

ECONOMIC OUTLOOK

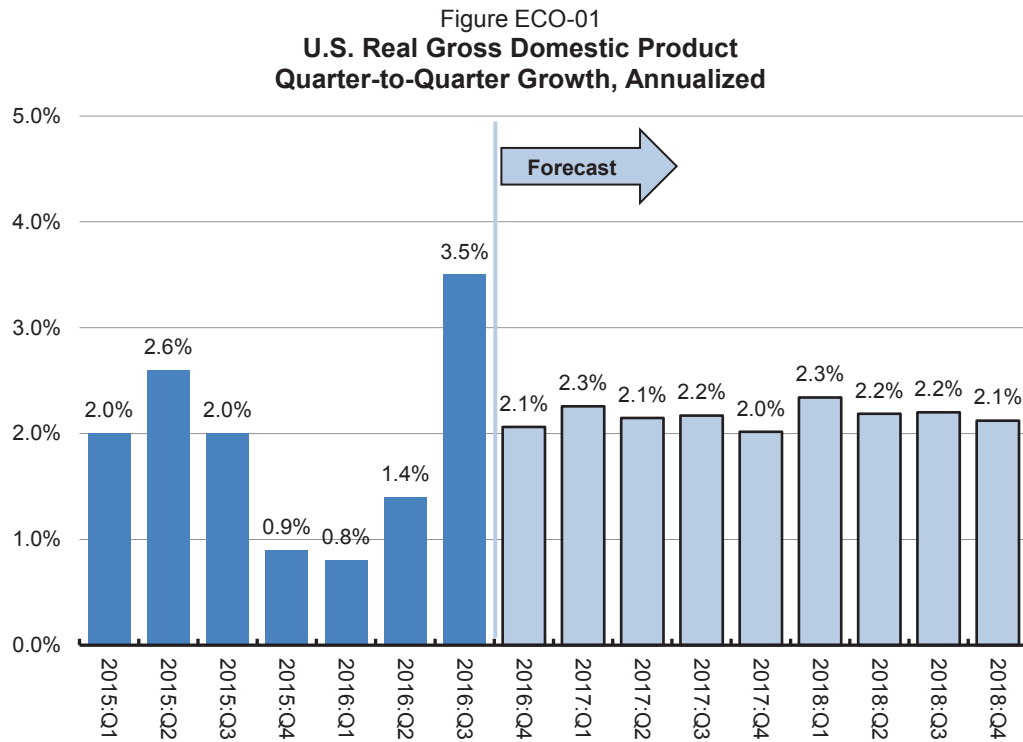
Growth has begun to slow in both the nation and California as the economy nears full employment. Jobs were added at a slower pace in 2016 than in 2015 while more people were drawn into the labor force in the nation and California. Inflation for the U.S. and California trended higher in 2016 due in part to housing costs, although the inflation rate is still relatively low.

The U.S. economy grew slowly in 2016, with consumption growth compensating somewhat for low investment and exports. The outlook assumes moderate growth throughout the forecast period, although the length of the current expansion would exceed that of the previous record if growth continues past 2018. Inflation is expected to rise gradually. A recession—sooner rather than later—or a stock market correction remain risks to the outlook. Housing constraints in California could limit future growth. In addition, significant policy changes in the U.S. or in foreign countries, such as to international trade or immigration, could lead to disruptions in the economy.

THE NATION – SLOWER GROWTH

The U.S. unemployment rate reached 5.0 percent in October 2015 and has since remained close to that level. Around 2.1 million people joined the labor force in 2016, which represents an increase of 1.4 percent, and a much faster pace than the growth of 0.8 percent in 2015. At the same time, nonfarm employment grew by 1.7 percent (2.5 million) in 2016, slower than the growth of 2.1 percent in 2015. The U.S. economy grew unevenly in 2016, with annual real Gross Domestic Product (GDP) growth expected

to be 1.5 percent. Consumption grew due to more workers finding jobs, but private investment and net exports were both negative. Growth is expected to pick up to a moderate pace beginning in 2017. (See Figure ECO-01 for details.)



Source: U.S. Bureau of Economic Analysis; CA Department of Finance Governor's Budget Forecast.

