ECONOMIC OUTLOOK

At the end of 2023, the economy remained resilient despite still-tight financial conditions—alleviating concerns for a near-term recession. With price pressures receding and the labor market gradually cooling, prospects for the Federal Reserve's goal of a "soft landing" (slowing inflation without an associated recession) have improved. Both U.S. and California inflation have slowed steadily since their respective June 2022 peaks of 9.1 and 8.3 percent year-over-year, with U.S. inflation at 3.1 percent in November and California at 3.2 percent in October, the latest available data. The Federal Reserve increased rates just 1 percentage point in 2023 compared to 4.25 percentage points in 2022 and has held the target range steady at 5.25 to 5.5 percent since July 2023. It is likely that the Federal Reserve may begin cutting rates in 2024.

Along with slowing inflation, the pace of national and state job growth nearly halved from 2022 to 2023 and can be comparable to the 2015-2019 pre-COVID-19 period. Growth slowed as labor markets tightened after both the state and the nation recovered all COVID-19 Pandemic-induced job losses by the middle of 2022. The two biggest near-term threats to economic growth are a possible resurgence of higher inflation and sustained high interest rates, as the risks from elevated tech sector layoffs and the potential banking crisis in the beginning of 2023 have receded.

U.S. REAL GROSS DOMESTIC PRODUCT (GDP) REMAINS SURPRISINGLY STRONG

Despite slowing job growth and high interest rates, U.S. real GDP growth averaged 3.1 percent over the first three quarters of 2023, buoyed by strong consumption and business investment boosted by federal manufacturing incentives, such as the Creating Helpful Incentives to Produce Semiconductors (CHIPS) Act. The third quarter's estimated growth rate of 4.9 percent was driven by unusually high inventory accumulation and government purchases, as consumption and fixed investment were in line with the first two quarters of 2023.

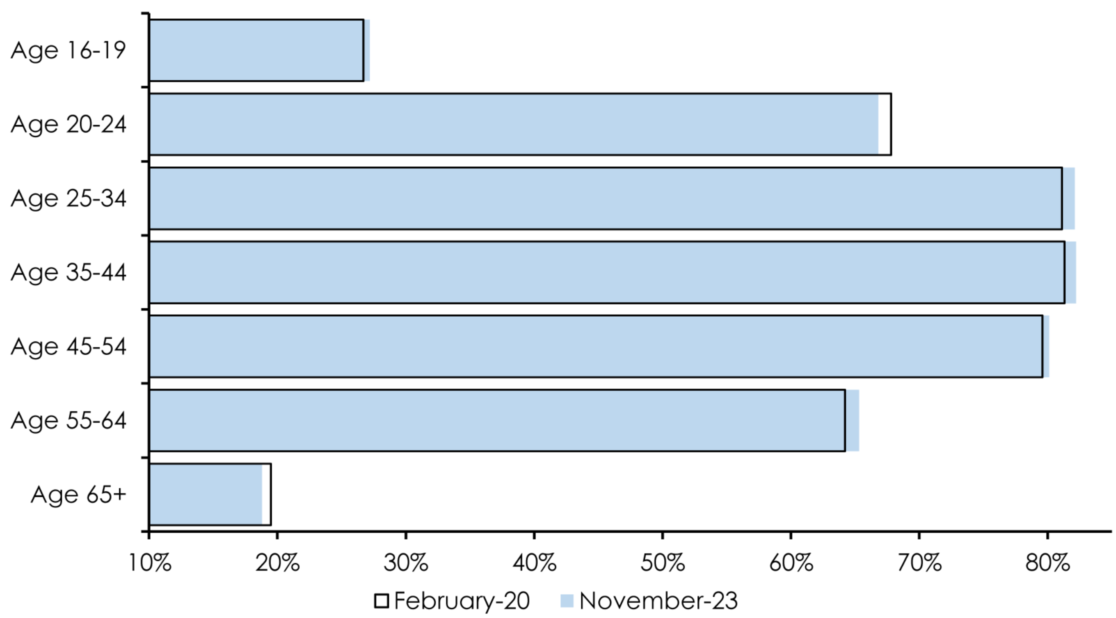
CALIFORNIA JOB GROWTH NORMALIZES, WAGE GROWTH STALLS

At the onset of the COVID-19 Pandemic, California lost nearly 2.8 million nonfarm payroll jobs in March and April 2020, with four out of five losses in low-wage sectors. Based on the Department of Finance's reclassification of the eleven major sectors in California (updating the reference year for classification from 2019 to 2022), the low-wage sectors are defined as those with average wages below the 2022 statewide average wage of just over $88,700 for all industries. The low-wage sectors now include construction and government along with trade, transportation, and utilities, private education and health services, leisure and hospitality, and other services. The share of jobs, which was evenly split prior to the reclassification, tilted towards low-wage sectors following the new classification, as over two-thirds of all nonfarm payroll employment in California is now classified as low-wage employment, which may have long-term implications for the state economy.

