ECONOMIC OUTLOOK

The first months of 2024 have continued the trend of steady but slowing economic growth, notwithstanding stubborn inflation and elevated interest rates. U.S. real gross domestic product (GDP) grew at an annualized rate of 1.6 percent in the first quarter of 2024 following six consecutive quarters of higher than 2-percent growth, buoyed by strong personal consumption. With a relatively strong and stable economy, the May Revision forecast projects U.S. GDP to grow at a steady but slowing rate from mid-2024 into early 2025 amid still-tight financial conditions driving lower levels of consumption. Credit conditions are projected to ease starting in mid-2024 with loosening monetary policy as the Federal Reserve cuts target interest rates. U.S. GDP is then projected to grow at steady-state rates between 1.5 and 1.9 percent starting in mid-2025 through the end of the forecast window in 2027.

While both U.S. and California inflation have slowed from their respective June 2022 peaks, U.S. inflation experienced a recent uptick to 3.5 percent year-over-year growth in March 2024 while California inflation stood at 3.3 percent in February 2024 (the latest data available), driven mainly by lagged shelter inflation. At the time the May Revision forecast was finalized, the Federal Reserve was widely expected to start cutting rates by June 2024. However, expectations have since shifted, and the Federal Reserve may instead hold rates steady until later in 2024 or even raise rates if inflation remains persistently elevated above the target 2-percent rate.

The biggest near-term threat to the forecast continues to be the likelihood that interest rates will stay higher for longer, especially if inflation does not resume its deceleration. The current high interest rates could curtail interest-sensitive consumer spending and business investment which would hamper economic activity more than projected. Moreover, if interest rates stay higher for longer, businesses and consumers' sanguine economic outlooks could falter, and increased concerns of a near-term recession could resurface.

LABOR MARKET UPDATES SINCE THE GOVERNOR'S BUDGET

The May Revision forecast incorporates the March 2024 benchmark revisions from the U.S. Bureau of Labor Statistics (BLS) and the California Employment Development Department (EDD). The annual benchmark revisions indicated October 2022 was an inflection point where the strong job recovery from the COVID-19 Pandemic was followed by stagnation, especially in the sectors that drove the recovery. As a result, nonfarm payroll employment in the state was 231,800 lower than the pre-benchmarked estimates as of December 2023. Even with the revisions, as of March 2024, California nonfarm jobs were 1.8 percent (319,200 jobs) above the February 2020 level, with six of the eleven major sectors having surpassed their respective pre-pandemic levels. The number of nonfarm jobs added in recent months suggests California payroll employment growth in the last eight months has been in line with the nation, and appears to be rebounding from essentially flat growth in prior months.

