

Forecasting the California Economy: Dead Reckoning in a Thick Marine Layer

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“Life can only be understood backwards; but it must be lived forwards.”
- Søren Kierkegaard, 1843

“And a lot of it will be wrong, but just enough of it will be right.”
- Ray Bradbury, *Fahrenheit 451*, 1953

“The future is uncertain but the end is always near.”
- Jim Morrison, 1970

The election is over, now what? Usually in the California report I present some data to help us understand the forces at work on the California economy. For the most part I will eschew this methodology in the December report because we are sailing in uncharted waters. Instead, what follows is a think piece on what I think are the important moving parts so as to better understand what we must look for as the seemingly random policy of the new administration takes form.

The metaphor for this forecast is dead-reckoning navigation. In the 19th Century the California coastal trade was dominated by schooners and steamers; ships that carried lumber, gold, building materials, food and people between the population centers. Without the benefit of GPS they relied on a system of navigation called “dead-reckoning.” This system applied the mathematics of speed and original location to determine the location of the ship.

Forecasting the evolution of the California economy for the next few years is a bit like dead reckoning. Sometimes, as with the *C.A. Thayer*, now a national landmark in San Francisco harbor, success was obtained. And sometimes, as with the *Winfield Scott* loaded with gold and headed for Southern California, currents and small errors in the calculation of its original position resulted in an unexpected collision with the rocky coast of Anacapa Island. We are not quite sure where the rocks are but for this forecast we are doing the best we can to avoid them. To be sure, the risks to the forecast as we try to see through this Trumpian marine layer are about as high as they have ever been, maybe higher.

From the U.S. forecast¹ we have an increase in defense spending and an infrastructure package combined with a lower tax rate, particularly for corporations and the highest income earners. The increase in defense spending will be disproportionately directed to California as sophisticated airplanes, weaponry, missiles and ships require the technol-

1. David Shulman, “*Trumponomics: From a Reckless Monetary to a Reckless Fiscal Policy*,” *UCLA Anderson Forecast*, December, 2016.

ogy that is produced here. Moreover, there are few places to build the proposed 150 new warships, and San Diego is one of them. Regionally, we expect a positive impact in the Bay Area and in coastal Southern California.

The infrastructure package may or may not be directed to California depending on a host of considerations. The Western Electrical Grid needs to be replaced and there is room for high-speed rail and water infrastructure. In addition, there is a need to repair and replace city roads within California. However, California is a sanctuary state and many cities such as Los Angeles and San Francisco are sanctuary cities. On the campaign trail President-Elect Trump stated that he would block funds to sanctuary cities.² So how much comes our way is an open question. Given the size of California's congressional delegation and the fact that this is a big unfunded (except for the assumed stimulated growth) spending program, Paul Ryan may need CA Democrats to vote for the package. In other words, we have no idea about the proposed infrastructure package and California.

Taking a look at the employment situation we find that California, in spite of the 5.5% unemployment rate is effectively at full employment. Total employment, the number of Californians who are employed, is at an all time record 18.4M, 7.9% higher than the previous 2007 peak. Non-farm payroll jobs are similarly at a record with 16.6M jobs and 7.4% above the previous peak.

So where will the people come from to do the work? Immigration of skilled workers from China and India does not seem to be a likely source as the new Attorney General, a close confidant of the President-Elect, opposes an expansion of the skilled worker visa program.³ Rather what we should expect is rising wages inducing skilled people who will then be able to afford the California lifestyle being induced to move to the Golden State.

So now the squeeze is on. California is barely producing housing to meet the native growth of the population. The percentage increase in housing permits during the last year was 3.4%, a decent increase and consistent with our

forecast, however it is insufficient to support any significant in-migration. The passage of housing measures such as the Los Angeles City measure on affordable housing and developer labor costs⁴ will retard the already slow growth of housing, at least until such programs are well understood. In San Francisco, the City Council's action for a moratorium on new housing in the Mission District because of the possibility that development will be a catalyst for gentrification⁵ portends more actions of a similar kind elsewhere. When housing supply does not go up and housing demand does, prices increase to ration the limited supply of housing. Sorry San Francisco, the gentrification is going to happen anyway and lower income Californians are going to be squeezed out. Look for them to move to other states where housing is more affordable, as even if they cannot enjoy the California life style, the lifestyle they will enjoy will be superior to the one which requires all their income or an extra job to purchase shelter.

But before you put your hands to your cheeks in a Edvard Munch painting imitation, there is more, and though you might not like it, it will relieve the housing squeeze somewhat. In his first interview after the election, President-Elect Trump said that he would start deportations of undocumented immigrants right away. The person in charge of this is the aforementioned Attorney General. It is estimated that between 22% and 26% of undocumented immigrants live here.⁶ Thus California is fertile ground for this deportation policy. This means many things, but with respect to housing, mass deportations means that the demand for housing will decrease. As well, rents will go down relative to what they would otherwise have been and not as many people will be squeezed out. The only fly in the ointment is the fact that downward pressure on rents will reduce incentives for building more housing.