Having borne the brunt of job losses during the COVID-19 Recession, the low-wage sectors' recovery lagged the high-wage sectors. However, job growth in recent months was more robust in low-wage sectors as lingering layoffs, the high interest rate environment, and recent entertainment industry strikes had more impact on the high-wage sectors. As of November 2023, California's low-wage sectors averaged a gain of 33,800 jobs per month in 2023, while high-wage sectors lost an average of 7,500 jobs monthly.

Unlike the relatively swift nonfarm job recovery following the COVID-19 Pandemic, the state's labor force has not recovered to its February 2020 pre-pandemic level as of November 2023, even as the labor force grew by 88,100 people through November. Despite strong labor force growth, only 77 percent of the just over 1 million people who left the workforce in the first three months of the pandemic had returned as of November 2023. In contrast, the nation's labor force recovered to its February 2020 pre-pandemic level in August 2022 and nearly 3.3 million people have joined the labor force year-to-date through November 2023. Labor force growth for both the U.S. and California have been primarily driven by prime-age workers (those between the ages of 25 to 54), which surpassed pre-pandemic labor force participation rates and recently reached their highest levels, 83.5 percent and 81.5 percent, respectively, in over a decade. (See figure on California Labor Force Participation Rate Recovery by Age.)

California Labor Force Participation Rate Recovery by Age
(Relative to Pre-pandemic February 2020 Rates)



Note: Labels represent November 2023 labor force participation rates.
February 2020 was the pre-pandemic peak, except for age group 16-19 (June 2020) and 20-24 (March 2020).
Source: California Employment Development Department, Labor Market Information Division;
California Department of Finance, 2024-25 Governor's Budget Forecast.

As of November 2023, the state's unemployment rate rose by 1.1 percentage points to 4.9 percent after falling to a record-low rate of 3.8 percent in July and August 2022. In comparison, the nation's unemployment rate increased by 0.3 percentage point to 3.7 percent in November since falling to its more recent record-low (since 1953) of 3.4 percent in January and April 2023. While unemployment in California may be rising somewhat faster than the nation, it is increasing from an extraordinarily low level, reflective of a tight labor market that is adjusting to more sustainable growth after rebounding so swiftly in the wake of the pandemic-induced recession. Further contributing to the state's rising unemployment rate is civilian household employment which plateaued over the last year, driven partially by reduced self-employment and independent contractor work which generally yield lower wages and offer fewer benefits.

After strong growth of 11.3 percent in 2020 and 7.7 percent in 2021 driven by unprecedented gains in high-paying sectors, California average wage growth declined 1 percent in 2022 but recovered to 4.2 percent year-over-year growth in the third quarter of 2023. The state's highest paying sectors (information and finance in particular) saw significant declines in 2022 due largely to much lower levels of irregular payments such as bonuses and options as stock prices dropped sharply, pushing overall wage growth to decline despite modest growth in most sectors. With asset markets recovering in 2023, wage growth resumed.

