



Controller's Quarterly

California Economic Challenges

Kathleen Connell, California State Controller

May 1999

Contents:

Controller's Message	2
Economic Outlook	3
Inside the California Economy	5
New Economic Drivers .	7
Manufacturing Then and Now	8
Wages and Workers	9
International Trade	10
Business Environment	11
Real Estate Trends	12
Minority Business Growth	13
Impact of Mergers	14
Facts & Figures	15



Message From State Controller **Kathleen Connell**

As the new millennium approaches, this edition of the Controller's Quarterly offers a retrospective look at the California economy over the last decade of this century. In many respects, the state has been transformed. Our economy has become far more diversified, both by region and by industrial sector. This "New Economy" will be our springboard for the Year 2000 and beyond.

Several guest authors contributed to this review of the past decade. Among the topics they cover are the dramatic changes in California's industrial profile. While manufacturing continues to play a vital role in the state's economy, it represents a declining share of total jobs. Within manufacturing, new high tech sectors have expanded while defense-oriented industries such as aerospace have shrunk.

Other articles report on the increasing role of the services-producing sector in generating new jobs. This encompasses a broad range of activities, including much of today's information technology, motion picture production, recreation, and health care. International trade also has become an important sector of California's economy.

The past decade also saw a widening of the wage gap, with wages growing more at the top and bottom of the income scale rather than in the middle. As one of our guest authors reports, wage trends reflect the economic well-being of families, raising concerns about the living conditions of the increasing number of families who depend on low-wage jobs.

California's business environment has changed over the past decade as well. Two authors cover this topic: one looks at how the state has become more proactive in retaining business; the other examines the growth of minority business in California. We also hear from an author who reviews the "thrills, chills, and spills" of California's real estate market during this decade.

As always, this Quarterly offers an analysis of the state's economic outlook for the year. I am pleased to report that last year's strong performance is continuing in 1999, although it is likely to be at a more moderate pace. Our goal should be to maintain this momentum into the next century and ensure that all California families have the opportunity to prosper in the new millennium.

KATHLEEN CONNELL

Controller
State of California

May 1999

California Economy

Controller's Outlook

The National Outlook

The U.S. economy ended 1998 in high gear and is still cruising. Spending by U.S. consumers has been the driving factor. Continued spending is reflected by first quarter retail sales, which were 8.6% higher than the same period of 1998. The other engine of growth has been private domestic investment, evidenced primarily by business expenditures for durable equipment.

Other economic indicators, however, suggest the economy is slowing. Seasonally adjusted monthly job growth in the first quarter of 1999 averaged 89,700 jobs, compared to 155,000 per month for the last quarter of 1998. Consumers have accelerated their buying by reducing savings, which declined in the fourth quarter of 1998. This trend cannot be sustained; consumer spending will slow, probably sooner rather than later. Corporate profits also have slowed. After-tax profits in the last quarter of 1998 were 3.0% below profits in the fourth quarter of 1997.

The U.S. economy's resilience in the face of slowdowns in the rest of the world is surprising. Last fall, Federal Reserve Chairman Alan Greenspan warned that the U.S. could not remain an "oasis of prosperity" amid financial turmoil elsewhere in the world. To date, however, it has remained just that oasis. The Asian and Latin American economic problems have thus far affected the U.S. economy only at the margins.

Some economists have even argued that the turmoil has

benefited the U.S. economy. The Federal Reserve lowered interest rates three times last fall, a move that would not normally occur in the midst of an already robust expansion. Lower interest rates stimulate the economy and tend to hold down the value of the dollar on world markets, keeping American goods more competitive. At the same time, foreign money seeking a safe haven flowed into the U.S., helping propel the stock market to new heights. The big unanswered question is, how long will this American nirvana continue?

California Outlook

As in the nation, job growth in California is slowing. In 1998, California added almost 450,000 jobs, a 3.4% growth rate. However, the rate for the 12 months ended in March was 3.0%. The average monthly increase in jobs in the first quarter

of 1999 was 23,000, while the average was 34,000 during the fourth quarter of 1998. The Controller's Council of Economic Advisors expects employment gains will moderate in 1999, down to 2.9%.

California's international exports continued to slow in 1998, falling 6.6%. Exports to Asia declined the most, 20.3%. This was partially offset by a 15.9% gain in exports to South America, a 10.7% increase to Canada and Mexico, and a rise of 9.9% to Western Europe. Fourth quarter data indicate a pronounced slowing of growth in exports to North America and Europe. South America was still up 13.3% in the fourth quarter compared to a year earlier, but that region is expected to show a sharp decline in early 1999 due to the Brazilian currency devaluation.

Unemployment in California has vacillated in the range

"The Controller's Council of Economic Advisors expects employment gains will moderate in 1999, down to 2.9%."

Figure 1

1999 Forecast by Controller's Council of Economic Advisors

Council Member	Employment Growth (Annual %)	Unemployment (Annual %)	Personal Income Growth (Annual %)	Res. Building Permits (Thou)
LA Economic Devt. Corp. (J. Kyser)	2.9%	5.5%	6.3%	160
Calif. Assn. of Realtors (G.U. Krueger)	3.0%	5.7%	5.9%	155
UCLA Anderson Forecast (T. Lieser)	3.4%	5.5%	6.4%	153
UC Berkeley, Center for Real Estate & Urban Economics (C. Kroll)	2.0%	6.0%	5.0%	135
Pacific Bell (J. Hurd)	3.0%	5.7%	5.3%	148
Bank of America (B. O'Connell)	3.2%	5.8%	6.5%	135
UCSB Economic Forecast Project (M. Schniepp)	3.0%	5.5%	5.2%	140
Mean	2.9%	5.7%	5.8%	147
Median	3.0%	5.7%	5.9%	148
State Controller	3.0%	5.7%	5.8%	145
1998 Actual*	3.4%	5.9%	6.6%	125

* "Actual" figures may vary from prior published figures to reflect new data that has become available. Source: State Controller's Office; Council of Economic Advisors

“Low mortgage interest rates contributed to a healthy housing market in 1998, with both housing sales and building permits rising sharply. The current year is shaping up to be a repeat of 1998.”

of 5.7% to 6.0% since last June. The Controller’s Council expects the average rate for 1999 will be 5.7%, down slightly from last year’s average of 5.9%

The Controller’s Council also forecasts that personal income growth in California will slow in 1999, to 5.8%, due primarily to slower employment growth. Turbulence in the stock market remains a potential threat to growth of personal income. For many employees in the Silicon Valley, stock options are a significant portion of their compensation.