In the Central Valley, where Donald Trump did relatively well, look for considerable disruption of its leading industry. As Arizona, Alabama and Georgia found out when they clamped down on undocumented immigrants in agriculture, farmers were unable to harvest all of their crops. A Forbes article documents Georgia trying to help farmers with

2. Reema Khrais, "Trump promises to block funding to sanctuary cities," *Marketplace*, November 14, 2016. <https://www.marketplace.org/2016/11/14/elections/trump-promises-block-funding-sanctuary-cities>

3. Amber Phillips, "10 things to know about Sen. Jeff Sessions, Donald Trump's pick for attorney general," *The Washington Post*, November 18, 2016. <https://www.washingtonpost.com/news/the-fix/wp/2016/11/18/10-things-to-know-about-sen-jeff-sessions-donald-trumps-pick-for-attorney-general/>

4. Chris Kirkham, "Los Angeles Builders Say New Affordable-Housing Rules Will Stifle Construction", *Wall Street Journal*, Nov. 17, 2016. <http://www.wsj.com/articles/los-angeles-builders-say-new-affordable-housing-rules-will-stifle-construction-1479398403>

5. Laura Dudnick, "City report finds Mission moratorium would drive up housing costs," *San Francisco Examiner*, September 10, 2015. <http://www.sfexaminer.com/city-report-finds-mission-moratorium-would-drive-up-housing-costs/>

6. reference

prison labor to avoid a second year of agricultural losses.⁷ It will happen here as well. It is estimated that half the farm workers in California are undocumented.⁸ If these numbers are even close, there will be a crisis in the Central Valley. Farmers are going to be paying more, perhaps a lot more, for farm labor, if they can find it at all, and it will take some time before they can switch to producing crops that can be harvested by machines.

Promises of more water deliveries will be hollow if the fruits, vegetables and nuts cannot be harvested. So in addition to the downward pressure on the demand for goods and services as a consequence of reducing California's population through deportation, there will be a decline in agricultural output and this will affect State GDP and employment. It should be noted that farm employment is a small percentage (2.3%) of California employment. So, even a 50% reduction will only result in a 1.2% reduction in total employment in the State, about half the recent annual growth rate of employment in the State. Now that marijuana is legal as far as the State is concerned (it is still not legal though)⁹, perhaps pick-your-own weed farms will solve the problem.

And then there are the trade wars. During the campaign, President-Elect Trump vilified China and Mexico for taking U.S. jobs. He promised to renegotiate treaties and agreements to "bring back American jobs." This, of course, ignores the fact that if the Chinese want to hold dollars instead of RMB, and who wouldn't, they must sell more to the U.S. than they buy from the U.S. Nevertheless, among the policy proposals were no obvious positive incentives to two of the top destinations for goods coming out of California and the top two countries sending goods through California's ports of entry to negotiate, only negative ones of very high tariffs.

It may be that the stick works and the trade deals are re-negotiated with a larger volume of trade going both ways. It is hard to say, and not the most likely outcome we see with our national forecast. Quite possibly there will be a

reduced volume of trade, and depending on whether or not the stick is swung, maybe a greatly reduced volume of trade. Elsewhere we have studied the impact on the Los Angeles economy.¹⁰ It will hit the East Bay, San Diego and the Inland Empire as well. Logistics is an important industry and a serious drop off in activity is bound to reverberate through the California economy.

So where does that leave us? I am afraid that we economists are not going to be much help in giving definitive answers this time. Stimulus in a tight economy on the one hand, a squeeze in housing on the other, a recession in the State economy in agriculture and in logistics on the third are all just speculations on big events that may or may not occur. We just don't know at this point. So we have a forecast which is our best guess and incorporates none of the above, but look to all of them to see in what direction we are wrong. Enjoy the forecast.

The forecast

The current forecast is slightly higher than our previous one through the end of 2017. This reflects the stimulus assumed in the national forecast, particularly through the defense appropriations. The weakness relative to the U.S. after that reflects the fact that California, having already reached near full-employment will benefit less from further stimulus than rust belt states and the fact that deportations of unskilled workers will impact food harvesting and food processing. We expect California's unemployment rate to have its normal differential to the U.S. rate at 5.2% by the end of the forecast period.

Our forecast for 2017 and 2018 total employment growth is 1.8% and 1.3% respectively. Payrolls will grow at about the same rate over the forecast horizon. Real personal income growth is forecast to be 3.6% and 3.8% in 2017 and 2018 respectively. Homebuilding will continue in California at about 120,000 units per year through the forecast horizon.

7. Benjamin Powell, "The Law Of Unintended Consequences: Georgia's Immigration Law Backfires," *Forbes*, MAY 17, 2012. <http://www.forbes.com/sites/realspin/2012/05/17/the-law-of-unintended-consequences-georgias-immigration-law-backfires/#24974c38404a>

8. <https://migrationfiles.ucdavis.edu/uploads/cf/files/2007-june/minescadata.pdf>
<https://migration.ucdavis.edu/cf/more.php?id=174>

9. The new attorney general, "Good people do not smoke marijuana." So once again we don't know if enforcement of the Federal ban on marijuana will take place.

10. William Yu, "The Economic Landscape for Los Angeles Under President Trump," *UCLA Anderson Forecast*, December 2016.