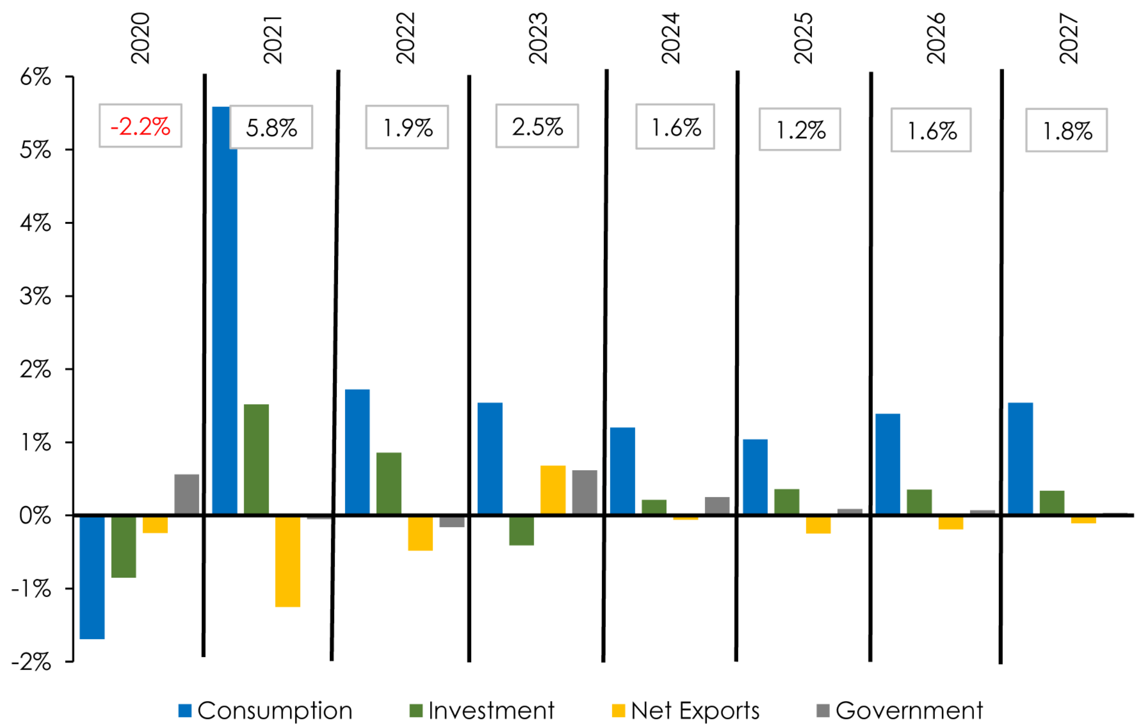
Inflation eased in 2023 but remained above the Federal Reserve's target of 2 percent. U.S. inflation has slowed to 3.1 percent as of November 2023, while California inflation fell to 3.2 percent in October 2023, the latest available data. U.S. shelter inflation, which accounts for 35 percent of the entire index, generally lags other components and only recently has begun to moderate on a year-over-year basis despite slow growth and even declines in market rents that began in late 2022. Shelter inflation peaked at 8.2 percent year-over-year in March 2023, reflecting rapid increases in rents in 2021 and early 2022. While it has slowed in recent months, it remained at 6.5 percent in November.

Residential building permits declined in 2022 due to higher interest rates, which slowed demand for housing and made construction loans more expensive. The first five months of 2023 saw declines on a year-over-year basis after which permit growth began to increase in June 2023, and has continued at a steady pace. The state averaged 100,600 residential permits from January to May on a seasonally adjusted annualized basis and then averaged 122,000 from June to November, the latest available data.

THE ECONOMIC FORECAST THROUGH 2027: SLOWING GDP GROWTH

U.S. GDP experienced strong growth averaging 3 percent from the third quarter of 2022 to the third quarter of 2023 but is projected to slow to below 1 percent annualized growth in the first half of 2024. (See figure on Contributors to U.S. Real GDP Growth.) High interest rates are projected to limit interest-sensitive consumption and business investment, and with usage no longer ramping up, federal manufacturing incentives under the CHIPS Act are not expected to add to the growth rate of investment. The Federal Reserve is projected to begin lowering target rates by the middle of 2024, causing demand to rebound as credit conditions ease and GDP growth returns to its projected steady-state growth rate of 1.8 percent by early 2026.