Low mortgage interest rates contributed to a healthy housing market in 1998, with both housing sales and building permits rising sharply. The current year is shaping up to be a repeat of 1998. The Controller’s Council projects residential construction will reach 147,000 units in 1999, up from 125,000 in 1998.

Employment

Construction continues to have the highest rate of employment growth of any sector of the economy. Its annual rate of

increase from March 1998 to March 1999 was 9.4%. Manufacturing jobs declined during that period. The losses occurred primarily in durable manufacturing, particularly in industrial machinery and electronic equipment, and were concentrated in Northern California. Employment in non-durable manufacturing rose during the 12-month period, led by jobs in food processing. Jobs in service-producing industries continued to increase faster than overall employment in the past 12 months, rising 3.4%. Business services are one of the most rapidly growing service sectors. In the past 12 months, more than 20% of all new jobs created in California were in business services.

Real Estate

The California Association of Realtors reports that in 1998 the median price of existing single family detached homes in California averaged \$201,410. This is the highest annual median ever for California. Last year’s home sales (628,260) also set a record in the state. The

first two months of 1999 indicate that prices and sales may achieve new records this year.

Santa Clara County posted the largest regional price increase in 1998 at 15.3%. However, the first two months of 1999 show a more widespread pattern of price increases, including a 12.3% increase in Los Angeles County from February 1998 to February 1999.

Residential Construction

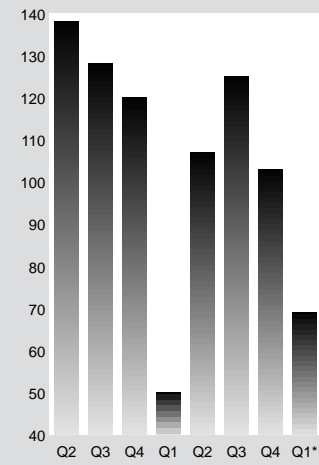
The first two months of 1999 show a strong upward trend in building permits. If this annualized rate were to continue, the total would reach 150,000 units this year. Southern California is especially robust, with residential permits increasing 37% over the first two months of 1998. In San Diego County, permits have surged 55% over last year at this time. Los Angeles County has seen a 67% increase but is still running at an annualized rate of less than 12,000 units. The smallest increase in permits was in the San Francisco Bay Area, but even that region posted a 26% increase over last year at this time. Non-residential construction is off to a slower start this year. The Construction Industry Research Board projects the dollar value of buildings on permits issued will rise only 5.1% in 1999. This would represent a marked slowing from the 17.1% increase that occurred in 1998.

Personal Income

Personal income in California grew at a healthy 6.6% in 1998. This has produced strong revenue growth for the state. This also is propelling the housing market and retail sales, which has benefited the revenue streams of state and local governments.

Figure 2

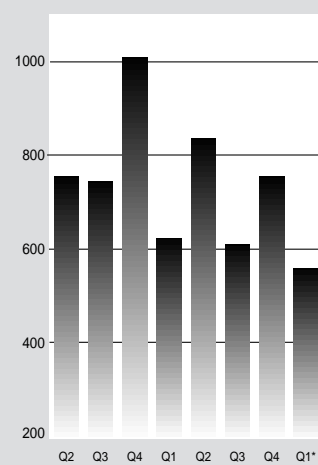
California Non-Farm Payroll Growth
(Seasonally Adjusted, In Thousands)



Source: Employment Development Dept. *Estimate

Figure 3

U.S. Non-Farm Payroll Growth
(Seasonally Adjusted, In Thousands)



Source: U.S. Bureau of Labor Statistics *Estimate

Inside the California Economy

Looking Back at the 1990s

During this final decade of the millennium, California's economy has undergone dramatic structural changes that have led to unprecedented strength. The momentum of 1998 — a milestone year for California's labor markets — carried over to 1999 virtually unabated. Employment growth through March is rising at a 3.0% clip; unemployment has dropped to 5.8%.

What are the reasons for such unprecedented strength? Are there economic lessons to be learned from the 1990s that will enable California to maintain its prosperity into the next millennium? The following retrospective look at the California economy provides insight into the favorable conditions that exist in the state today.

Regional Rotation of Economic Leadership

Over the past decade, economic strength has rotated be-

tween the regions of California, particularly between the north and south. In 1994 and 1995, Northern California counties led the state out of the recession with solid gains in non-farm employment, particularly business services and durable manufacturing jobs. As aerospace manufacturing industries fell apart in Southern California, new technology industries began to surge in the north. By 1996, the San Francisco and Silicon Valley labor markets were red hot. Job creation, income, and consumption growth easily exceeded the Southern California experience at mid-decade.

Toward the end of 1997, however, economic weakness in Asia and the decline in semiconductor prices culminated in weaker labor markets in Santa Clara and San Francisco counties. By the summer of 1998, a rotation of economic leadership was in the making. Southern

California tightened up its labor market slack and growth accelerated, led largely by the Inland Empire counties of Riverside and San Bernardino, as well as Ventura and Orange counties. Beginning in August 1998, job growth in Southern California exceeded job growth in the north (Figure 1). Even in durable manufacturing, Southern California took the lead in job growth (Figure 2).

Rapid job expansion throughout California and new highs in the domestic equity markets also led to solid gains in income. Consumption of retail goods and services soared in California, but the retail market advantage in 1998 went to Los Angeles, Orange, San Diego, Ventura, and the Inland Empire counties.

This late decade surge by Southern California demonstrates the importance of regional rotation of economic leadership. Just as the north

"Just as the north carried California out of the recession in 1994, today it is Southern California's strength that is providing stable economic growth for the state."

