara and San Luis Obispo, in the Tahoe Basin and other winter sports areas.

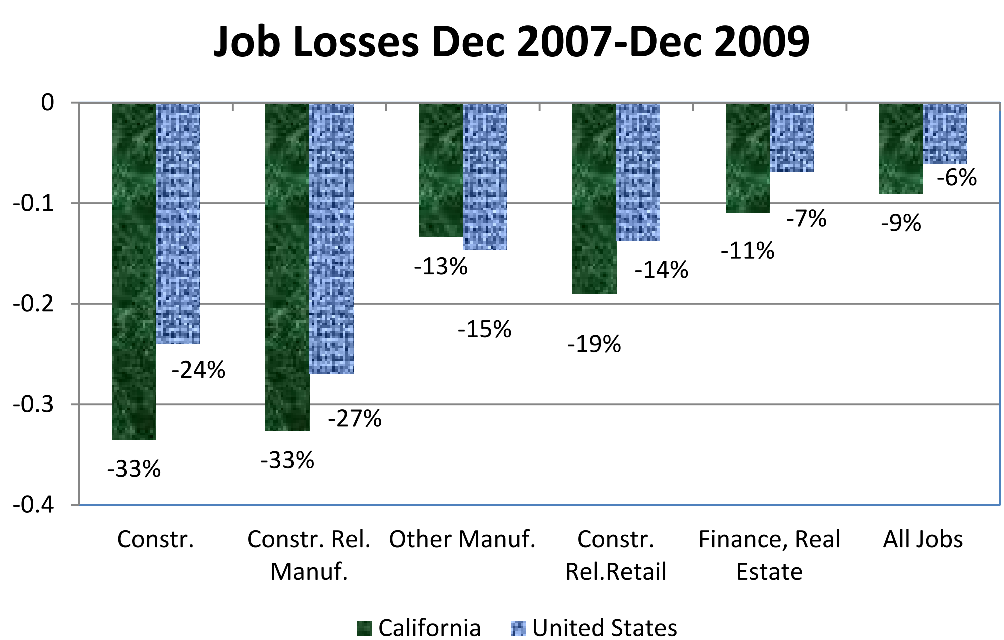


Why Did California Fall Behind During the Recession?

The primary reason for the state's severe job slump and surge in unemployment was the sharp decline in construction spending. Between 500,000 and 600,000 jobs were lost directly related to the construction recession as housing permits fell from 200,000 units in 2005 to approximately 40,000 in 2009 and 2010. In addition the state saw a loss of $60 billion (60%) in the value of construction.



The chart below shows California underperformed the nation in construction related sectors during the recession as a result of the large decline in homebuilding. But California did not, for example, lose a share of manufacturing jobs during this period outside of those related to construction. As in earlier periods, California's relative economic performance is the result of specific industry trends such as defense spending, construction and the dot.com bubble.

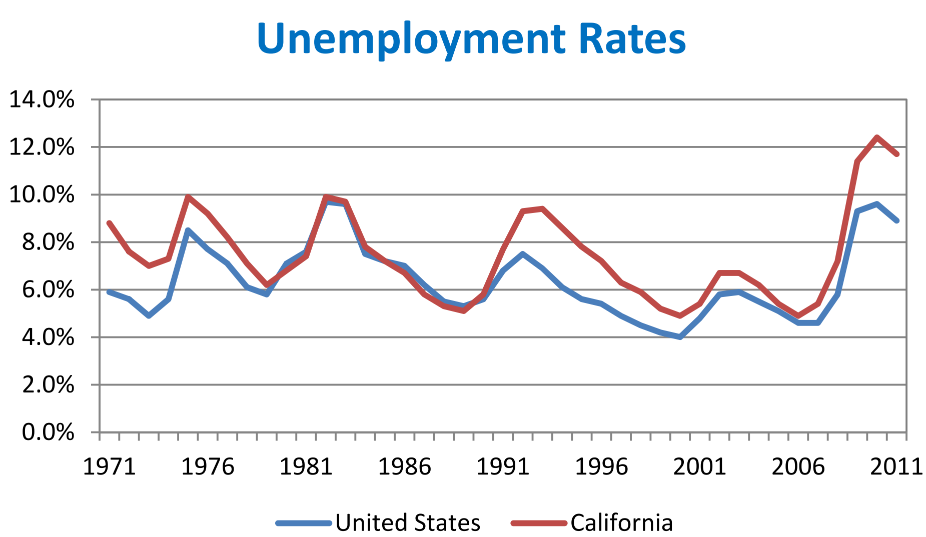


A second cause for the state's relatively large job losses is the high concentration of jobs related to foreign trade and the sharp drop in exports and container shipments as the world economy followed the U.S. into recession.