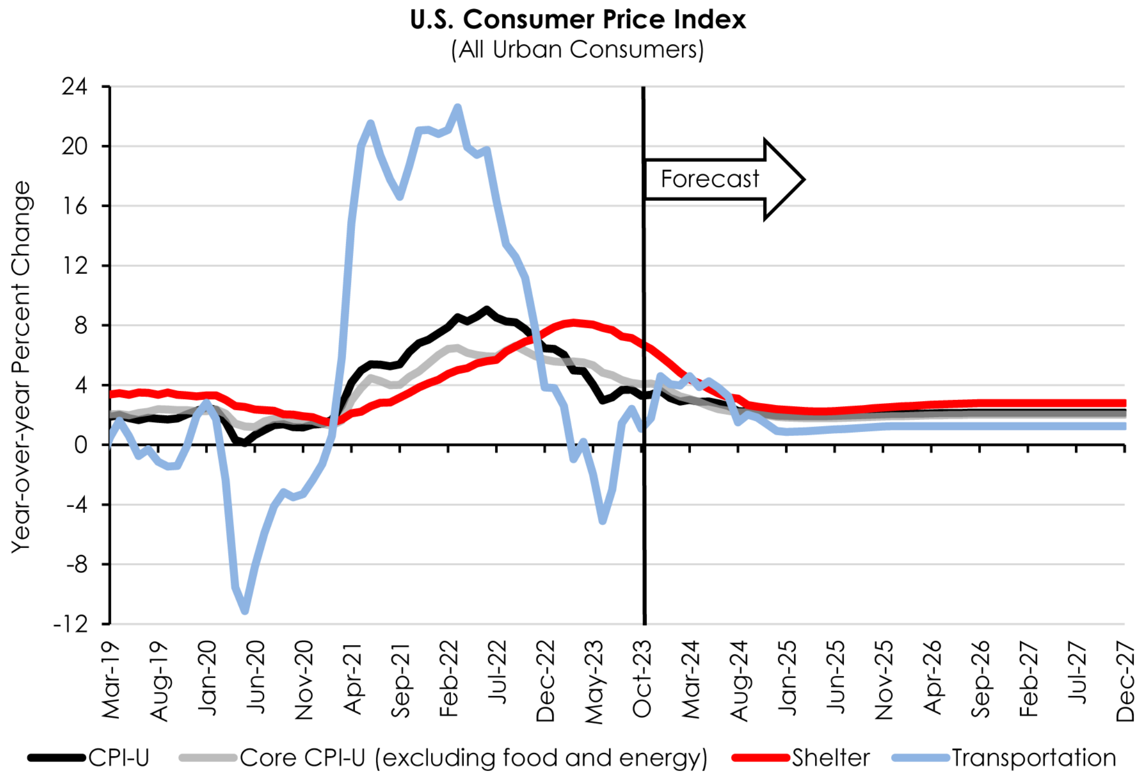
Contributors to U.S. Real GDP Growth



Source: U.S. Bureau of Economic Analysis; California Department of Finance, 2024-25 Governor's Budget Forecast.

INFLATION PROJECTED TO DECELERATE FURTHER

The Governor's Budget economic forecast projects U.S. headline inflation will continue to moderate as the Federal Reserve maintains its current restrictive monetary policy through the middle of 2024. Inflation is projected to slow to historical rates of between 2 and 3 percent for both the nation and the state (somewhat higher in California) by late 2024. Shelter inflation, which has been largely responsible for keeping U.S. headline inflation above the Federal Reserve's 2-percent target rate, is projected to fall below 3 percent year-over-year by late 2024 and remain below that level as market rent growth remains subdued. (See figure on U.S. Consumer Price Index.)



Source: U.S. Bureau of Labor Statistics; California Department of Finance, 2024-25 Governor's Budget Forecast.

JOB GROWTH PROJECTED TO CONTINUE SLOWING

In line with projected U.S. real GDP growth slowing through mid-2024, California's nonfarm payroll job growth is projected to remain moderate through early 2024 and to start slowing in the second half of the year and into 2025. The number of nonfarm jobs recently added suggests that employment growth is reverting to historical trends as the labor market is now in the post-pandemic recovery period. California added an average of 26,300 jobs through November 2023, and averaged a year-over-year growth rate of 2.2 percent, similar to the 2.3-percent average annual growth from the pre-pandemic five-year period of 2015 – 2019 (with an average monthly job gain of 29,800).

California's labor force is projected to grow at a slowing rate as it returns to pre-pandemic trends. Growth is projected to slow from 0.9 percent in 2023 to 0.5 percent in 2027 as population growth, particularly among working-age individuals (those between the ages of 16 to 64), is projected to decline throughout the forecast window (2023 through 2027). The Governor's Budget economic forecast projects labor force growth will moderate as the labor market cools. California's unemployment rate is projected to rise through 2025 as tight financial conditions further soften the labor market. As employment growth plateaus, the unemployment rate is projected to peak in early 2025 at 5.2 percent before moderating thereafter.

MODEST WAGE GROWTH PROJECTED

California average wage growth is projected to recover to 2.7 percent in 2023 and 3.4 percent in 2024, as irregular payments return to a normal level after plunging in 2022, in line with movements in market valuations of technology (tech) firms. With the economy and tech firms in particular strengthening in 2025, average wages are projected to grow 3.7 percent annually from 2025 on, slightly below the growth rates in 2018 and 2019 before the pandemic. (See figure on Economic Indicators at the end of this chapter.) Average wages in the information sector, by far the state's highest-paying sector as it includes many leading tech firms, are projected to recover from the 10.2-percent plunge in 2022 to relatively modest growth of 3.5 percent in 2023 and 2024 before returning to their long-term average growth rate of 6 percent in 2025 and beyond as the state's tech industry recovers from its current sluggishness.