Figure 1

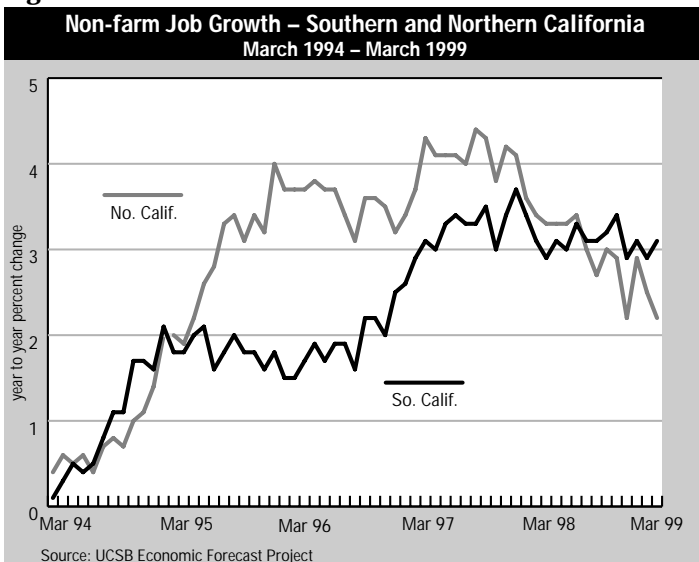
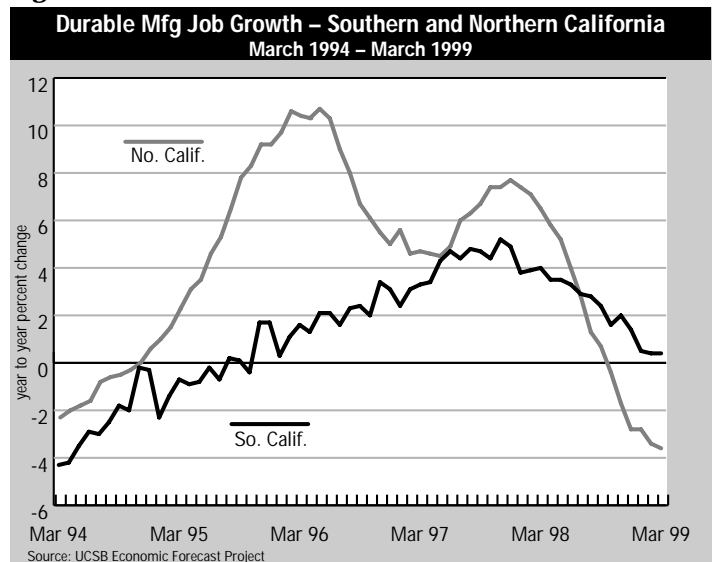


Figure 2



“What is clear is that the California economy is resilient, broad based, and differentiated north to south...Firms are stronger than ever and able to compete more effectively in domestic and world markets. ”

carried California out of the recession in 1994, today it is Southern California's strength that is providing stable economic growth for the state.

From Manufacturing to Services and Information Technology

As a result of the structural changes that have taken place over the past decade, California now has a more broad-based economy. It has become less dependent on manufacturing. Its new engine of growth is services, principally business services, movie production, amusement and recreation, health care, and engineering and management services.

In 1985, jobs in the durable manufacturing sector constituted 13% of total non-farm employment in California, with much of the industry based on defense. Today, durable manufacturing accounts for 8.8% of non-farm employment.

By comparison, jobs in the business services sector, which represented 6% of total non-

farm employment in 1985, now represent 8.7%. Since 1990, the leading producer of jobs in the California economy has been business services, catching up with durable manufacturing in total jobs (Figure 3). Business services include database and software development, including some multimedia applications and services. Much of the new technology and IT employment falls within this sector.

Mergers and Downsizing

More mergers and takeovers occurred in the U.S. during the 1990s than in any previous decade. Financial institution mergers have become common in California. In 1990, California's financial landscape included home-grown giants Security Pacific, First Interstate, Bank of America, and Wells Fargo Bank. Today, Security Pacific and First Interstate are memories. Bank of America and Wells Fargo recently merged with NationsBank and Norwest, respectively. Bank of America is now headquartered in Charlotte, N.C., while Norwest's corporate offices are in Minneapolis.

That's just the financial sector. Earlier in the decade, there were a number of consolidations that resulted in restructuring and cost cutting. Notably, Lockheed joined with Martin Marietta; their corporate headquarters moved to Georgia. More recently, Netscape was acquired by Virginia-based AOL.

The result is less competition and less corporate activity and profits in California. However, mergers and consolidations also result in less duplication, less fat, and greater efficiency through corporate re-

organization and worker downsizing. These activities strengthen firms for the longer term and enable them to compete successfully in national and foreign markets. Firms and the industries in which they reside are stronger, more resilient, and less vulnerable to unexpected economic crises such as the Asian currency devaluation.

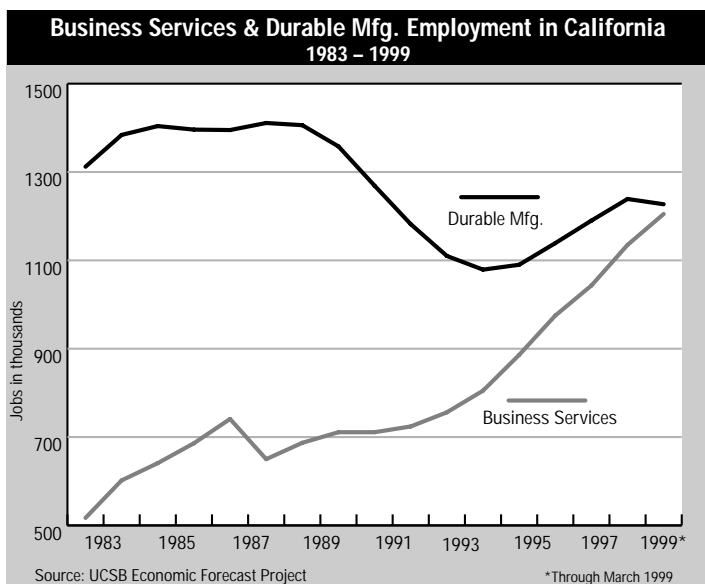
Lessons Learned

Changes to the California economy during the 1990s seemed to occur at the speed of light. What were Netscape, the Pentium processor, DVD technology, NationsBank, or 1.7% inflation back in 1990? Could anyone have predicted that the economy would suffer its worst recession in 40 years followed by its most prolific expansion ever? Lessons learned from the 1990s help explain the current prosperity of California but provide little direction.

What is clear is that the California economy is resilient, broad based, and differentiated north to south. The changes of the past decade enabled California to withstand economic downturns by diversifying regionally and by sector. While vulnerabilities also may have been created, the economy remains healthy to date. Firms are stronger than ever and able to compete more effectively in domestic and world markets.

Probably the most important lesson gained from the 1990s is that the state was able to undergo fundamental economic change. Such adaptability will be critically important as California prepares for new and as yet unknown events in the coming millennium.

Figure 3



The New Economic Drivers



By Cynthia Kroll
*Regional Economist,
 Fisher Center for Real Estate
 and Urban Economics,
 UC Berkeley*

This past decade saw a restructuring of California's economy, with a reduced reliance on defense-based industries, an expansion of other high technology sectors beyond their traditional niches, growth of the services and distribution sectors that support these expanding industries, and improved competitiveness of firms. Many of these emerging sectors are characterized by rapid change, however, suggesting that even with a strong economy, California will continue to be faced alternately with the demands of rapid growth and the concerns raised by cyclical slowdowns.