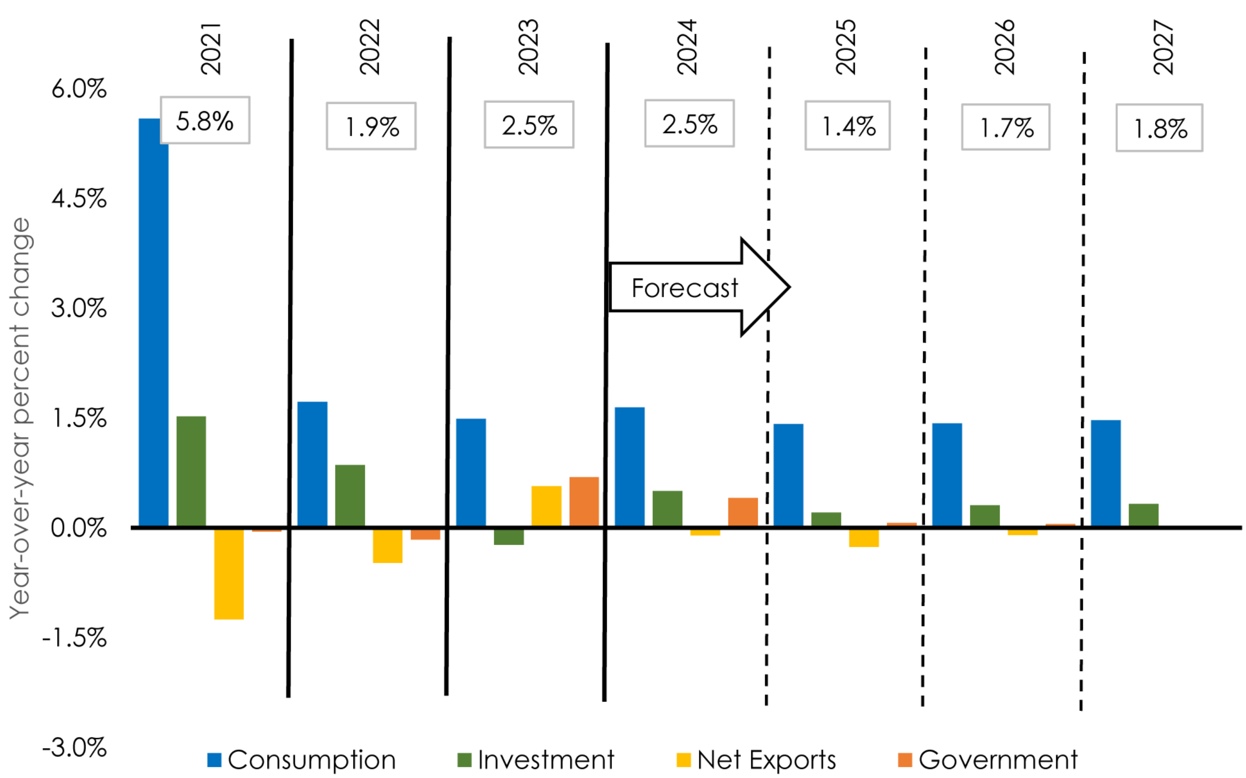
Unlike the swift nonfarm job recovery, the state's labor force has not yet recovered to its pre-pandemic level as of March 2024. Nevertheless, the labor force grew steadily in 2023, growing by 0.7 percent, slightly lower than the Governor's Budget projection of 0.9 percent but still higher than the 2019 pre-pandemic growth of 0.5 percent. Despite relatively healthy labor force growth, only 76 percent of the just over 1 million people that left the workforce at the beginning of the COVID-19 Pandemic have returned. While at lower levels, California's labor force participation rate has also continued its recovery, driven primarily by participation amongst prime-age workers (those between the ages of 25 to 54) which surpassed its pre-pandemic rate in September 2022 and remained 0.7 percentage point higher than its February 2020 level, further emphasizing the state's slow but ongoing labor force recovery.

As of March 2024, California's unemployment rate had risen 1.5 percentage points to 5.3 percent since falling to a record-low rate of 3.8 percent in August 2022. In comparison, the nation's unemployment rate fell to a historical low of 3.4 percent more recently in January and April 2023 and has since increased to 3.8 percent as of March 2024. California's civilian employment growth has been essentially flat since the second half of 2022 while the U.S. has remained relatively healthy, resulting in the state's unemployment rate rising faster than the nation. However, while California's unemployment has risen by about 300,000 since August 2022, more than 75 percent of this increase can be attributed to labor force growth as opposed to reduced civilian employment. In other words, the increase in the unemployment rate is more attributable to those entering or re-entering the labor force to look for work rather than to employers laying off workers.

THE ECONOMIC OUTLOOK THROUGH 2027: SLOWING BUT STEADY GDP GROWTH

As with the Governor's Budget forecast, economic growth is projected to continue in the May Revision forecast, driven by strong but slowing personal consumption. Growth is projected to moderate into 2025 due to the impacts of restrictive monetary policy and then return to around 1.9 percent by 2027 in line with steady-state growth trends after the widely expected rate cuts from the Federal Reserve.