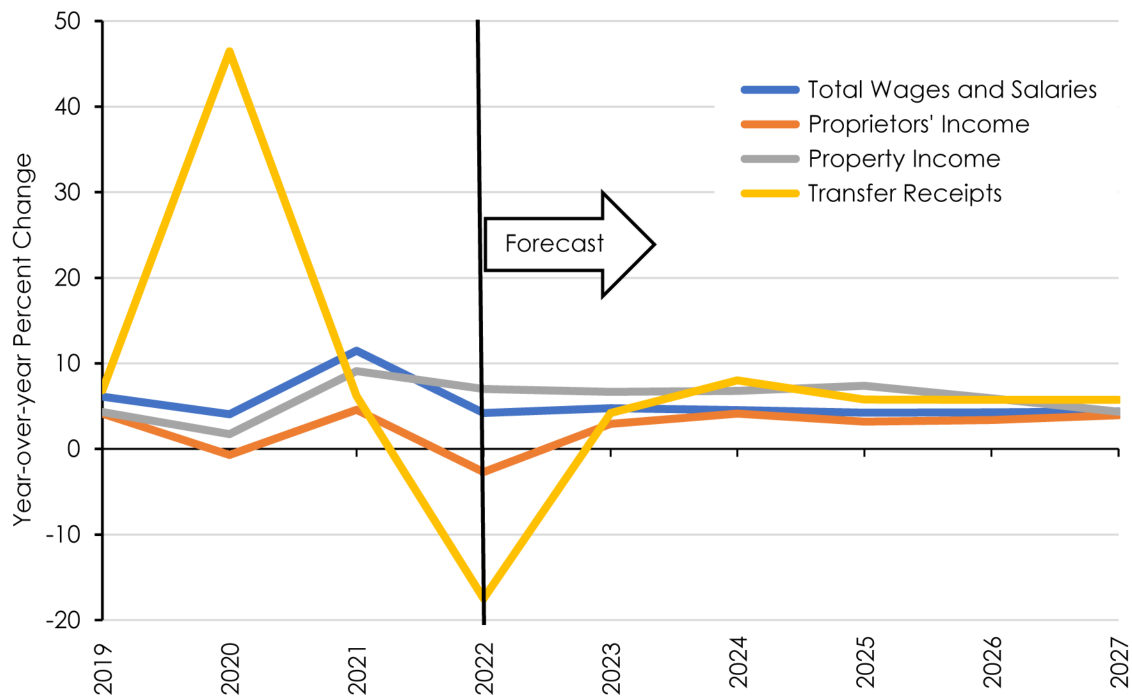
PERSONAL INCOME GROWTH CONTINUES DESPITE SLOWER WAGE GROWTH

Personal income headline growth averaged 4.4 percent on a year-over-year basis in the first half of 2023, relatively strong growth compared to a contraction of 0.2 percent in 2022, driven mainly by declining transfer receipts due to the end of pandemic-related assistance programs. Headline growth is projected to moderate in 2025 into 2026, driven by slightly slower growth in total wages as payroll employment slows in 2025. Revisions to 2022 data saw the largest downward revision to actual data with a level shift down of about $49 billion at the end of 2022 in total wages and salaries. Total wages are still projected to continue to drive headline growth through the forecast window, despite downward revisions, as they make up more than half of total personal income. However, with slower nonfarm job growth into 2025, total wages are projected to experience a similar slowdown before moderating into 2026 and 2027. This weaker job growth is also projected to slightly slow growth in proprietors' income, which covers the profits of non-corporate businesses.

Property income growth, which is comprised of interest, rental, and dividend income, is projected to peak in 2025, driven by interest income which is largely pegged to the federal funds rate. Interest income is projected to have a lagged effect (slowing a quarter or two later) as interest rates are projected to begin falling in 2025. Rental income growth, which tends to be driven by shelter inflation, is projected to peak in 2024 and later slow into 2027 as rents begin to ease in line with slowing shelter inflation. Dividend income saw notable upgrades in 2021 and 2022 followed by continued strength in the first half of 2023.

As interest rates are projected to ease in 2025, the majority of the personal income components, such as property income and total wages, are also projected to begin reverting to their historical growth trends of around 4 percent by 2027. (See figure on California Personal Income Growth.)

California Personal Income Growth



Source: U.S. Bureau of Economic Analysis; California Department of Finance, 2024-25 Governor's Budget Forecast.