Although all regions were hard hit by the recession the largest losses were in the Los Angeles Basin, hit by declines in construction, trade and tourism, in the Sacramento region hit by losses in construction and related sectors and in the San Joaquin Valley, which like the Sacramento region and the Inland Empire, had been the center of the housing boom in the middle of the past decade.

The California and National Economy Generally Move in the Same Direction

State and national unemployment rates generally move in the same direction although the state unemployment rate has sometimes temporarily exceeded the national rate. California's unemployment rate exceeded the national rate by as much as 3% after the Vietnam War, in the early 90s aerospace restructuring and today from the large construction losses. And our unemployment rate has been above average in the mid 70s and after the dot.com bubble. Each time before the state's unemployment rate moved toward the national rate as the state has posted above average job growth during long periods of expansion.



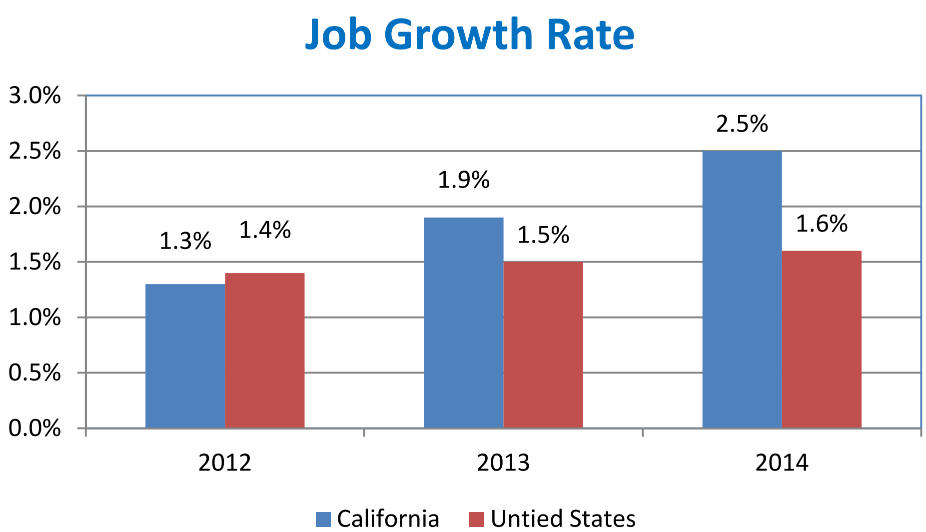
In the March 2012 UCLA Anderson forecast for California, Jerry Nickelsburg, UCLA's Senior Economist specializing in the California economy writes:

"Unlike the 1990s, California's high unemployment rates are not indicative of the sickest economy in the country. Rather, the increases in the labor force (shown in this report on page 3) *are indicators of improving job markets. There are 48 states with unemployment rates lower than California, but unlike California, in most of these states discouraged workers are remaining discouraged and in a number even more are becoming discouraged."*

Can California Again Outpace the National Economy as the Recovery Continues?

The latest UCLA Anderson forecast and recent CCSCE projections answer that question “yes”. For example, the UCLA forecast has the state adding 825,000 jobs between 2011 and 2014 led by gains in Professional and Business Services.

The UCLA forecast has the state outpacing the nation in job growth in 2013 and by a larger amount in 2014. Both UCLA and CCSCE have the state adding jobs at a faster rate than the nation to 2020.



Here are the reasons followed by a discussion of the challenges that need to be successfully addressed.