Contributions to U.S. Real GDP Growth

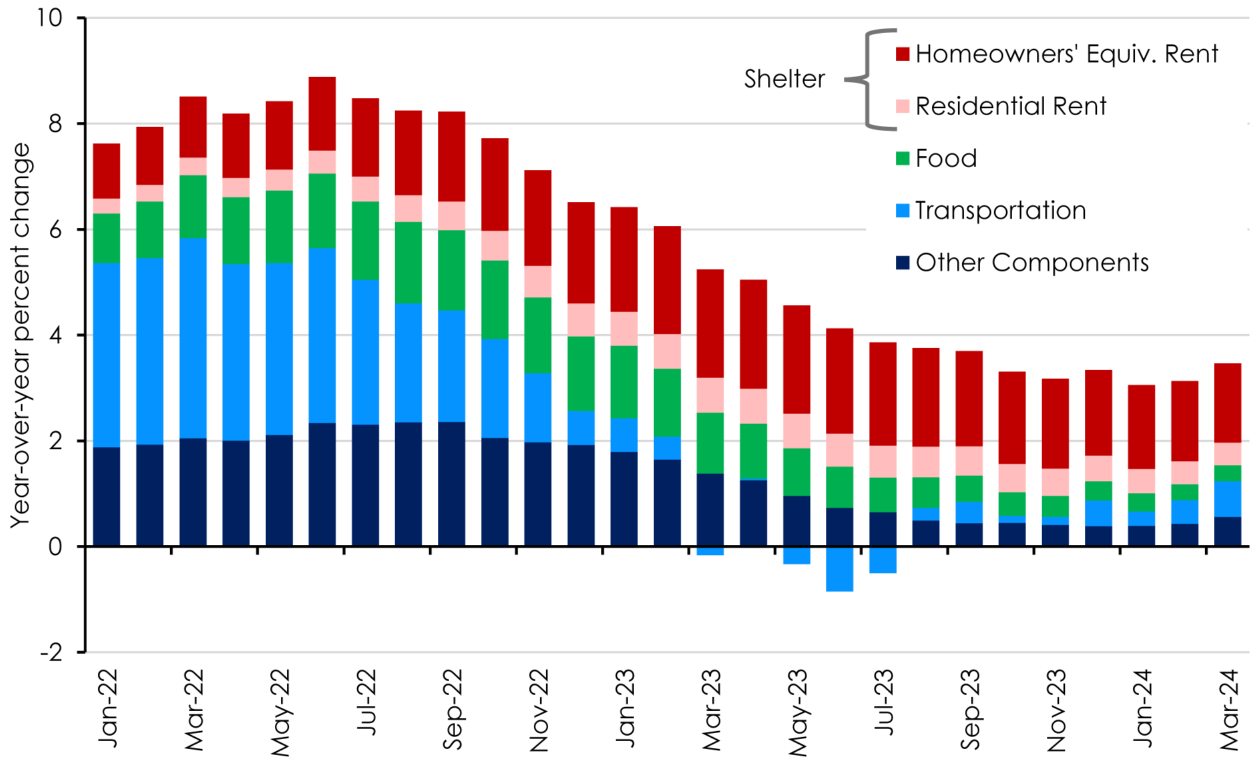


Sources: U.S. Bureau of Economic Analysis; California Department of Finance, 2024-25 May Revision Forecast.