The Federal Reserve raised interest rates in December 2016 for only the second time in eight years. Interest rates are expected to increase very gradually over the next few years, while inflation is expected to remain around the Reserve target of 2 percent. Although oil prices remained low, higher housing and medical costs pushed up inflation to over 1 percent in 2016. See Figure ECO-02 for highlights of the national and California forecasts.

CALIFORNIA – CONTINUED GROWTH

California's growth has continued, with the state becoming the 6th largest economy in the world in 2015. California's unemployment rate fell to 5.5 percent in February 2016 and is

Figure ECO-02

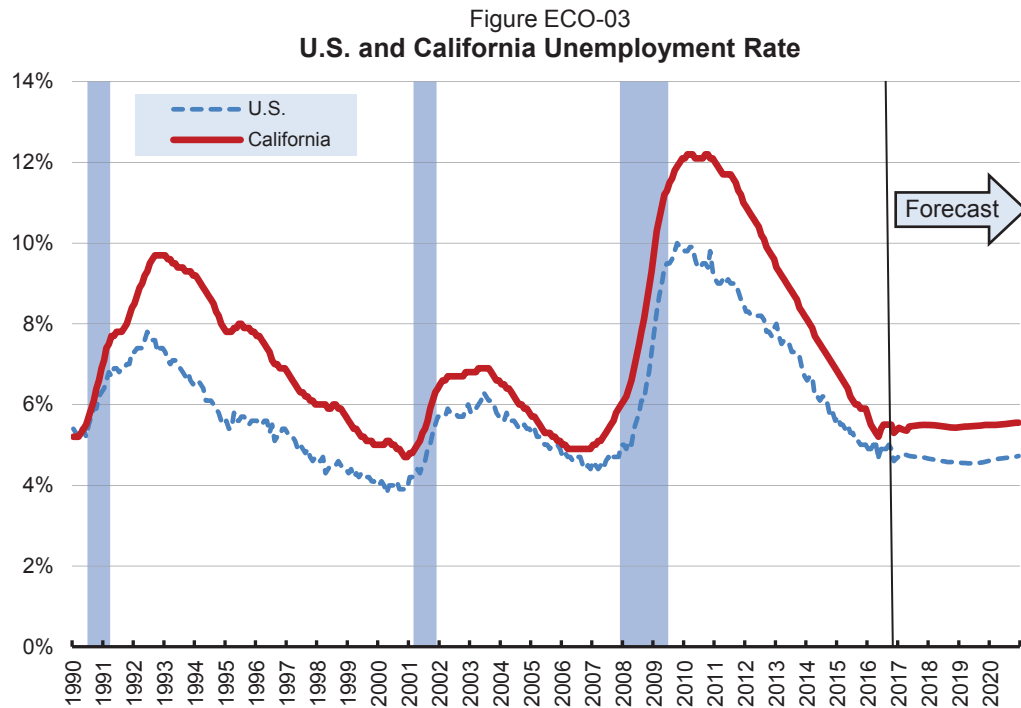
Selected Economic Indicators

United States	2012	2013	2014	2015	2016	2017	2018
					Estimated	Projected	Projected
Nominal gross domestic product, \$ billions	\$ 16,155	\$ 16,692	\$ 17,393	\$ 18,037	\$ 18,564	\$ 19,408	\$ 20,274
Real gross domestic product, percent change	2.2%	1.7%	2.4%	2.6%	1.5%	2.2%	2.2%
<i>Contributions to real GDP growth</i>							
Personal consumption expenditures	1.0%	1.0%	2.0%	2.2%	1.8%	1.7%	1.7%
Gross private domestic investment	1.5%	1.0%	0.7%	0.8%	-0.3%	0.6%	0.9%
Net exports	0.1%	0.3%	-0.2%	-0.7%	-0.1%	-0.2%	-0.4%
Government purchases of goods and services	-0.4%	-0.6%	-0.2%	0.3%	0.2%	0.1%	0.0%
Personal income, \$ billions	\$ 13,915	\$ 14,074	\$ 14,810	\$ 15,459	\$ 15,971	\$ 16,665	\$ 17,484
Corporate profits, percent change	10.0%	1.7%	5.9%	-3.0%	-1.7%	4.3%	4.6%
Housing permits, thousands	830	991	1,052	1,183	--	--	--
Housing starts, thousands	784	928	1,001	1,108	1,152	1,226	1,320
Median sales price of existing homes	\$ 177,200	\$ 197,400	\$ 208,900	\$ 223,900	--	--	--
Federal funds rate, percent	0.1%	0.1%	0.1%	0.1%	0.4%	0.8%	1.5%