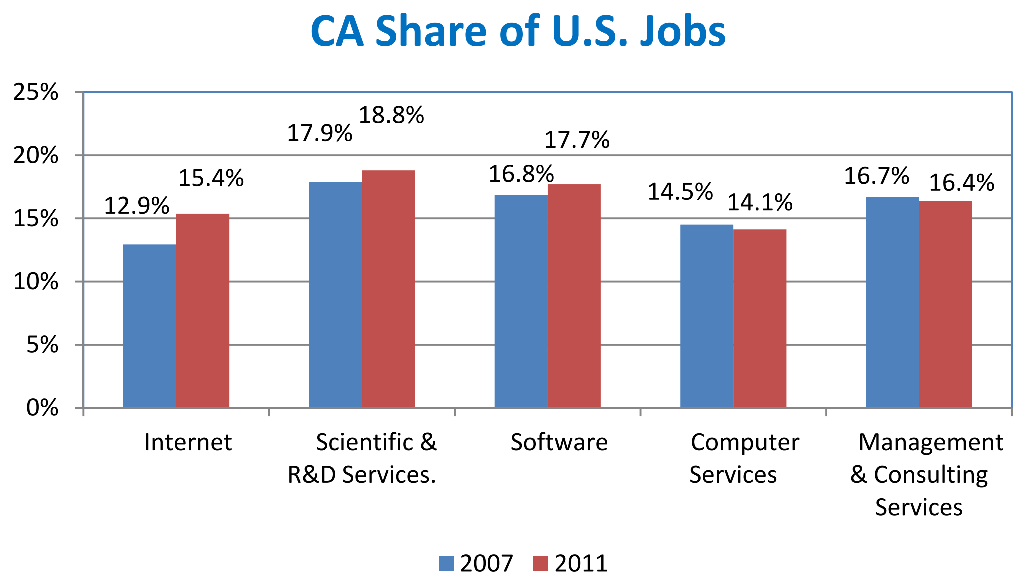
While California’s recession was deeper than the nation’s as a result of the large construction-related job losses, the “good news” part of recent job trends is that, unlike in the early 1990s, the state’s economic base and long-term potential was not damaged by the recession.

The primary components of California’s economic base are professional and information services, manufacturing, agriculture, foreign-trade activities and the entertainment and tourism sector.

High Wage Growth Sectors

The largest pool of high wage job growth expected in the nation is projected to come from professional services including computer, R&D and scientific and consulting services and from information services including software and the broad array of Internet-related activities. **And California has an above-average share in all of these key sectors as shown on the following page.**

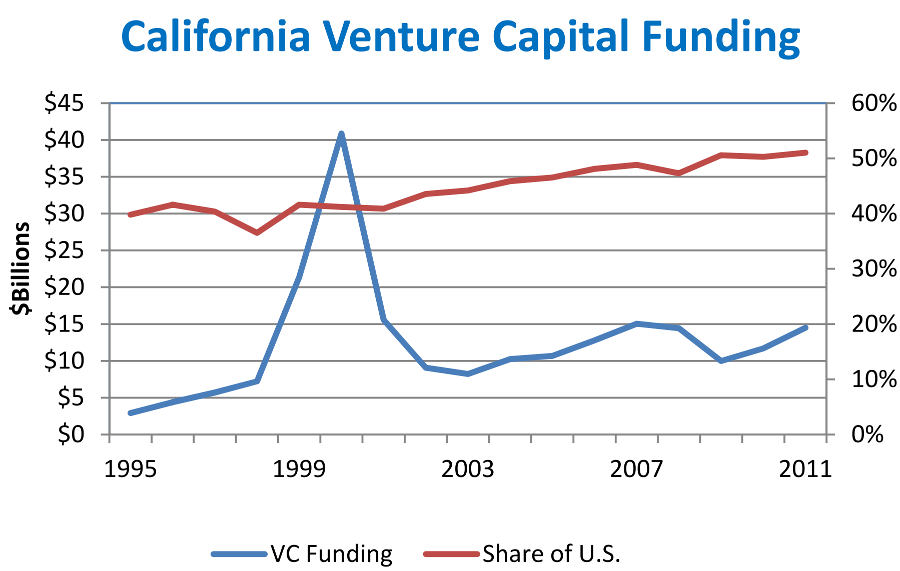
California has approximately 11% of all U.S. jobs but much higher shares in these high-wage, high-growth sectors, which maintained their competitive position during the recession.