Manufacturing continues to play a defining role in California's economy, although representing only 14.4% of California's non-agricultural employment in 1998 compared to 17.1% a decade ago. High tech sectors are central to this role, but they have been sharply redefined. When major defense sectors continued to decline, other high tech sectors led the expansion. For example, in elec-

tronic equipment employment grew 25.6% from 1993 to 1998, while total personal income in electronics grew 43.8% from 1993 to 1997, the most recent year for which income data is available. Industrial equipment, including computers, saw a 19.8% increase in employment and a 48.2% growth in income over the same periods. (A decade earlier, industrial equipment was losing employment; electronic equipment employment was growing slowly.)

Behind these aggregate figures is a transformation that has affected not only high tech manufacturing but other sectors as well. New capital expenditures, increasing 29.5% from 1987 to 1996 in inflation-adjusted terms, have translated into productivity increases in California manufacturing, where value added per production worker rose 12.4% for manufacturing as a whole. Value-added gains were particularly high in technology-dependent sectors, rising 63.2% in electronic equipment and 23.9% in industrial machinery over this period. Related to these productivity changes are changes in sector production processes. For California companies, much of the production activity occurs out of state, while the development work and customized production remains centered in California.

Driving California's high tech growth is a revolution in computer networking and Internet use. Changes affect not only companies traditionally classified as high tech manufacturing firms but also a new array of both manufacturing and services "multimedia" firms and many software companies. Since 1996, revenues of networking companies, many headquartered in California, have more than doubled. Stock valuation has quadrupled or more for California Internet

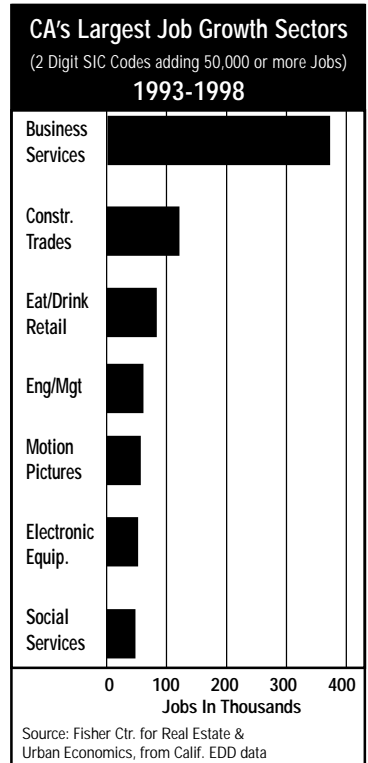
companies in the past year.

While high tech manufacturing played a key role in California's expanding economy, it has been a relatively small job producer statewide. The bulk of new jobs has been and will be in the services producing sectors, but trade and financial services play weaker roles now. Business services, which includes computer programming and software sectors, accounted for half of all services employment growth in California from 1993 to 1998. Motion pictures, including movie production, added as many jobs as electronic equipment manufacturing from 1993 to 1998 and accounted for 18.5% of non-farm job growth in Los Angeles County in that period.

It is important to note that although high tech manufacturing, multimedia, and business services have led the 1990s expansion, these sectors alone do not carry California's economy and are not poised for uninterrupted job growth. Of the state's driving sectors cited above (electronic equipment, industrial machinery, business services, and motion pictures), only business services enters 1999 with a positive rate of growth. The fastest growing employment sector in California in February 1999 is construction.

Technology-based industries likely will continue to play a key role in California's economy in the next decade despite current slowdowns. Their flexible organization and global production network position these industries to benefit from worldwide growth. At the same time, this set of industries challenges California in many ways, from educational preparedness to the housing and transportation infrastructure required to support the demands of growth.

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"The greatest change in California's industrial structure occurred with the decline of aerospace manufacturing. Predominantly defense-oriented and federally funded, California aerospace employment peaked at 380,000 in 1986, fell to 165,000 in 1995, and has risen only modestly since that time."

California's Industrial Profile: Ten Years (and an Era) Ago



By Tom Lieser
Executive Director, UCLA
Anderson Forecast

Aerospace

The greatest change in California's industrial structure occurred with the decline of aerospace manufacturing. Predominantly defense-oriented and federally funded, California aerospace employment peaked at 380,000 in 1986, fell to 165,000 in 1995, and has risen only modestly since that time. Jobs in these industries paid well, with wages more than 60% higher than overall manufacturing wages in California (1996 UCLA estimate). High wages reflected higher education; an estimated 32% of all aerospace workers held college degrees, nearly twice the proportion in other durable goods industries (1996 Rand estimate).

Collateral damage from the loss of aerospace dollars extended to many other areas of the California economy. Home prices in Los Angeles County fell nearly 25% from 1989 to 1995 as "move-up" buying dried up in response to the loss of

high-income jobs. As real estate soured, employment declined in related areas of banking, accounting, and even law. Federal government payrolls shrank as military bases were shuttered.

Agriculture

California's other major industry of ten years ago was agriculture. Farm activity is probably best measured by income rather than employment. By the income measure, the farm sector has maintained its 1988 share of California income. In 1997, gross farm income of \$26.8 billion was 54% higher than in 1988, the same increase recorded by total personal income. Although 1998 appears to have been a no-growth year for farm income (reflecting El Nino storm damage and reduced export sales to Asia), last year's circumstances appear unlikely to be repeated.

Financial and Business Services

Employment in the financial institutions industry in California declined more than any major sector except aerospace. Although banks and thrift institutions in the state have resumed profitable growth, employment in 1998 was nearly 23% below the 1988 level. Other financial sectors have added strongly to payrolls: employment at brokerage and investment firms has risen 66% in the past decade. Finance companies and mortgage brokers have gained market share at the expense of banks and thrifts.

Business services, a large and diverse group of activities, was typified ten years ago by its large element of business-to-business services such as temp agencies, photocopying firms, and custodial services. Its most dynamic element, however, has been its core of high tech ser-

vices including software, Internet service providers, and other relatively new data-processing activities which have pushed this industry to 10% annual growth rates during three of the last four years.

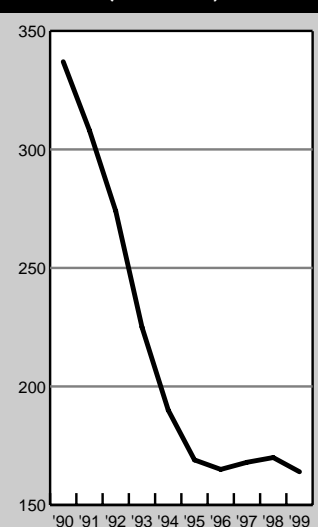
Construction

During the building boom of the late 1980s, the construction crane was often cited as the California state bird. Real estate investment from other states and from abroad was attracted by California's rapid growth. The recession of the early 1990s produced a 60% decline in residential building permits and a similar drop in the dollar value of nonresidential permits, which reached a 1988 peak of \$14.1 billion that was not exceeded until 1998. Total employment in the construction industry, not nearly as cyclical as physical output measures, peaked at 562,000 in 1990, declined 21% by 1993, and finally exceeded its prior peak in 1998.