Consumer price index, percent change	2.1%	1.5%	1.6%	0.1%	1.3%	2.1%	2.3%
Unemployment rate, percent	8.1%	7.4%	6.2%	5.3%	4.9%	4.7%	4.6%
Civilian labor force, millions	155.0	155.4	155.9	157.1	159.3	161.2	163.0
Nonfarm employment, millions	134.2	136.4	138.9	141.8	144.3	146.1	147.4
California							
Personal income, \$ billions	\$ 1,839	\$ 1,862	\$ 1,978	\$ 2,104	\$ 2,191	\$ 2,288	\$ 2,387
California exports, percent change	1.5%	4.0%	3.4%	-4.9%	--	--	--
Housing permits, thousands	59	86	86	98	97	105	115
Housing unit net change, thousands	45	59	69	67	--	--	--
Median sales price of existing homes	\$ 319,310	\$ 407,150	\$ 446,890	\$ 474,420	--	--	--
Consumer price index, percent change	2.2%	1.5%	1.8%	1.5%	2.3%	2.7%	2.9%
Unemployment rate, percent	10.4%	8.9%	7.5%	6.2%	5.5%	5.5%	5.5%
Civilian labor force, millions	18.5	18.7	18.8	19.0	19.2	19.3	19.5
Nonfarm employment, millions	14.8	15.2	15.6	16.1	16.5	16.8	16.9
<i>Percent of total nonfarm employment</i>							
Mining and logging	0.2%	0.2%	0.2%	0.2%	0.1%	0.1%	0.1%
Construction	4.0%	4.2%	4.3%	4.5%	4.7%	4.8%	5.0%
Manufacturing	8.5%	8.3%	8.2%	8.1%	7.9%	7.7%	7.7%
High technology	2.3%	2.2%	2.2%	2.1%	2.1%	2.1%	2.1%
Trade, transportation, and utilities	18.5%	18.4%	18.4%	18.3%	18.2%	18.1%	18.0%
Information	2.9%	3.0%	3.0%	3.0%	3.0%	2.9%	2.9%
Financial activities	5.2%	5.2%	5.0%	5.0%	4.9%	4.9%	4.9%
Professional and business services	15.2%	15.4%	15.6%	15.5%	15.7%	15.6%	15.6%
High technology	2.4%	2.4%	2.5%	2.6%	2.8%	2.8%	2.8%
Educational and health services	15.1%	15.2%	15.2%	15.3%	15.4%	15.7%	15.7%
Leisure and hospitality	10.8%	11.1%	11.3%	11.4%	11.5%	11.6%	11.7%
Other services	3.4%	3.4%	3.4%	3.4%	3.4%	3.3%	3.3%
Government	16.1%	15.7%	15.5%	15.3%	15.2%	15.1%	15.1%

Forecast based on data available as of November 2016.

Percent changes calculated from unrounded data.