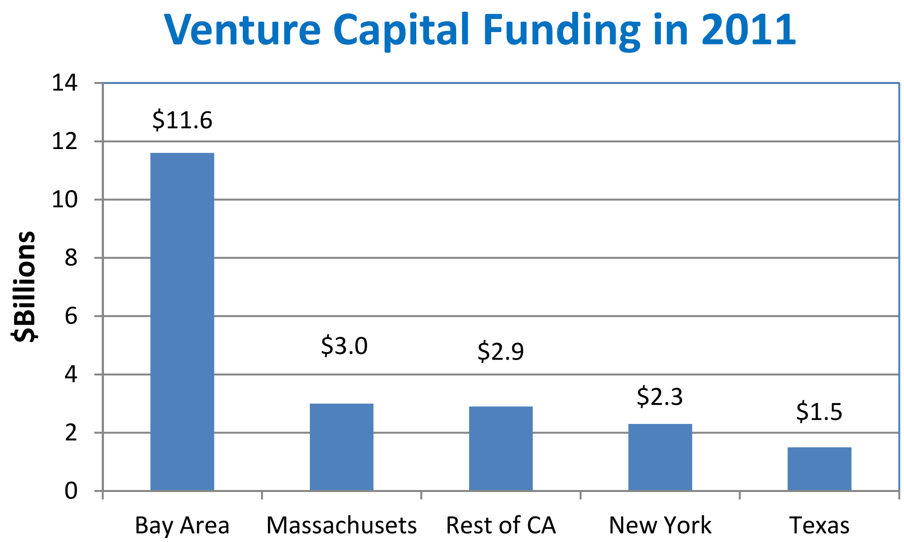
If California maintains or increases the current share of these fast-growing sectors, substantial high-wage job growth will result over the next decade.

Venture Capital Funding

Venture capital funding, critical to developing new goods and services, is growing again and California's share remains at 50% up from 40% a decade ago.

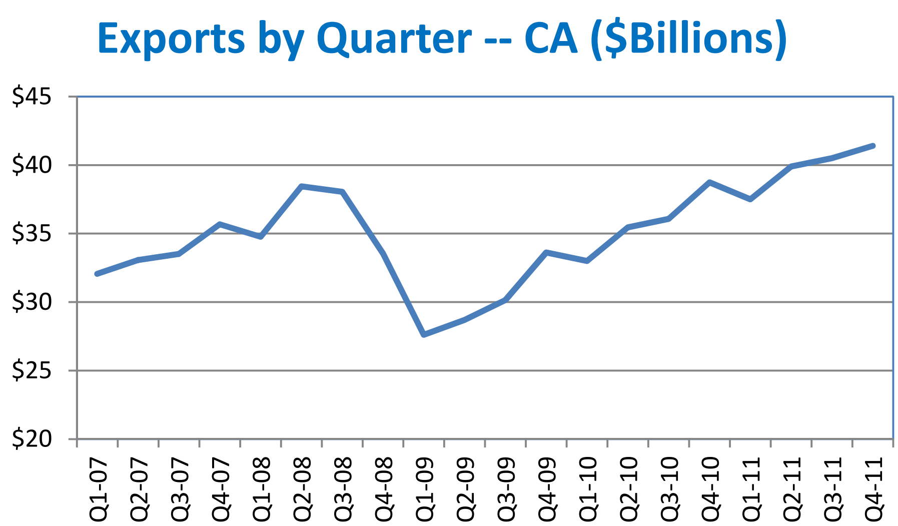


The state's venture capital funding is concentrated in the Bay Area but if the rest of California were a state by itself it would rank a close second in VC funding.