STUBBORN INFLATION SLOW TO COOL

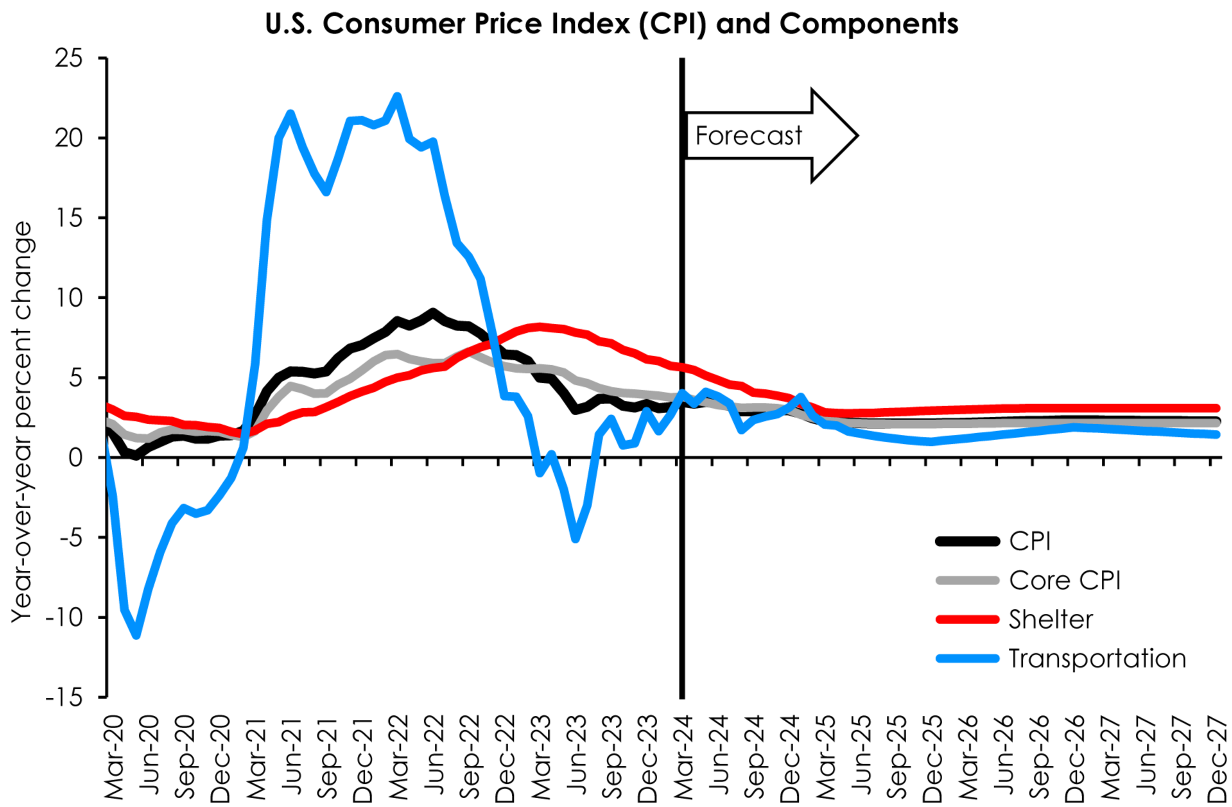
Inflation slowed sharply from its peak of 9.1 percent for the U.S. and 8.3 percent for California in June 2022 but has since hovered above 3 percent for both, more than a full percentage point higher than the Federal Reserve's target rate of 2 percent. Shelter inflation, the largest component of services, generally lags other components and has declined slower than projected. It peaked at 8.2 percent in March 2023 in the U.S. and stood at 5.7 percent in March 2024. The slower decline in shelter prices has kept overall inflation for the U.S. and California elevated.

Contribution to U.S. Consumer Price Index



Sources: U.S. Bureau of Labor Statistics; California Department of Finance, 2024-2025 May Revision Forecast.

The May Revision forecast projects U.S. headline inflation will continue to moderate as the Federal Reserve maintains its tight monetary policy stance through the middle of 2024. Shelter inflation is still projected to decelerate but at a slower rate than in the Governor's Budget forecast. Inflation is projected to then slow to historical rates of between 2 and just below 3 percent for both the nation and the state by early 2025.



Sources: U.S. Bureau of Labor Statistics; California Department of Finance, 2024-25 May Revision Forecast.
Core CPI excludes food and energy.

JOB GROWTH TO RETURN TO STEADY-STATE

California's nonfarm payroll job growth is projected to slow from late 2024 into the second half of 2025, a one-quarter lag from the projected slowdown in U.S. real GDP growth. Given the typical lag between economic activity and employment growth, the May Revision forecast projects job growth to be slowest in the second half of 2025, a slightly delayed time frame from the Governor's Budget forecast. This is due mainly to the robust U.S. real GDP growth in 2023, and relatively healthy nonfarm employment growth in the first few months of 2024. California-based firms will likely continue to attract their historical share of nationwide venture capital investment which is generally expected to fuel job growth in nascent industries. However, due to some lingering layoffs and the current high interest rate environment, the technology sector, which includes some of the most highly compensated workers in the state, is projected to add fewer jobs in 2024 than it did in 2023. As economic activity rebounds with looser monetary policy, the state's nonfarm payroll employment is projected to return to a steady-state average growth rate of 0.7 percent in 2026 and 2027.

California's labor force growth is projected to continue albeit at a slowing rate as it approaches its pre-pandemic level. Due to lower-than-expected actuals in 2023 and downward benchmark revisions, labor force growth projections through the forecast window (2024 to 2027) have been revised slightly lower than the Governor's Budget. California's labor force is projected to grow by 0.5 percent in 2024 before slowing to 0.3 percent growth by 2027, in line with the state's population projections, particularly amongst working-age individuals (those between the ages of 16 to 64) whose numbers are projected to decline through the forecast window. California's unemployment rate is projected to remain at 5.3 percent through the first half of 2025 as tight financial conditions continue to soften the labor market before moderating as credit conditions ease. See the Economic Indicators figure at the end of this chapter.

