State Board of Equalization

Economic Perspective

Summary of Recent Economic Developments *January 1999*

Board Members

Johan Klehs
Hayward
First District
(510) 247-2125

Dean F. Andal
Stockton
Second District
(209) 473-6579

Claude Parrish
Torrance
Third District
(310) 217-6815

John Chiang
Los Angeles
Fourth District
(818) 901-5733

Kathleen Connell
Sacramento
State Controller
(916) 445-2636

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E. L. Sorensen, Jr.
Executive Director

❖ *U.S. Economic Developments*

Above Average Growth Continues in Late 1998

Over the past ten years U.S. real gross domestic product (GDP) has increased an average of approximately 2.6 percent per year. For the first three quarters of 1998, real GDP rose at an average annual rate of 3.7 percent. This is an exceptionally strong rate, particularly considering the worldwide financial crises, extreme domestic stock market fluctuations, and slowing profits growth that took place in 1998. The year with the fastest growth rate in the last thirteen years was 1997, when real GDP rose 3.9 percent.

Monthly economic statistics released so far for the last few months of 1998 indicate that economic growth continued at a rate above its long-term average in the fourth quarter of 1998. U.S. nonagricultural employment increased an average of 264,000 employees per month from October through December. This figure is greater than the average 1998 gain of 239,000 employees per month. U.S. retail sales rose an average of 0.9 percent per month from October through December after averaging a 0.1 percent decline per month during the previous three months. The index of leading economic indicators jumped 0.6 percent in November, the largest one-month increase in over two years. According to the Conference Board, which publishes the index, it is likely that real GDP rose between 2.5 percent to 3.0 percent in the fourth quarter of 1998, and that the economic expansion is likely to continue through at least early 1999. (Source: *The Conference Board News, Leading Economic Indicators*, December 30, 1998.)

Slower Growth Expected in 1999

Many economists expect 1999 real GDP growth to slow considerably from that of 1998. A *Wall Street Journal* survey of 54 economists, published in early January, showed that they have an average annual 1999 forecast of approximately 2.1 percent growth in real GDP. (Source: January 4, 1999 *Wall Street Journal*.) Many of the economists surveyed attribute the slower growth to reasons such as a worsening of international financial crises, an overvalued stock market, slower growth in consumer spending, and weaker corporate profits.

❖ California Economic Developments

Few Changes in Employment Growth in Second Half of 1998

Similar to the U.S. economy, the California economy continued to perform well overall in late 1998. One of the most comprehensive measures of economic growth available for states on a timely basis is nonagricultural employment. In December 1998, California nonagricultural employment was 2.8 percent above the December 1997 level. The corresponding annual growth rate for each month, July through December, has varied in a relatively narrow range, between 2.8 percent and 3.3 percent. For all of 1998, nonagricultural employment increased 3.2 percent over 1997. This rate is close to the 1997 growth rate of 3.3 percent, which was the fastest annual increase of the 1990s. (Source: California Employment Development Department, interim industry employment.)

Declining Exports Slow Manufacturing Employment

While the state's economy has performed well overall, declines in exports, primarily to Asia, have reduced growth in manufacturing. California exports to the state's top ten Asian trading partners declined 26.6 percent in the third quarter of 1998, compared to exports to the same countries in the third quarter of 1997. With the sharp declines in exports to these countries, total California exports declined 9.4 percent in the third quarter of 1998. (Source: U.S. Department of Commerce and Massachusetts Institute for Social and Economic Research, University of Massachusetts.) The export declines are largely responsible for reductions in monthly manufacturing employment growth in late 1998. In early 1998, manufacturing employment was increasing at rates over 4 percent annually compared to the corresponding months in 1997. But by late 1998, manufacturing employment had comparable annual growth rates of around 1 percent.

Slowing Employment Growth Expected in 1999

Though there is little evidence of significant slowing in employment growth other than manufacturing in recent months, many forecasters expect overall growth in California nonagricultural employment to be lower in 1999. The December *Western Blue Chip Economic Forecast*, a consensus average forecast of seven California economists, calls for nonagricultural payrolls to increase 2.2 percent for 1999, which is considerably slower than the 3.2 percent increase of 1998.

Strong Construction Activity Continuing

In contrast to this recent weakness in manufacturing, economic activity in construction remained strong throughout 1998. For nearly all of 1998 (the first 11 months), California building construction has continued to increase rapidly, nearly matching the rate of 1997. The total value of California building construction permits issued jumped 21 percent in 1997 (constant 1998 dollars).

For the first eleven months of 1998, the total value of California building construction permits rose 19 percent compared to the total value of the first eleven months of 1997. The trends of the last several months were similar to those of the entire eleven-month period. (Source: *California Construction Review*, Construction Industry Research Board, December 31, 1998.)

