Summary of Recent Economic Developments  August 2003

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❖ U.S. Economic Developments

Weak First Half of 2003

Available data suggest that economic growth was very sluggish during the first half of 2003.

Real gross domestic product (GDP). GDP increased only 1.4 percent in the first quarter. Many economists expect similarly weak growth in the second quarter. In contrast, growth in real GDP has increased an average of 3.2 percent per year over the past ten years.

Employment figures. From January through June 2003, U.S. nonagricultural employment declined 0.3 percent. The U.S. unemployment rate has risen steadily since January, as more workers entered the labor force. Starting at a 5.7 percent rate in January, the U.S. unemployment rate reached 6.4 percent in June. This is the highest it has been since 1994.

Industrial production and retail sales. Growth has also been very slow in industrial production and retail sales, two other important measures of economic activity.

New home construction. The strongest sector in early 2003 has been new home construction. Annualized seasonally adjusted housing starts for the first six months of 2003 have stayed near last year’s relatively high average level of 1.7 million units.

Stronger Growth in Second Half?

A vast majority of economists expect stronger growth in real GDP in the second half of 2003. A survey of 30 economists polled by BusinessWeek shows that all but one of them expect second-half 2003 growth to be stronger than first-half growth. There are several reasons to expect stronger growth.

Business spending
- Interest rates have continued to decline, which is stimulating consumer and business spending.
- The effects of the recently enacted federal income tax cut should begin to become evident in the second half. Economists generally expect the tax cut to add about one percent to the growth rate of real GDP on an annualized basis over the next several quarters.
- Another factor adding to growth in the economy is that businesses need to purchase more capital equipment just to keep up with economic depreciation. Over the past several quarters, capital spending by nonfinancial corporations has been too low to keep pace with depreciation. This implies that the stock of productive assets is shrinking, which according to BusinessWeek has never before happened in the post World War II era.
- Not only is there a need for businesses to invest in more capital equipment, but strong profits and cash flows suggest that they are capable of such spending. The Businessweek article stated that “In the first quarter, cash flow was sufficient to cover 90% of all capital spending, the highest such coverage in a decade.”

Consumer Confidence

Not only are there reasons for business spending to increase, but consumers are beginning to become more confident of the future, which also portends increased economic growth. According to the Conference Board (a private consulting firm who publishes a widely used index of consumer confidence), consumers have become much more optimistic in recent months, despite a rising unemployment rate. The Conference
Board’s index of consumer expectations increased from 69.6 in March to 95.9 in June. The index of leading economic indicators, which includes consumer expectations and nine other indicators of future growth, jumped 1.1 percent in May. Eight of the ten indicators that make up the index increased.

**Gross Domestic Product Annual Average**
While economists expect increased growth in real GDP in the second half, the weak first half will pull down the overall annual average for 2003. The average forecast of a panel of 35 economists surveyed in May by the Federal Reserve Bank of Philadelphia calls for real GDP to increase 2.2 percent in 2003. The June 2003 UCLA Anderson Business Forecasting Project also expects an identical 2.2 percent real GDP growth rate this year. This is about the same as the 2.4 percent growth rate for 2002.


❖ **California Economic Developments**

**Recession Continues in First Half of 2003**
The California economy appears to have been even weaker than the U.S. economy in the first half of 2003. According to the June UCLA forecast report, the California economy was still in a recession in the first half. Nonagricultural employment (one of the most comprehensive indicators of statewide economic well-being available on a timely basis) has declined from February through May. Even with a small increase, nonagricultural employment in June 2003 was 0.7 percent below that of June 2002.

**UCLA Predicts Second Half Turnaround**
Following the growth pattern of the U.S. economy, UCLA economists believe that the California economy will improve during the second half of this year. Their forecast calls for nonfarm payroll employment to increase just 0.4 percent in 2003. Consistent with anticipated weak growth in payroll employment, UCLA expects the unemployment rate to average 6.7 percent in 2003. This rate is the same as the average for 2002 and for January through June 2003.

**Small Increase in First Quarter 2003 Taxable Sales**
Taxable sales growth has been very weak since the recession began in March of 2001. Annual data for 2001 indicate that taxable sales were flat, decreasing by 0.1 percent. Preliminary estimates for 2002 show that taxable sales declined by 0.8 percent.

Taxable sales appear to have risen slightly in the first quarter of 2003. Based on preliminary data for California, the Board of Equalization estimates an increase of 0.8 percent in taxable sales for the first quarter of 2003 compared to taxable sales in the first quarter of 2002. However, growth in taxable sales remains far below the long-term average and even farther below the recent experience of the late 1990s dot-com boom. From 1992 through 2001 taxable sales increased an average of 5.1 percent per year. Taxable sales jumped 10.0 percent in 1999 and 11.9 percent in 2000, at the height of the dot-com boom.

**Strong Residential Construction Activity and Prices**
As in the rest of the nation, home construction has been one of the few bright spots of the California economy in recent months. From January through May of 2003, California residential construction permits have averaged 208,000 units on a seasonally adjusted annual average basis. This is 24 percent above the 168,000 residential permits issued in 2002. If the early 2003 rate of permits issued is maintained for the rest of the year, more residential permits will be issued in 2003 than in any year since 1989. Home prices and resales have also remained
strong during the first four months of 2003. According to the California Association of Realtors, January through April 2003 home sales have declined 5 percent from last year’s record levels. Home prices for January through April 2003 have increased at double-digit rates compared to the same months of 2002. The early 2003 increases follow a 20 percent increase in the California median home price in 2002. In April 2003, the median price of a single detached California home was approximately $364,000.

**Consumer Spending for Major Sectors**

Consumer spending is a very important component of U.S. gross domestic product (GDP), accounting for close to 68 percent of GDP in 2000. (Businesses, governments and the difference between exports and imports account for the remaining 32 percent of GDP. By definition, consumer spending does not include housing, which is considered to be business investment spending.)

A recent Bureau of Labor Statistics (BLS) article has more closely examined consumer spending.\(^1\) It provides detail on consumer shares of domestically produced GDP by industry for 2000 and forecasts for 2010. The results of this breakout provide important information for analyzing overall U.S. and California economic developments.

From this article, the chart above shows consumer shares of domestic final demand spending in 2000 for major industries, ranked from lowest to highest shares of consumer spending.\(^2\) As shown in the chart, consumer spending averaged 59 percent of all domestic spending for all industries in 2000. (This is lower than the 68 percent
cited above because imported goods, such as automobiles, are a much greater share of consumer spending than they are of business or government spending.)

As one may expect, consumers purchase relatively large shares of “service-producing” sectors (finance, insurance and real estate, services, trade, communications, and utilities). Consumer shares of these sectors are all over 80 percent of final demand (ranging from 83 percent for utilities to 89 percent for finance, insurance, and real estate). Businesses and governments account for the remaining 11 to 17 percent of domestic final demand for service-producing industries.

At the other end of the spectrum, consumers account for only 21 percent of domestic final demand spending on durable goods. The remaining 79 percent of durable goods production is sold to businesses or governments.

These data have important implications for analyzing economic developments and policies. If consumer spending increases more than overall GDP, service-producing industries are likely to benefit disproportionately. And fiscal policies enacted that are designed to stimulate consumer demand, such as federal individual income tax cuts, will have much larger impacts on service-producing industries than they would on agriculture, manufacturing (particularly durable goods manufacturing) or transportation. However, policies that stimulate businesses will probably have much greater impacts on durable goods manufacturing than most other industries.


2 Construction and mining are not included as major sectors in the chart, since by definition all final demand spending in these sectors is considered by the U.S. Department of Commerce to be business spending, not consumer spending.