WAGE GROWTH TO CONTINUE AT A MODERATE PACE

California average wage growth contracted by 0.7 percent in 2022 and then recovered to 4.3 percent in 2023, due largely to higher levels of various irregular payments such as bonuses and options as stock prices saw renewed strength in 2023. These payments account for a disproportionate share of high-wage earners' pay and as they fluctuate, state revenues can also be affected. The information sector, with some of the highest earners in the state, in particular saw very strong average wage growth even with a decline in employment.

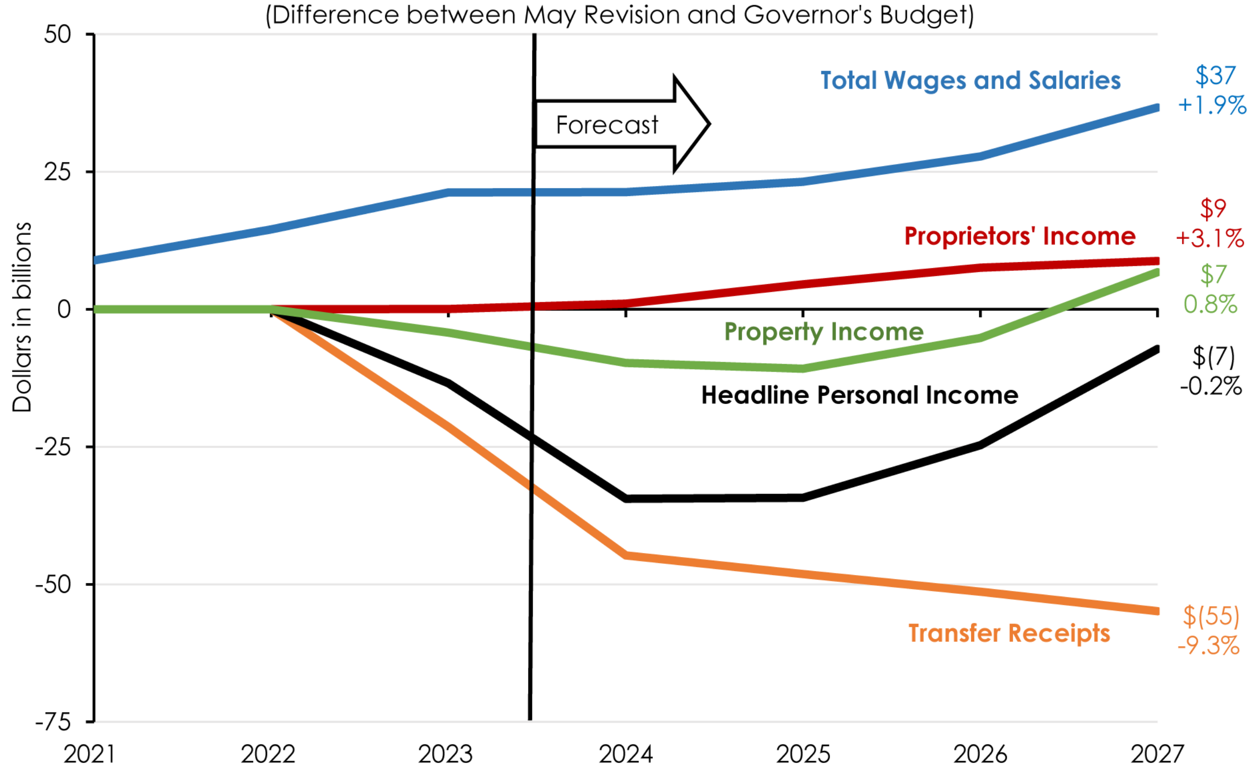
California annual average wage growth for all sectors is projected to remain close to its 2023 (and pre-pandemic) pace with growth rates of 3.5 to 3.9 percent over the forecast window. Wages in the high-paying information sector are projected to grow at their historical average annualized rate of 6 percent over the forecast window after crashing in 2022 and recovering strongly in 2023.