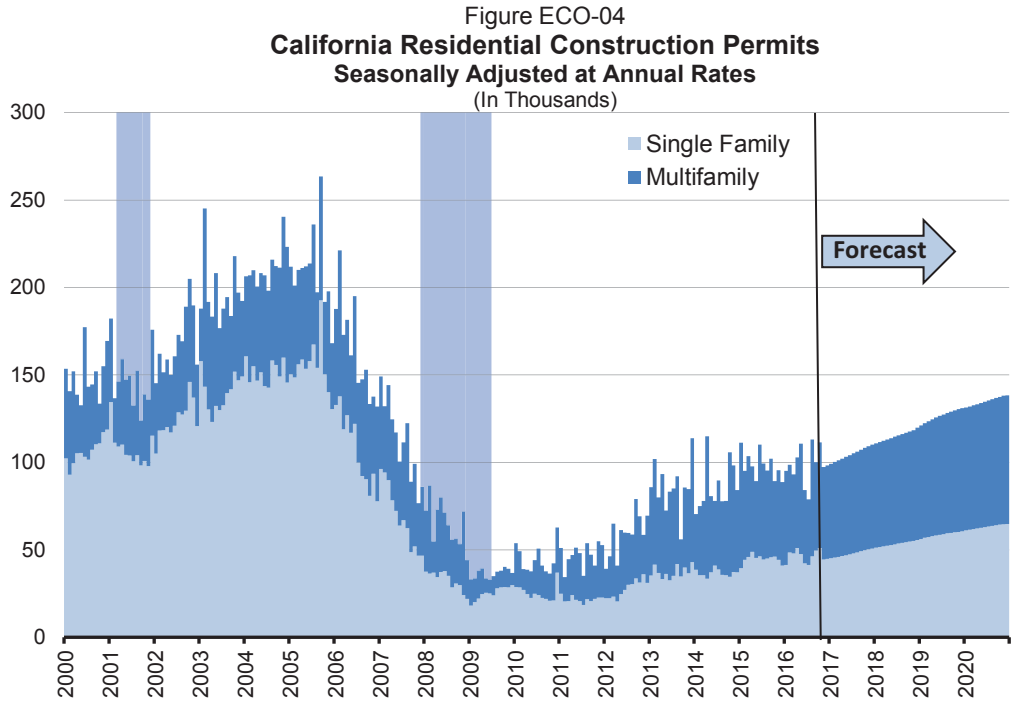
expected to remain near that level (Figure ECO-03). The labor force expanded by around 200,000 workers, or approximately 1.2 percent in 2016. This was higher than the growth of 0.8 percent in 2015, and is the largest gain since 2008.



Shaded areas indicate U.S. recessions.
Source: U.S. Bureau of Labor Statistics; CA Employment Development Department, Labor Market Information Division; CA Department of Finance Governor's Budget Forecast.

Despite the increase in the minimum wage from \$9 to \$10 per hour on January 1, 2016, lower-wage sectors such as leisure and hospitality and educational and health services continued to grow in 2016. The stronger-than-expected growth in these sectors also led to greater labor force participation, with rising rates despite an aging population. This, in turn, led to slower wage growth than expected in 2016, and lowered overall personal income growth. The increase to \$10.50 per hour for employers with more than 25 employees at the beginning of 2017 is assumed to be followed by all scheduled minimum wage increases through \$15 per hour in the outlook. Personal income growth is expected to remain at 4.4 percent in 2017 and annually thereafter.

Consumer inflation has averaged only 2 percent in California and 1.6 percent in the nation since 2010, as measured by the Consumer Price Index (CPI). Inflation began to pick up in 2016 due largely to increasing housing costs, rising medical care outlays, and recovering energy prices. California’s higher housing costs, particularly in the Bay Area, have resulted in higher state inflation relative to the nation. Overall California consumer inflation is expected to average 2.3 percent in 2016, 2.7 percent in 2017, and 2.9 percent in 2018. Low levels of housing permits relative to demand are expected to continue in 2017 and 2018 (Figure ECO-04). The statewide median sales price of an existing single-family home was \$513,520 in October, around \$80,000 below the pre-recession peak of \$594,530 reached in May 2007, and more than double the national median price of \$232,200.



Shaded areas indicate U.S. recessions.
Source: CA Construction Industry Research Board; CA Homebuilding Foundation;
CA Department of Finance Governor's Budget Forecast.

RISKS TO CONSIDER

In addition to the risk of a recession, there are several risks to the state's economy in the next few years, including rising housing prices, disruptions to trade, or a stock market correction.

HOUSING

Since 2010, California's housing supply has expanded slowly and unevenly across regions, causing statewide housing stress. California's total nonfarm employment grew by about 2 million from 2010 to 2015 while the supply of housing units grew by less than 300,000 units. The stress is particularly stark in the Bay Area, where nonfarm employment increased by nearly 600,000 while housing supply edged up only 72,000 units. The lag in the supply of housing has kept home prices and rental costs high.

With job growth continuing to be concentrated in the Los Angeles area and the Bay Area, the increased demand, combined with the low supply of housing will continue to push up prices. Rising wages can compensate somewhat for a high cost of living, but there are limits to how much companies can afford to pay workers. If workers are not willing to work for the wages offered, and companies are unable to relocate to lower-cost areas in the state or move here from elsewhere, job growth may stall.

TRADE

International trade is a vital component of the U.S. and California economy with the sum of imports and exports equal to around 30 percent of the nation's GDP. California is the home of the nation's busiest international ports and is one of the leading producers and exporters of high value-added technology products. A significant number of jobs are linked directly to international trade. In 2015, \$165 billion worth of commodities were exported to the rest of the world through California ports including computers and electronics, machinery, chemicals, transportation equipment, and agricultural products. California's top three trade partners are Mexico, Canada, and China.