Retail Trade

Ten years ago, retail trade employed 2.15 million persons in California, about 18% of total non-farm employment. Although retail jobs have increased over the past decade, the gain is only about 10% of the total rise in non-farm jobs over that period. In part, the sluggish growth reflected the severity of the early 1990s decline in home prices, a loss of wealth that undermined consumer spending. California taxable sales declined 3.5% from 1990 to 1993. Moreover, even with a return of robust sales growth in recent years, retail job growth has been restrained by lean margins, reflecting industry consolidations and competitive pressures from mail-order sellers and, increasingly, Internet vendors.

CA Employment in Aerospace Mfg. (in thousands)



Source: UCLA Anderson Forecast

Wages and Workers



By
Deborah Reed
Public Policy Institute
of California

Wage trends are an important indicator of how the economy is performing for workers. Because labor market earnings are the main source of family income, wage trends also reflect the economic well-being of families. Economists typically focus on wage trends for males in order to measure general labor market realities without the complicating effects of changes in labor force participation, as in the case of female wage trends.

The recession of the early 1990s brought substantial wage declines for male workers in California. While total employment numbers returned to pre-recession levels in late 1995, recovery in terms of male wages has been slower. At the median and below, male wages had not recovered as of 1997, the most recent data available.

The Wage Gap Grew

In 1989, male wages at the median were close to \$600 per

week in real, 1997 dollars. By 1997, the median wage fell to \$550 per week. The middle bar in Figure 1 shows the 7% drop in median wages over the period. Below the median, the wage decline was even greater with the 25th percentile falling 11%. Wage growth occurred only at the very top of the distribution with male wages growing by about 6% from \$1300 to \$1375 at the 90th percentile. Compared to the rest of the nation, California had greater decline at the bottom and middle of the wage distribution and greater growth at the top of the distribution (see Figure 1).

These trends translate to a growing wage gap in California. The earnings of men at the 75th percentile relative to those at the 25th percentile is one measure of the gap. Between 1989 and 1997, the 75/25 ratio grew from 2.7 to 2.9 in the state. By comparison, the wage gap in the rest of the nation grew during the recession but fell to its pre-recession level of 2.4 in 1997.

Causes: Rising Returns to Skill and Immigration

The two leading causes of the widening wage gap are the rising returns to skill and immigration. Returns to skill measure the difference in earnings between workers with a high level of skill and less-skilled workers. The two measures of skill available in income surveys are years of schooling and work experience. In 1989, among the native born, a male worker with a high school diploma earned 20% more than did a male worker with 11 years of schooling but no diploma. By 1997, the return to a high school diploma increased to 37%. The returns to a college degree ver-

sus a high school diploma increased from 63% to 69% over the same period. The returns to 25 years of labor market experience relative to five years increased from 72% to 91%.

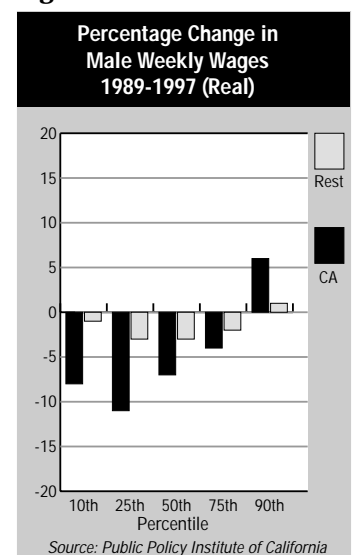
Immigration contributed to the growing wage gap in the state because the proportion of immigrants in the workforce has grown substantially and because immigrants tend to be more concentrated in the bottom of the wage distribution. Between 1989 and 1997, the share of immigrants in the male workforce grew from 29% to 36%. In recent years, about half of all immigrants have had wages in the bottom third of the wage distribution. Low levels of education explain some of the tendency for immigrants to be more concentrated at the bottom of the wage distribution. Over 40% of immigrants in the male workforce had less than a high school diploma compared to only 7% of natives.

Concerns

The wage trends of the last decade continue longer trends. Real wages at the 25th percentile declined 40% over the last three decades. The 75/25 ratio grew from 1.8 to 2.3 during the seventies and from 2.3 to 2.7 during the eighties. In light of the length and causes of these trends, it seems reasonable to anticipate that the large wage gap will continue in California. This raises concerns about the living conditions of families of low-wage workers for whom earnings are the major source of income. Furthermore, as the distribution of income has widened, differences in economic opportunities have become more consequential and equal opportunity may be harder to attain.

“Compared to the rest of the nation, California had greater decline at the bottom and middle of the wage distribution and greater growth at the top of the distribution... These trends translate to a growing wage gap in California.”

Figure 1



California's International Trade Economy



By Gordon Palmer
*Manager of Master Planning,
Port of Long Beach*

"In the last eight years, the share of California's economy devoted to producing merchandise goods for export has almost doubled, from 5.6% in 1990 to about 10% in 1998. California is the nation's leading producer of merchandise goods for export to foreign countries."

If California were an independent nation, its \$1 trillion economy would be the seventh largest in the world — slightly smaller than the United Kingdom and Italy but larger than the economies of China, Brazil, and Canada. The Economic Report of the Governor estimates that international trade represents about 15.5% of the state's economy and is growing in importance.

Export Leader

In the last eight years, the share of California's economy devoted to producing merchandise goods for export has almost doubled, from 5.6% in 1990 to about 10% in 1998. California is the nation's leading producer of merchandise goods for export to foreign countries. Today, California makes over 15% of all U.S. export products, while in 1990 its share was only 11%. In addition, California companies are world leaders in many service industries such as computer software, multimedia, and entertainment. Growth in trade was one of the state's few strengths during the

recession of the early 1990s and has helped lead the economy throughout the decade. Clearly, international trade is one of the most important industries in California's economy.

California exports its products throughout the world. Merchandise exports to the major Asian countries comprises 39% of all the state's exports. Although many of these countries have suffered through the Asian financial crisis, they are expected to recover and again be the fastest growing economies in the world. Exports to NAFTA partners Mexico and Canada represent another 25% of our exports. California businesses are well positioned to take advantage of their Pacific Rim location to play an even larger role in international trade in the future.