PERSONAL INCOME GROWTH DRIVEN BY STRONGER WAGE GROWTH

The May Revision forecast incorporates two additional quarters of personal income data through the fourth quarter of 2023 and also includes revisions to historical data. California personal income growth was slightly slower in the second half of 2023 than projected in the Governor's Budget. The downward revision to the 2023 estimate was driven by a notably lower level of Medicare transfers than estimated in the second quarter of 2023, pushing down the level of personal income growth.

The downgrade in transfers more than offset the upward revision of total wages and salaries which generally drives headline growth. Historical total wages and salaries were revised up, including $21 billion in 2023. The components of property income, which is the sum of interest, rental, and dividend income, saw minor revisions to actuals. The May Revision forecast projects interest income will have a more pronounced lagged effect compared to the Governor's Budget forecast as interest income has not been as high as previously projected even though interest rates remain high. Rental income, which tends to be driven by shelter inflation trends, remained elevated and is now projected to peak at 7.3 percent in 2025 and slow to 4.9 percent in 2027 as rental prices begin to ease. Dividend income saw a minor upward revision in 2023 and has been upgraded relative to the Governor's Budget with the assumption that the stock market continues to perform well based on its strength to date.

Personal Income Components
(Difference between May Revision and Governor's Budget)

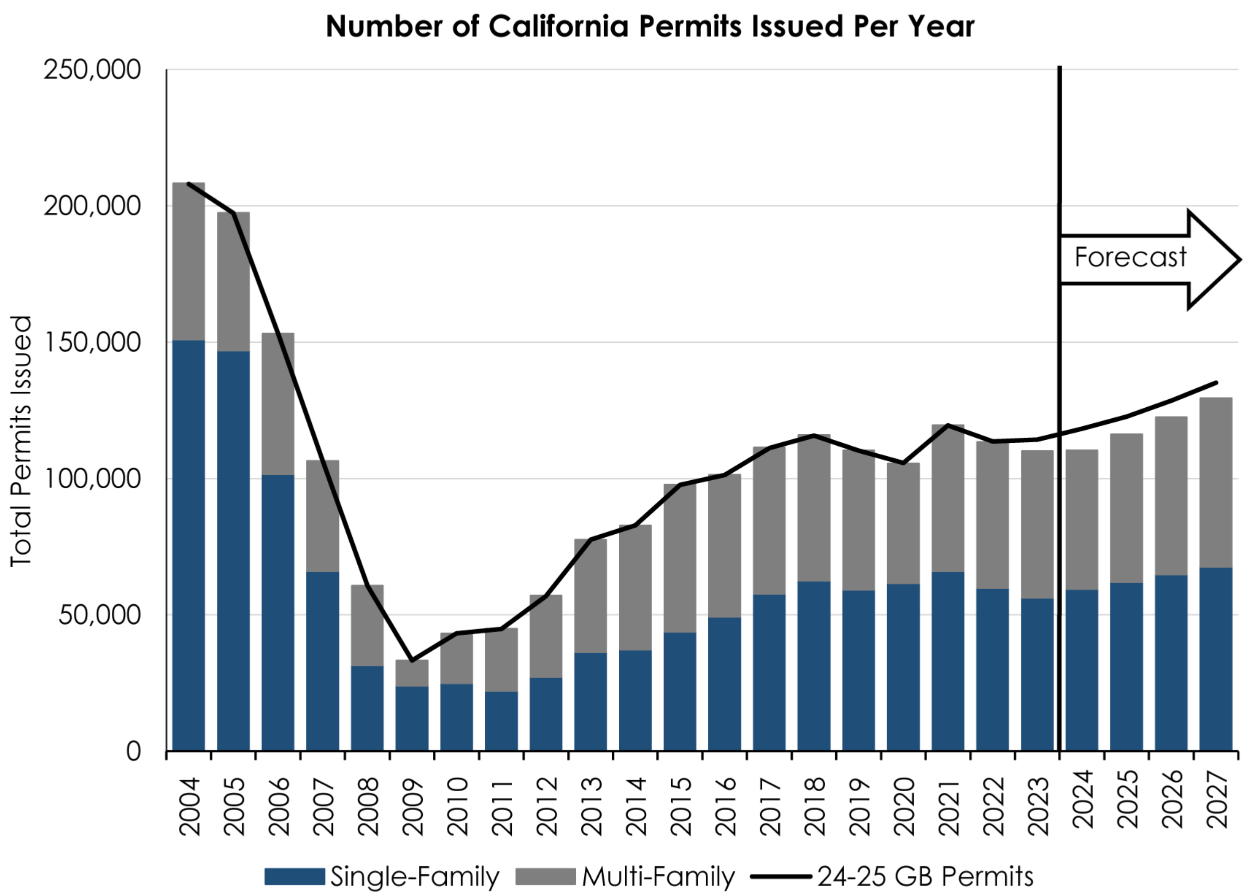


Note: Changes to projections reflect revisions to historical data.
Sources: U.S. Bureau of Economic Analysis; California Department of Finance, 2024-25 May Revision Forecast.

Headline personal income growth is projected to average 4.9 percent annually throughout the forecast window. Total wages and salaries are projected to continue growing, averaging 4.5 percent through the forecast window, likely boosting personal income tax revenues. As interest rates begin to ease in 2025, the majority of the personal income components are projected to revert to their historical growth trends by the end of the forecast window in 2027.

PERMITS PROJECTED TO SEE SLOW GROWTH IN 2024