Third Quarter Taxable Sales Growth Moderate

The Board of Equalization's preliminary estimate shows that taxable sales increased 5.4 percent in the third quarter of 1998 compared to the third quarter of 1997. This growth rate is lower than the 6.3 percent growth rate for 1997 as a whole, but within the range of recent quarterly growth rates. From the first quarter of 1997, California quarterly taxable sales growth rates have ranged from a low of 5.1 percent to a high of 7.8 percent. During these seven quarters, taxable sales rose at quarterly rates between 5 and 6 percent four times, between 6 and 7 percent once, and over 7 percent twice.

❖ *Redefining Income Lowers the U.S. Saving Rate*

There have been numerous recent press reports expressing alarm over low or even negative monthly U.S. personal saving rates. However, while the saving rate has been declining for many years, a large part of recent declines may merely reflect definitional changes in personal income made in 1998 by the U.S. Department of Commerce. The saving rate is calculated from data collected on income and spending. Personal income is defined as total earnings by persons (rather than corporations) during a given current production period. The current production period is generally defined as a quarter or a year. Personal saving, as defined by Commerce for national income accounting purposes, is the residual of disposable personal income (personal income after income taxes) minus personal consumption expenditures. The personal saving rate is defined as personal saving divided by disposable personal income.

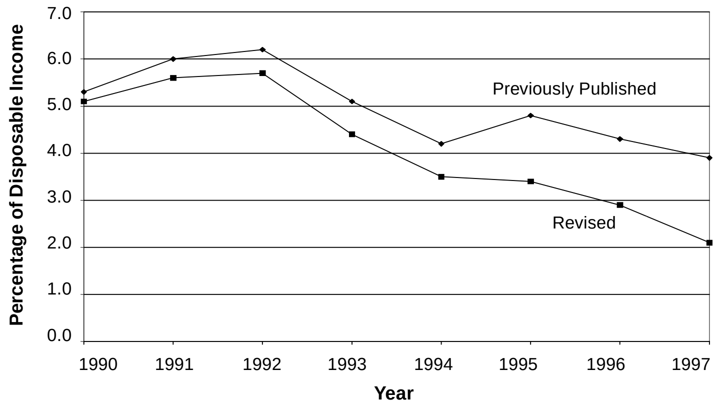
Most U.S. personal income is derived from wages, salaries, and noncorporate profits. Personal income also includes corporate dividends. However, realized capital gains, while considered to be income for income tax purposes, are not defined as income for national income accounting purposes. The reason they are excluded from national income is that capital gains are revaluations of *previously existing* assets. National income accounting is designed to measure the value of what the economy produced in the *current* production period.

Realized capital gains by individuals have never been included by the Department of Commerce as a component of personal income. Publicly regulated investment companies (mutual funds) also derive capital gains from purchases and sales of stocks and bonds and distribute them to shareholders. Until last year, these capital gains distributions were included in the Commerce definition of dividend and personal income. They were intentionally somewhat "misplaced" as a component of personal income since they are difficult to categorize. The Department of Commerce rectified this inconsistency by redefining dividend income to exclude capital gains distributions, thus lowering personal income. Commerce re-estimated historical personal income using this new definition for 1982 and following years.

The redefinition lowered the personal saving rate, compared to what it would be under the old definition, by excluding a component of income used to calculate the rate. The chart in the following column compares the revised and previously published U.S. personal saving rates calculated by the Department of Commerce during the 1990s. (Source: U.S. Department of Commerce, *Survey of Current Business*, August, 1998.) Under both definitions the saving rate has declined sharply since 1992. As shown in the chart, the impacts of the definitional changes have been particularly large from 1995 through 1997, a period when stock market values jumped each year, resulting in large capital gains distributions by mutual funds. In 1997, the saving rate was 3.9 percent of disposable income as originally published. But under the new definition the rate dropped by nearly half, to a minuscule 2.1 percent of income. The saving rate kept declining throughout 1998, continuing a trend that started in 1992.

A declining saving rate is still a matter of concern for the long-term health of the economy. All other factors remaining the same, lower saving rates mean that fewer domestic resources are available for investment. After all, investment is associated with productivity and our standard of living. But we need to be careful to understand the impacts of these definitional changes before becoming overly concerned about reports of negative saving rates.

Revisions to the U.S. Personal Saving Rate During the 1990s



Source: U.S. Department of Commerce, *Survey of Current Business*, August, 1998.

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If you would like to be added to the mailing list, need additional copies, or have any questions or comments, please contact:

Joe Fitz, Chief Economist
State Board of Equalization
450 N Street, MIC:68
P. O. Box 942879
Sacramento, CA 94279-0068
(916) 323-3802
jfitz@boe.ca.gov