A Major Trade Center

In addition to producing our own products for international markets, California serves as the major trading center for the entire country. The value of merchandise trade passing through our customs districts is the highest in the nation. California handles about 22% of the value of all merchandise trade shipped in and out of the United States. In value terms, California's seaports and airports handle more waterborne and airborne cargo than anywhere else in the country. The Los Angeles Customs District leads the nation in value of goods shipped.

Waterborne trade is the major transportation system linking California to the world. More than \$195 billion worth of waterborne trade was handled by California's ports in 1998, almost one-third of all U.S. waterborne trade. By far the largest share of that trade moves in containers

through the Ports of Long Beach and Los Angeles (more than \$163 billion). Just since 1990, the number of containers moving through the two neighboring ports doubled to a total of 7.5 million 20-foot equivalent units of container cargo in 1998. This volume ranks the joint port complex as the third largest in the world behind Singapore and Hong Kong.

Trade and Jobs

Trade through our ports and airports has direct links to the state's economy. The U.S. Maritime Administration estimates that California's seaports help support 1.3 million jobs in the state. Los Angeles International Airport estimates that 393,000 jobs in the local economy are supported by activity at that airport. Recent cargo forecasts indicate that waterborne trade is expected to more than triple between now the year 2020. This growth would support an additional 870,000 jobs in Southern California, about 13% of all the new jobs projected within the five-county region.

Port Improvements

To realize this potential, California's ports and airports are investing in new, state-of-the-art facilities. The Ports of Long Beach and Los Angeles are investing about \$4 billion in port improvements and the Alameda Corridor railroad track consolidation project. San Francisco International Airport is spending \$2.4 billion on airport improvements. Several communities are developing new air and water cargo handling facilities on closed military bases. Through these types of investments, California's economic advantages and benefits in international trade will continue to grow in the future.

California's Business Environment: What a Difference A Decade Makes



By Jack Kyser
*Chief Economist,
L.A. County Economic
Development Corporation*

In 1990, there was a swagger in the step of California. Its economy was strong, and even though it knew aerospace job cuts were coming, the attitude was that we can cope with this. What fools we were.

The cuts in aerospace were swifter and much deeper than forecast. In addition, the business community around the state was grouching over a lengthy list of concerns. These included the rapidly escalating cost of workmen's compensation insurance plus a lot of abuse of the system, a cumbersome and time-consuming permitting process with outright hostility on the part of many bureaucrats toward business, and high living costs due to the rapid run-up in home prices.

Sensing vast opportunity, a host of states and metropolitan areas were actively recruiting business out of California, and some even had full-time offices in the state.

Compounding the situation was that "economic development" was seldom discussed anywhere in the state. The attitude was, if a firm goes, one will come along to take its place. Not only did a system have to be put in place, but a lot of education of both business and government was required about what economic development would do.

The period 1991 through 1993 was grim for California with over 400,000 jobs being lost. This loss haunts us still, since many were in the high-paying aerospace sector, and a current concern is income inequality.

A lot has been done to improve the business environment in California. There was reform of the workmen's compensation system, streamlining and reform of the permitting process at both the state and local level, and deregulation of the electric utility industry. In the meantime, all around the state economic development organizations were either established or reinvigorated. The results have been satisfying, since we are at new record levels of employment.

But we can't relax. It's time to move into a new and more challenging phase in economic development. This calls both for more effectively communicating to business what such an activity can do, and to addressing public policy issues like the quality of education K-12, and adjusting the tax structure so that cities do not chase after retail sales tax revenue, with

the unintended consequence of creating low-wage, no-benefit jobs. Land use is also an issue, especially re-using land for industrial sites that can house well-paying manufacturing jobs. And the issue of housing availability and affordability is back, which means that land use is again an issue. It will all impact on how good a business environment we have in the future.

Adding to the fun is the fact that those states and metropolitan areas are still out there trying to lure business out of California. They no longer have offices here, but are singing some of the same old siren songs, such as low land and labor costs and a great workforce. The bottom line is that economic development has to be done in good times as well as bad, and that we have to continually get better at it.

"A lot has been done to improve the business environment in California. There was reform of the workmen's compensation system, streamlining and reform of the permitting process..., and deregulation of the electric utility industry. ...The results have been satisfying, since we are at new record levels of employment."

California's Evolving Housing Market



By Bruce Karatz
*Chairman/CEO, Kaufman and
Broad Home Corporation*

“Looking back on the past decade, even Disney would be hard pressed to create an amusement park ride any wilder than the thrills, chills, and spills experienced by California’s housing industry. But as we enter the 21st century, housing construction is now back on track, and demand for housing is at record levels.”

Looking back on the past decade, even Disney would be hard pressed to create an amusement park ride any wilder than the thrills, chills, and spills experienced by California’s housing industry. But as we enter the 21st century, housing construction is now back on track, and demand for housing is at record levels.

Construction of new housing units is expected to increase nearly 20% this year to 150,000, but California still will be 100,000 units short of its needs. Pent-up demand drove the median price for a new house in California last year to \$208,500, 37% above the national median. And, with only 37,000 new multi-family units projected this year in a state with more than 30 million residents, resurgence in rental housing construction seems assured.

Taking a Look Back

We haven’t seen this kind of strength since the late 1980s, when construction soared and California’s vibrant economy was touted as “recession proof.” Unemployment barely broke 5% in

1989, and interest rates were dropping from earlier double-digit levels. Single-family housing permits reached nearly 163,000 that year and the median price of a new house jumped from \$20,000 to \$178,000.

Then the bottom dropped out. The end of the Cold War savaged California, eliminating hundreds of thousands of defense jobs. The state sank into a recession deeper than any since the Great Depression, forcing a fundamental restructuring of the economy. California, always quick to rebound from downturns, experienced a painfully slow recovery.

By 1992, unemployment hit 9.3%. New home permits plummeted below 69,000, a 58% drop from the 1989 peak. From 1991 to 1993, the median price slid nearly 8%. Apartment construction, already stung by federal tax law changes gutting tax advantages of residential income property, plunged to 15,000 in 1993 from 160,000 in 1986.

The state’s sagging economy also exacerbated problems masked during better times. In two decades, California went from one of the most affordable places to buy a home to one of the most expensive. High land prices and exorbitant development and entitlement costs pushed the cost of finished lots in California above 30% of the price of the house compared to 22% to 23% in other states, according to the NAHB. That obstacle remains today.

Changes triggered by Proposition 13 also weakened the housing market and continue to impede housing construction. For two decades, revenue-strapped cities have heavily favored retail commercial development over residential construction in order to replace lost property tax with sales tax income.

The Changing Face of the Industry

The slowdown wiped out many builders and caused others to leave or refocus their efforts out of state. Kaufman and Broad, once known as a California builder, will deliver approximately 22,000 units this year in seven states.