California's residential construction sector continues to be constrained by high interest rates. In 2023, residential permits declined from 2022, falling by 2.9 percent to around 110,000 permitted units. The May Revision forecast projects slow permit growth in 2024, with total units growing about 0.3 percent from 2023 as high interest rates slow the demand for housing and make building inputs and construction loans more expensive. Single-family units, which declined in 2022 and 2023, are projected to rebound in 2024, but multifamily units are estimated to contract by 5.5 percent, the largest annual decline since 2020. Residential permits are then projected to begin growing at a faster pace in the second half of 2024 through 2027 as the Federal Reserve decreases interest rates, making construction inputs more affordable and boosting production.



Sources: U.S. Census Bureau; California Department of Finance, 2024-25 May Revision Forecast.

Immediate Risks to the May Revision Economic Forecast

Immediate risks to the forecast remain driven by persistent inflation and elevated interest rates. If inflation is slow to return to the Federal Reserve's target rate of 2 percent, the Federal Reserve could maintain high target rates which would result in additional drag on interest-sensitive spending. The current high interest rate environment could hamper economic activity by more than projected, especially given more cautious lending practices and if consumers curtail discretionary spending. Escalating geopolitical conflicts would likely increase economic uncertainties for the U.S. and California, even with a potential boost from increased defense spending.

The Department of Finance has not modeled a recession scenario. However, if inflation takes longer to cool and interest rates remain high for longer than projected in the May Revision baseline forecast, continued tight credit conditions could further discourage economic activity. This could deepen the expected economic slowdown and push the economy into a mild recession with steeper declines in investment and interest-sensitive consumption. GDP and nonfarm payroll employment would likely contract, and the unemployment rate would increase even further. This would then result in lower personal income growth due to lower total wages, negatively impacting state revenues.

Other geopolitical risks also remain, including an escalation of tensions between China and Taiwan. Long-term structural downside risks to the state economy and budget continue, including climate change and more frequent extreme weather events such as wildfires, drought, and floods, the challenges of an aging cohort that is becoming an increasingly larger share of the total population, declining migration inflows, lower fertility rates, ongoing stock market volatility, high housing and living costs, and potentially worsening income inequality.