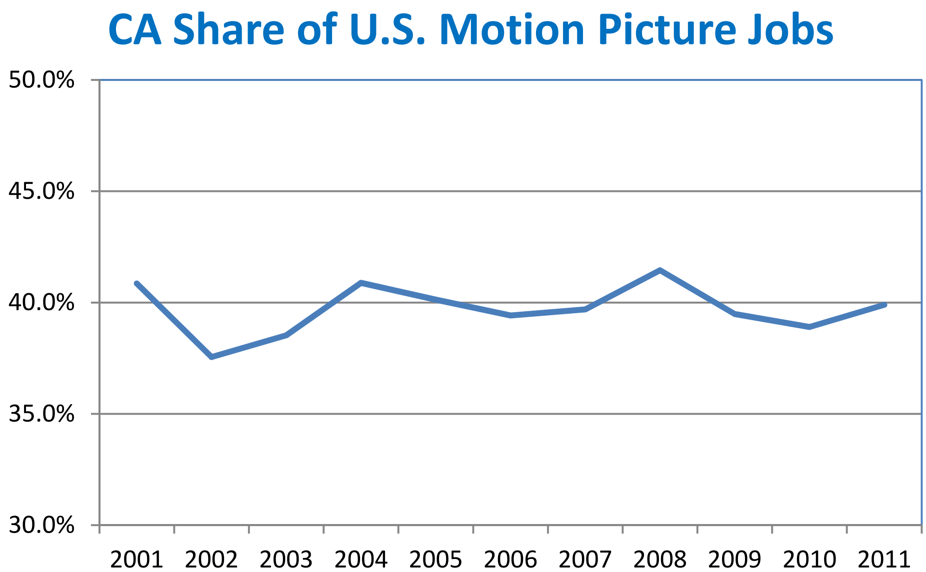


At the same time past VC investments are showing returns as companies including LinkedIn, Zynga and, soon, Facebook have successful IPOs.

Another part of the state's economic base is producing goods and services that are exported around the world. At the same time, California is the major center for imports from and exports to the Pacific Rim. Port traffic is returning toward pre-recession highs and exports of goods made in California reached record levels in recent months as shown below. And for every two dollars of goods exports there is roughly one dollar of service exports.



In addition our tourism sector will benefit from world income growth as California firms and the weather combine to provide enjoyable business and personal travel attractions. Finally, California's creative entertainment side (creative in production **and** post-production activities) continues to be the dominant center in the nation. Despite a lot of media stories on California losing a share of motion picture jobs, when all components of the industry are included the state's share has remained steady over the past 10 years.



Competing for Prosperity—Jobs, Infrastructure, Workforce

The regional forums identified broad agreement that the state will benefit from developing an economic strategy and one based on good information about future trends and the state's best areas of opportunity.

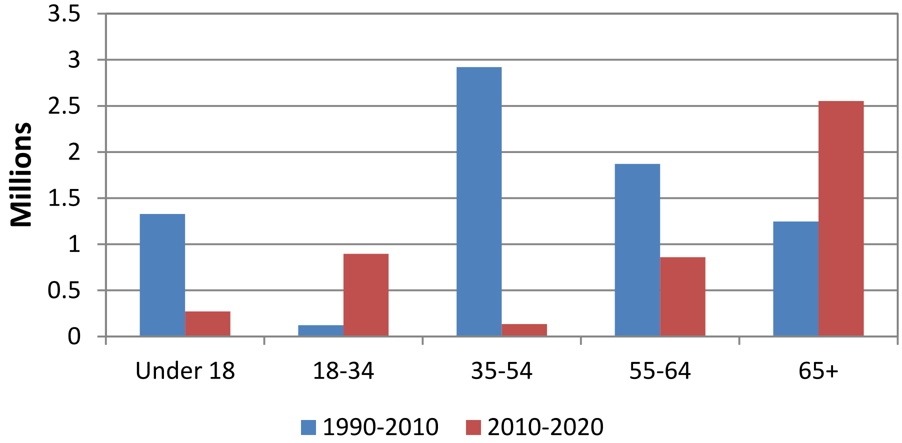
They found broad agreement that additional infrastructure investments are needed (the Think Long report identified $750 billion) and that these investments serve double duty as a competitiveness strategy for business location and a quality of life strategy for residents.