The U.S. has 14 free trade agreements currently in force with 20 countries, and companies based in California have developed global supply chains for the products they sell. If goods made abroad are cheaper, that benefits U.S. buyers. Countries can also benefit from specializing in the types of goods they are efficient at producing, such as high value-added technology products. Changes to existing free trade policies could cause prices to spike, and could lead to job losses as the economy adjusts.

This would particularly hurt lower-income workers, who would face higher prices on the goods they buy.

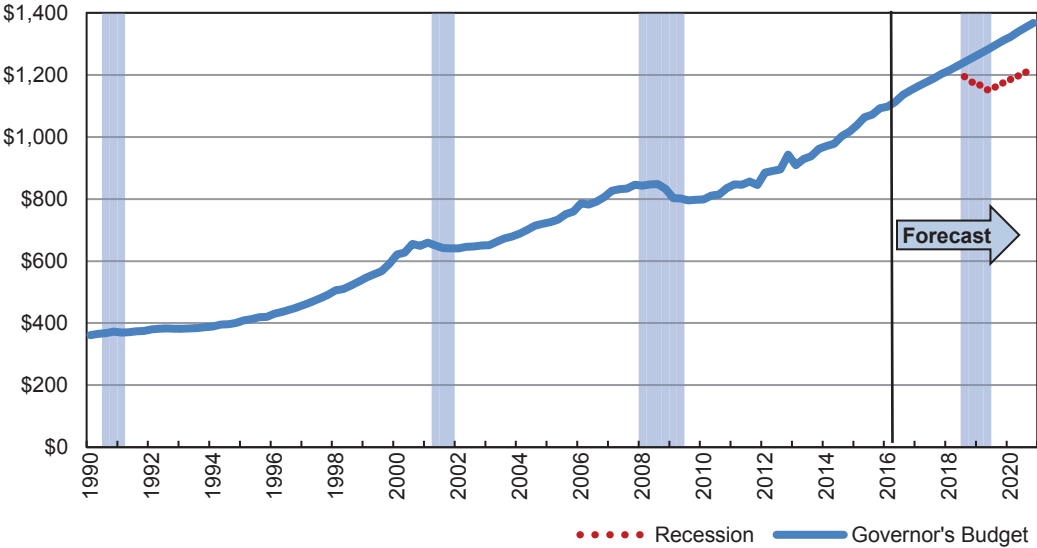
STOCK MARKET

The S&P 500 index ended 2016 9.5 percent higher than at the end of 2015, and has now been rising on an annual basis since 2009. California is home to many large companies, and their growth has pushed up employment, particularly in high-wage jobs. This supports personal income growth and revenues in the state. Even absent a recession, a stock market correction that causes firms to slow or reverse their growth would significantly affect California.

PLANNING FOR THE NEXT RECESSION

The current economic expansion has lasted since mid-2009, but on average, expansions last for only around five years. As described in the Introduction, it would be a historical anomaly for there not to be a recession before 2020. Even a fairly mild recession in the U.S. would be difficult for California. Under a moderate recession scenario for the U.S. over 2018-2019, real U.S. GDP would fall by 0.4 percent. California would lose almost one million jobs, and wages and salaries would initially fall by more than 5 percent, with an ongoing difference versus the forecast of about 10 percent (Figure ECO-05).

Figure ECO-05
California Wages and Salaries Would Drop Below the Forecast During a Recession
(Dollars in Billions)



Shaded areas indicate U.S. recessions.
Source: U.S. Department of Commerce, Bureau of Economic Analysis; CA Department of Finance.

ECONOMIC OUTLOOK

In addition, as a recession would likely be accompanied by a large fall in the stock market, revenues would be strongly affected.

While this recession scenario is not based on any particular trigger, recessions occur when an imbalance between expectations and the underlying economy is forced to correct. Previous corrections have included rebalancing following overvaluations in the technology sector at the beginning of the century, or overinvestment in housing in the last recession. In the current expansion, most growth in the U.S. is due to rising consumption as people find work and make more money. As discussed above, there are a number of potential changes that could cause people to reassess their expectations, and thus start a recession.