PERMITS GROWTH MODEST IN 2023, PROJECTED TO IMPROVE IN 2024

California is projected to issue 114,300 total residential permits in 2023, a slight increase from 113,600 in 2022. The first quarter of 2023 saw slow growth for residential construction coming out of a sharp drop in permitting from 120,600 in the third quarter of 2022 to 88,600 in the fourth quarter on a seasonally adjusted annualized rate. The state saw a boost in residential permits in the second and third quarters of 2023, averaging 121,400 annually. Even with this boost, a slight decline in permits is projected in the fourth quarter of 2023 as permitting in the fourth quarter historically lags other quarters.

Residential permits are then projected to begin growing in 2024 and continue through 2027 as the Federal Reserve cuts interest rates, averaging 126,200 units annually through the rest of the forecast window.

Risks to the Forecast

Immediate risks to the Governor's Budget economic forecast stem from inflation and interest rates. The Federal Reserve could maintain high target rates for longer than expected if inflation is slow to approach its target rate of 2 percent, which could result in additional drag on interest-sensitive spending. The current high rates could also hamper economic activity more than projected, especially given more cautious lending practices and the possibility that consumers will curtail discretionary spending. There is also a specific risk that Iran could be drawn into the current Israel-Hamas conflict and disrupt oil shipping through the Persian Gulf, driving oil prices up and causing other supply chain issues.

The Department of Finance did not model a recession scenario, but if a recession were to develop, it would likely be relatively mild and begin toward the end of 2024 driven by high interest rates causing deeper declines in interest-sensitive spending than projected in the baseline. A subsequent recovery to steady-state growth would likely then begin in 2025 as looser credit conditions boost interest-sensitive consumption and investment.

Other risks also remain, including an escalation of tensions between China and Taiwan. Long-term structural downside risks to the state economy and budget also persist, including climate change and its attendant more frequent extreme weather events such as wildfires, drought, and floods, the challenges of an aging population, declining migration inflows, lower fertility rates, chronic stock market volatility, high housing and living costs, and potentially worsening income inequality.

Economic Indicators

Annual Percentage Change unless Otherwise Indicated

	2019	2020	2021	Actual <- 2022	-> Forecast 2023	2024	2025	2026	2027
United States									
Real GDP	2.5%	-2.2%	5.8%	1.9%	*2.5%*	*1.6%*	*1.2%*	*1.6%*	*1.8%*
Unemployment Rate (percent)	3.7%	8.1%	5.4%	3.6%	*3.6%*	*3.8%*	*4.4%*	*4.7%*	*4.6%*
Nonfarm Employment	1.3%	-5.8%	2.9%	4.3%	*2.4%*	*0.7%*	*-0.3%*	*0.0%*	*0.4%*
Personal Income	4.7%	6.9%	9.1%	2.0%	*5.3%*	*5.0%*	*4.8%*	*4.4%*	*4.5%*
CPI Inflation Rate (percent)	1.8%	1.2%	4.7%	8.0%	*4.2%*	*2.6%*	*2.0%*	*2.1%*	*2.2%*
California									
Unemployment Rate (percent)	4.1%	10.2%	7.3%	4.2%	*4.6%*	*5.1%*	*5.2%*	*5.0%*	*4.8%*
Civilian Labor Force	0.7%	-2.3%	0.1%	1.4%	*0.9%*	*0.8%*	*0.6%*	*0.5%*	*0.5%*
Nonfarm Employment	1.5%	-7.1%	3.5%	5.6%	*2.2%*	*1.0%*	*0.4%*	*0.5%*	*0.6%*
Residential Permits (thousands of units)	110	106	119	114	*114*	*118*	*123*	*129*	*135*
Average Wages	4.4%	11.3%	7.7%	-1.0%	*2.7%*	*3.4%*	*3.7%*	*3.7%*	*3.7%*
Personal Income	5.3%	9.0%	8.9%	-0.2%	*4.7%*	*5.2%*	*5.0%*	*4.7%*	*4.5%*
CPI Inflation Rate (percent)	3.0%	1.7%	4.3%	7.4%	*3.8%*	*3.0%*	*2.4%*	*2.6%*	*2.7%*

Governor's Budget Forecast based on data available as of November 2023. Figures in italics indicate forecasts.
Sources: U.S. Bureau of Economic Analysis; U.S. Bureau of Labor Statistics; U.S. Census Bureau; California Employment Development Department, Labor Market Information Division; California Department of Finance, 2024-25 Governor's Budget Forecast.