Today, California enjoys a robust economic environment. Employment growth remains strong and interest rates are low. New housing permits have jumped 47% since 1995. Yet the consolidation trend continues. Larger regional and national firms are replacing smaller firms as dominant industry forces. The top 10 builders’ share of single family housing starts increased to 8% in 1997 from 4.7% in 1992, according to U.S. Census figures.

Most growth has been through acquisitions. Since 1995, for example, Kaufman and Broad acquired seven home-building companies in five states. With the purchase of California-based Lewis Homes this year, we became the largest homebuilder in the U.S.

Outlook for the New Millennium

Despite recent signs of recovery, fundamental problems remain; their resolution cannot come from the private sector alone. If the state’s goal is to create more affordable housing units, state and local government must adopt policies to achieve that objective. Builders cannot effectively control land prices or the cost of materials or labor; the primary determinants of housing prices. Government must work with builders to tailor entitlement, land use, and tax policies to provide more efficiency and incentives that will stimulate home construction and help meet California’s housing needs in the century ahead.

Financing Minority Business Growth



By Glenn Yago

*Director of Capital Studies, and
Michael Harrington, Research
Adjunct Fellow, Milken Institute*

Minority-owned businesses have grown explosively over the past 10 years. In fact, they are growing at double the rate of all firms in the U.S. economy, both in numbers of new firms and total sales. Recent estimates place the number of minority-owned firms at nearly two million. Of these, nearly 25,000 firms have sales of more than \$1 million. Nearly one-third of these firms, (over 7,000) are located in California.

In California, it is becoming quaint to refer to these as minority businesses (owned and/or led by Asian-, African-, or Native-Americans) since they are rapidly becoming the major source of new business formation in this dynamic economy. Skill-intensive areas such as finance, insurance, real estate, and business services are the fastest growing kind of minority-owned enterprises.

Entrepreneurial business growth has proved to be the most successful avenue for wealth accumulation for lower- and middle-income groups. A growing pool of educated and managerial experienced minorities entered the labor force

due to increased college attendance since the late 1960s. This pool of talent has reached an age cohort of 35-50, when entrepreneurial potential is at its peak.

Minority groups represent 26.1% of the population but own only 11.6% of the nation's businesses. This 11.6% share receives only 6.2% of total sales. Demographic projections show that by 2010 all minorities will represent one-third of the population. By 2050, the total minority share is projected to rise to almost 50% of the population.

Minority firms are more likely to employ minority workers and thus provide an important entry point into the labor market for these workers. Sustaining economic growth requires more financial and management support for these new markets. Despite high aggregate growth rates since the 1990-91 recession, income and wealth polarization patterns continue to be unmitigated. For the U.S. and its fuel pump of economic growth — the dynamic California economy — to maintain overall competitiveness and sustain lasting prosperity, economic participation must be broadened. Given current population trends, minority businesses and minority communities cannot continue to be marginalized.

Capital access is a prerequisite for increased participation in the mainstream economy. Minority businesses are underserved. New research on bank lending in the small business credit market sheds additional light on the business-financing environment that minority entrepreneurs face. Minority businesses are significantly more likely to be denied bank credit and, when successful, receive smaller loans relative to comparable non-minority businesses. Recent research contrasts business lending with mortgage lending in the black community. The unexplained gap between

rates of denied loans for blacks and whites is 3.5 times greater for blacks in the small business credit market compared with the mortgage market. The difference can be attributed to the existence of special programs and regulatory incentives that encourage banks to increase mortgage lending in the minority communities and also to the well-developed secondary market for mortgage loans. In other words, pooling loans and then reselling them in the secondary market appears to reduce the likelihood of racial discrimination in credit lending. Due to the anonymity of markets, they appear to be more color-blind than institutional sources of capital over time.

Small business investment financing is very dependent on paid-in equity capital, borrowers' credit histories, and heavily collateralized bank financing. Minorities have significantly lower net worth and liquid financial assets. Thus, minority-owned firms are overly dependent on commercial bank credit and receive smaller and fewer loans. Existing minority financing programs focus largely on commercial bank lending. Yet small businesses require equity financing. Of the total amount of equity capital invested in the U.S., minority businesses receive 1% to 2%. New and existing minority firms are thirsting for capital resources.

The capital market gap in the minority business sector is largely due to financial structural factors that impede the flow of funds to both equity and debt capital. Equity-linked debt instruments are specifically lacking in the capital structure of these businesses. This situation presents an opportunity to carve a channel from growing capital markets to emerging domestic businesses by designing and developing innovative financial instruments and policy mechanisms.

"Minority-owned businesses have grown explosively over the past 10 years... [N]early 25,000 firms have sales of more than \$1 million. Nearly one-third of these firms, (over 7,000) are located in California."

"From a regional perspective, California seems to be losing ownership of its telecommunications companies and banks in this latest wave of consolidations."

Surfing the Merger Waves: Is California Losing?



By Glenn Yago
*Director of Capital Studies
Milken Institute*

The U.S. is currently going through the fifth and largest merger and acquisition wave in its history. The first great merger wave followed the depression of the late 19th century. In an effort to secure economies of scale and maintain market share in their growing markets, firms began to merge.

The second wave followed World War I and shifted the merger mix from horizontal to vertical integration. Firms were no longer able to engulf competitors; instead they purchased companies that operated at different stages of the production process. The third wave (late 1960s) was motivated by the desire for diversification through conglomeration. The fourth wave, in the 1980s, restructured and dismantled those conglomerates and led to increased corporate focus and productivity that spurred growth in the nineties. In the 1990s, the fifth wave of corporate consolidations is character-

ized by consolidation of market share and acquisition of new technologies.

From a regional perspective, California seems to be losing ownership of its telecommunications companies and banks in this latest wave of consolidations. First, Pacific Telesis was purchased by SBC Corp in 1997. Last year, Bell Atlantic announced its intended purchase of GTE. Now, AirTouch has been acquired by Vodafone.

A little more than a decade ago, California held a global competitive advantage as an emerging financial center for the Pacific Basin economies. Los Angeles, and later San Francisco, evolved quickly as the center of financial service providers. From 1976 to 1986, depository institutions in Los Angeles went through rapid transformation with explosive growth. Output expanded 325% and employment increased 54%, outpacing the nation as a whole.

Financial institutions and services based on emerging financial innovations and technologies were largely resident within the state. California's changing landscape (high rate of in-migration and rapid small business formations) benefited tremendously from the locally owned expanding financial sector. For example, while total employment in Los Angeles increased 30% from 1976 to 1986, depository institution employment grew by 55%.