And they found broad agreement that a world-class workforce through education and training initiatives also serves double duty as a competitiveness strategy for business location and a prosperity strategy for California workers.

In addition the forums agreed that world-class customer service and smart regulatory policy are important components of a state competitiveness strategy.

Moreover, the next decade will bring continued demographic change—the aging of the baby boom generation, continuing growth in the state's Latino and Asian populations—with profound implications for workforce, housing and the economy.

California Population Growth

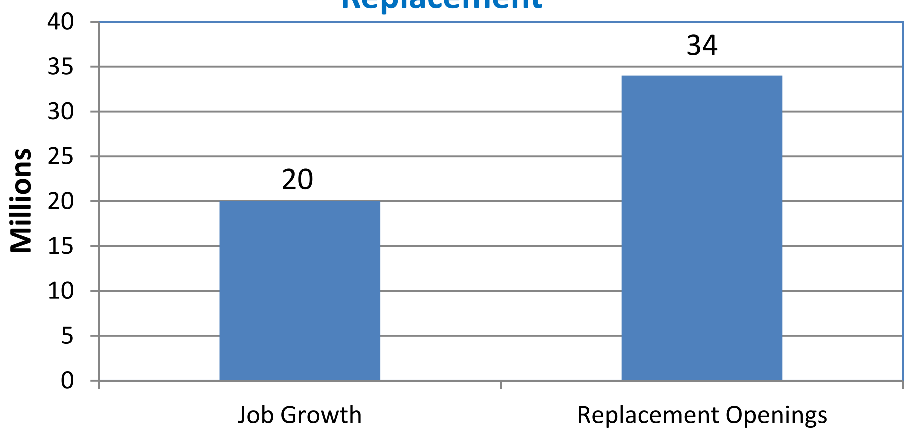


Compared to the past 20 years, there will be no growth in the family age (35-54) groups with most growth in the 55 and above age groups and in the number of young adults. These changes show the baby boomers moving out of the 35-54 age groups and beginning to move into retirement with implications for workforce--replacing the retiring baby boomers--and housing--where will young adults and aging baby boomers want to live and in what kind of housing.

One other workforce trend is clear—most job openings in the decade ahead will come from replacing existing workers and this is true for most occupations.

New Bureau of Labor Statistics projections show that there will be nearly 2 job openings from replacements for every opening from job growth between 2010 and 2020. These trends bring both **hope**--that there will be jobs across all skill levels--and **challenge**--to provide education and training to meet the needs of companies and workers alike.

U.S. Job Openings from Growth and Replacement



Competing for Entrepreneurs Includes Competing for Workers

California competes for both entrepreneurs and families and competes for talent and innovation in both groups. While the current period of high unemployment may give the illusion that there is no need to compete for workers and their families, there are both current talent shortages and the imminent retirement of the baby boom generation will soon push California into a period of much more substantial potential talent shortages.

Recent surveys of high tech employers in Silicon Valley confirmed what is being reported from a variety of sources—that even with high unemployment workers with technical skills are often hard to find. While regional and state leaders think about strategies to compete for high wage industries, these industries are thinking about strategies to meet their high skilled workforce needs.

Many strategies identified in the regional forums serve double duty as they help respond to the needs of businesses and residents simultaneously. Education and training, infrastructure and housing rank high on the list of firms and residents. And even in regulatory strategies, there may be win-win reforms that benefit all.

The Silicon Valley Leadership Group's 2011 CEO Business Climate Survey identified the connection between business and resident challenges in making California a great place to both work and live:

Increasingly it is difficult for Silicon Valley companies to compete against other centers of innovation and entrepreneurship—both domestic and abroad. Among the unique challenges are globalization and the international competition for talent. A deteriorating state infrastructure in areas ranging from public education to public transportation has added to the difficulties of recruiting the best workforce, finding them available housing and educating their children to be tomorrow's world-class workforce.

There is not yet agreement on the best mix of reforms and additional targeted resources and, to the extent additional resources are needed, how best to collect more investment funding. These choices continue to be a challenge for the upcoming Summit and state leaders and residents but they present an opportunity for the state's regions, industries and residents to find agreement in strategies that will improve the future for residents and firms.