Economic Indicators

Annual Percentage Change unless Otherwise Indicated

	2019	2020	2021	2022	2023	Forecast 2024	2025	2026	2027
United States									
Real GDP									
May Revision, April 2024	**2.5%**	**-2.2%**	**5.8%**	**1.9%**	***2.5%***	***2.5%***	***1.4%***	***1.7%***	***1.8%***
Governor's Budget, November 2023	2.5%	-2.2%	5.8%	1.9%	*2.5%*	*1.6%*	*1.2%*	*1.6%*	*1.8%*
Unemployment Rate (percent)									
May Revision, April 2024	**3.7%**	**8.1%**	**5.4%**	**3.6%**	***3.6%***	***3.9%***	***4.2%***	***4.5%***	***4.5%***
Governor's Budget, November 2023	3.7%	8.1%	5.4%	3.6%	*3.6%*	*3.8%*	*4.4%*	*4.7%*	*4.6%*
Nonfarm Employment									
May Revision, April 2024	**1.3%**	**-5.8%**	**2.9%**	**4.3%**	***2.3%***	***1.4%***	***0.1%***	***0.0%***	***0.3%***
Governor's Budget, November 2023	1.3%	-5.8%	2.9%	4.3%	*2.4%*	*0.7%*	*-0.3%*	*0.0%*	*0.4%*
Personal Income									
May Revision, April 2024	**4.7%**	**6.9%**	**9.1%**	**2.0%**	***5.2%***	***5.0%***	***5.2%***	***5.0%***	***4.8%***
Governor's Budget, November 2023	4.7%	6.9%	9.7%	2.0%	*5.3%*	*5.0%*	*4.8%*	*4.4%*	*4.5%*
CPI Inflation Rate (percent)									
May Revision, April 2024	**1.8%**	**1.2%**	**4.7%**	**8.0%**	***4.1%***	***3.1%***	***2.2%***	***2.2%***	***2.3%***
Governor's Budget, November 2023	1.8%	1.2%	4.7%	8.0%	*4.2%*	*2.6%*	*2.0%*	*2.1%*	*2.2%*
California									
Unemployment Rate (percent)									
May Revision, April 2024	**4.1%**	**10.2%**	**7.3%**	**4.3%**	***4.7%***	***5.2%***	***5.3%***	***5.1%***	***4.9%***
Governor's Budget, November 2023	4.1%	10.2%	7.3%	4.2%	*4.6%*	*5.1%*	*5.2%*	*5.0%*	*4.8%*
Civilian Labor Force									
May Revision, April 2024	**0.5%**	**-2.2%**	**0.0%**	**1.1%**	***0.7%***	***0.5%***	***0.4%***	***0.3%***	***0.3%***
Governor's Budget, November 2023	0.7%	-2.3%	0.1%	1.4%	*0.9%*	*0.8%*	*0.6%*	*0.5%*	*0.5%*
Nonfarm Employment									
May Revision, April 2024	**1.5%**	**-7.1%**	**3.5%**	**5.5%**	***0.9%***	***1.0%***	***0.4%***	***0.6%***	***0.8%***
Governor's Budget, November 2023	1.5%	-7.1%	3.5%	5.6%	*2.2%*	*1.0%*	*0.4%*	*0.5%*	*0.6%*
Residential Permits (thousands of units)									
May Revision, April 2024	**110**	**105**	**120**	**113**	***110***	***110***	***116***	***122***	***129***
Governor's Budget, November 2023	110	106	120	114	*114*	*118*	*123*	*129*	*135*
Average Wages									
May Revision, April 2024	**4.4%**	**11.2%**	**7.7%**	**-0.7%**	***4.3%***	***3.5%***	***3.8%***	***3.8%***	***3.9%***
Governor's Budget, November 2023	4.4%	11.3%	7.7%	-1.0%	*2.7%*	*3.4%*	*3.8%*	*3.7%*	*3.7%*
Personal Income									
May Revision, April 2024	**5.3%**	**9.0%**	**8.9%**	**-0.2%**	***4.2%***	***4.6%***	***5.0%***	***5.0%***	***5.0%***
Governor's Budget, November 2023	5.3%	9.0%	8.9%	-0.2%	*4.7%*	*5.2%*	*5.0%*	*4.7%*	*4.5%*
CPI Inflation Rate (percent)									
May Revision, April 2024	**4.2%**	**1.7%**	**4.3%**	**7.4%**	***3.9%***	***3.3%***	***2.7%***	***2.7%***	***2.7%***
Governor's Budget, November 2023	3.0%	1.7%	4.3%	7.4%	*3.8%*	*3.0%*	*2.4%*	*2.6%*	*2.7%*

2024-25 May Revision Forecast based on data available as of April 2024.

Governor's Budget Forecast based on data available as of November 2023. Figures in italics indicate forecasts, including 2023 figures for Governor's Budget Forecast.

Sources: U.S. Bureau of Economic Analysis; U.S. Bureau of Labor Statistics; U.S. Census Bureau; CA Employment Development Department, Labor Market Information Division; California Department of Finance, 2024-25 May Revision Forecast.