Rapid expansion in capitalization and employment in the finance sector during the 1980s make a compelling argument for its importance to small and mid-sized businesses. Employment in savings and loans and credit union industries increased 321% and 578% from 1976 to 1986, respectively. They catered to small and mid-sized enterprises and nurtured their

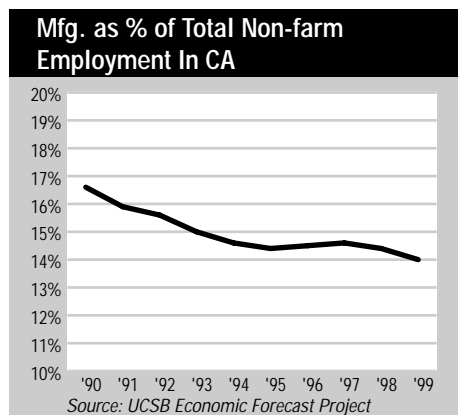
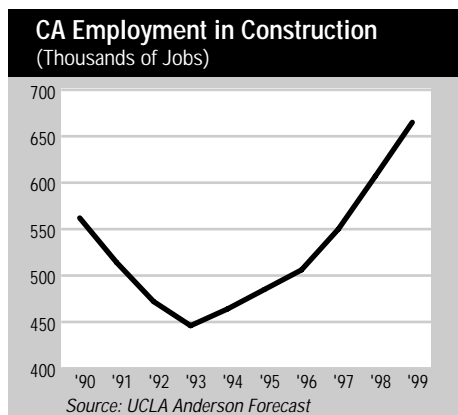
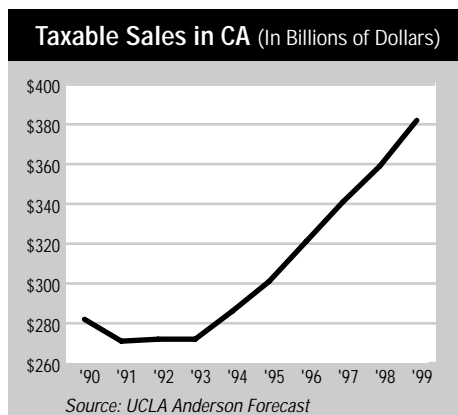
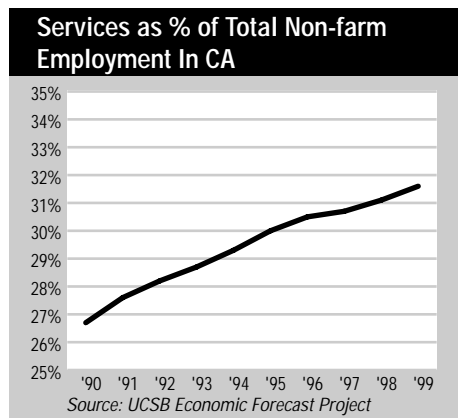
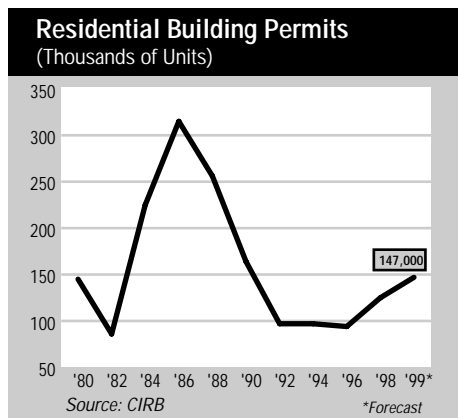
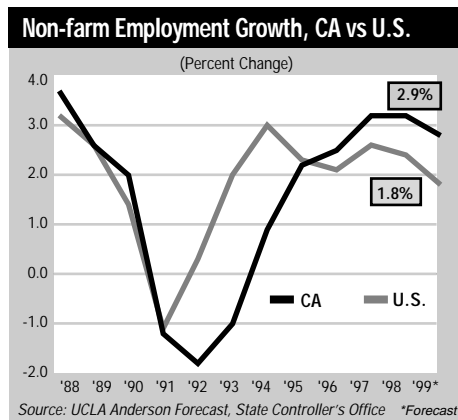
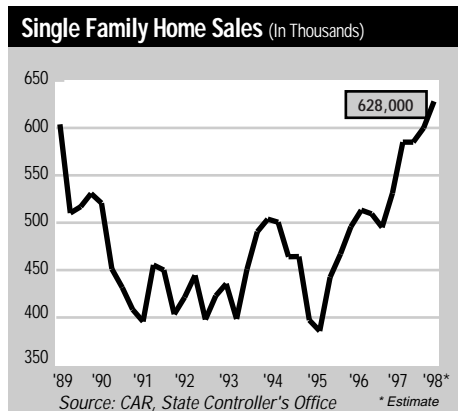
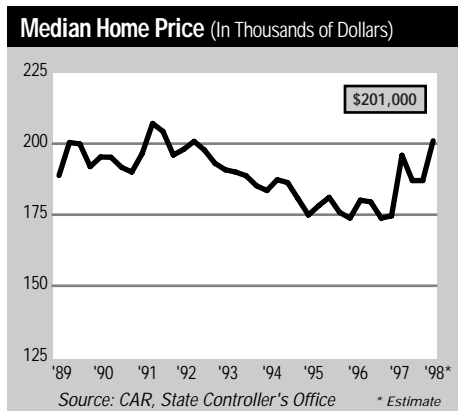
growth. More flexible and agile local lending institutions developed relationship lending that penetrated small technology growth and/or ethnic-owned businesses far better than larger banking institutions. Business formation and job creation were among the highest in the country.

Over the past decade, the combination of financial regulation, industry consolidation, and demise of locally owned thrifts and banks conspired to reduce California's and Los Angeles' potential global leadership in finance that had evolved since the days of A. P. Giannini. The state and metropolitan area suffered far greater job losses than the U.S. average. Depository institutions lost 31% of their job base from 1986 to 1996, far above the nation's 12% decline, from efficiency gains in industrial organization and operations.

The obvious question is whether the state can continue to thrive without a solid, competitive, localized financial base. The remarkable recovery in the Los Angeles area depends extensively on the small-business growth of the past few years. High tech start-ups and service-oriented entrepreneurial firms require diverse local sources of financing. Whereas supply factors in the labor market (education, skills, migration) affect job creation and retention, demand factors (business formation and growth) are determined more by aggregate economic activity, which is highly influenced by this change in industrial structure and organization of the financial services industry. In short, there is considerable unrealized potential economic growth that could be negatively affected by this loss of financial comparative advantage.

Facts and Figures

Important Information About California



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Kathleen Connell
California State Controller
P.O. Box 942850
Sacramento, CA 94250
(916) 445-2636

<http://www.sco.ca.gov>