State Board of Equalization

Economic Perspective

Summary of Recent Economic Developments *May 2001*

❖ *U.S. Economic Developments*

Slow Economic Growth in Last Half of 2000

The second half of 2000 was characterized by below-average economic growth. From 1991 through 2000, real GDP increased an average of 3.4 percent per year. In the third quarter of 2000 (July through September) real gross domestic product (GDP) rose just 2.2 percent, followed by an even slower 1.0 percent gain in the fourth quarter. Monthly data released for several economic indicators, including employment, industrial production, retail sales, and consumer confidence, continue to suggest that weak growth persisted into the first quarter of 2001. The advance estimate shows that real GDP increased 2.0 percent in the first quarter. However, advance estimates are based on incomplete data and are subject to large revisions. The “final estimate” of first quarter 2001 real GDP is scheduled to be released in late June.

Weak Growth Expected to Continue

Many economists are predicting that growth will continue to be sluggish throughout 2001. In late February, the Philadelphia Federal Reserve Bank released the results of a survey of 35 economic forecasters. The average forecast of this survey called for real GDP to increase 2.2 percent in 2001. Growth of this magnitude would be well below the long-term average of 3.4 percent. The most recent UCLA Anderson Economic Forecast, released in early April, is even more pessimistic. The UCLA forecast calls for real GDP to rise just 0.7 percent in 2001, followed by a 1.3 percent increase in 2002. Based on a study of previous economic cycles, UCLA believes that there is a 90 percent chance that the U.S. economy will begin to be in recession (defined as two consecutive quarters of declines in real GDP) within a year.

Economists expect weaker growth to continue in 2001 for several reasons. For consumers, deteriorating consumer confidence, unstable financial markets, and uncertain electricity and natural gas prices in certain areas of the nation are expected to lead to continued weakness in spending. For businesses, in addition to facing the same unstable financial and energy markets affecting consumers, declining earnings and difficulty in obtaining credit are additional factors contributing to reduced spending and hiring of employees. Early 2001 data show continued weakness in manufacturing, with new orders falling and inventories rising. Consumer and business spending together typically account for about 80 to 85 percent of gross domestic product.

U.S. Unemployment Rate Expected to Rise Throughout 2001

So far in 2001 the slower economic growth has had only a small impact on the unemployment rate. The U.S. unemployment rate was 4.3 percent in March 2001. For the first quarter of 2001, the U.S. unemployment rate averaged 4.2 percent, up slightly from averages of 4.0 percent in both the third and fourth quarters of 2000. However, UCLA is predicting the U.S. unemployment rate will rise substantially during the rest of the year. The UCLA April 2001 forecast shows an average U.S. unemployment rate of 4.8 percent in 2001 and 6.1 percent in 2002.

(Information derived from: U.S. Department of Commerce, STAT-USA website: www.stat-usa.gov; "Survey of Professional Forecasters," Federal Reserve Bank of Philadelphia, February 20, 2001, website: www.phil.frb.org; *UCLA Anderson Forecast*, April 2001.)

❖ *California Economic Developments*

Employment Growth Remains Strong in Early 2001

The weakness of the U.S. economy has not yet been obvious in data currently available to us for California. One of the most comprehensive measures of economic well being available for states on a timely basis is monthly nonagricultural employment. The data for the first quarter of 2001 show that California nonagricultural employment increased 3.5 percent compared to the same period of 2000. This growth rate is lower than the average annual 2000 California nonagricultural employment growth rate of 3.8 percent. For the five-year period 1996 through 2000, nonagricultural employment increased an average of 3.2 percent per year.

Employment Growth Expected to Slow

Slower national economic growth will likely result in slower California economic growth, since a large portion of California output is sold in national markets. Higher gas and electricity costs will also cut California economic growth in 2001, since consumers will have less income to spend on other goods and services. In late February, the Legislative Analyst's Office (LAO) released an economic forecast as a part of its review of the *Governor's Budget*, which was released in January 2001. The LAO forecasted California nonagricultural employment to increase 2.2 percent in 2001. This forecast is similar to the April 2001 UCLA Anderson economic forecast for 2001. In April, UCLA predicted that California nonagricultural employment would increase 2.4 percent in 2001. The UCLA forecast shows nonagricultural employment growth slowing further in 2002, to an increase of 1.6 percent.

Unemployment Rate Continues to Decline in Early 2001

Unlike the rising U.S. unemployment rate, the California unemployment rate has somewhat surprisingly continued to decline in the face of slowing national economic growth. In the first quarter of 2001, the California unemployment rate averaged 4.6 percent. This is below the fourth quarter 2000 average rate of 4.8 percent.

Slowdown in Late 2000 Taxable Sales Growth

The Board of Equalization's preliminary estimate shows that taxable sales increased 6.1 percent in the fourth quarter of 2000 compared to the fourth quarter of 1999. This growth figure is well below the double-digit growth of the previous four quarters. Using the preliminary fourth quarter figure, an estimate of annual taxable sales growth in 2000 would be an increase of 10.8 percent. To put the quarterly and annual growth figures into perspective, annual taxable sales rose 6.2 percent in 1997, 5.2 percent in 1998, and 10.0 percent in 1999. Therefore, while fourth quarter growth was well below average annual growth of 1999 and 2000, it was similar in magnitude to growth in 1997 and above average growth in 1998.

(Information derived from; California Employment Development Department (EDD), "California Interim Industry Employment Series," Labor Market Conditions in California, April 13, 2001, EDD Labor Market Information website: www.calmis.ca.gov; California Legislative Analyst's Office, *The 2001-02 Budget*: *Perspectives and Issues; The UCLA Anderson Forecast,* April 2001; Board of Equalization, News Release #12, March 23, 2001, website: www.boe.ca.gov.)

❖ *A Review of Natural Gas Prices in Late 2000*

In late 2000, California began experiencing an acute energy crisis in both the natural gas and electricity markets. The Federal Reserve Bank of San Francisco (FRBSF) published a succinct discussion of plausible causes for increases in 2000 U.S. natural gas prices, which will be summarized below.[1] California imports approximately 85 percent of the natural gas it uses, with about 50 percent coming from other states and 35 percent from Canada. About 31 percent of California's in-state electricity production is from natural gas-fired generating plants.[2]

Dramatic Increase in U.S. Natural Gas Prices

According to the FRBSF article, the average daily December 2000 "spot price"[3] at the Henry Hub – the benchmark for U.S. natural gas prices in Henry, Louisiana – was $6.31 per million British Thermal Units (MMBTU), about three times higher than the average December 1999 spot price. U.S. prices of natural gas at the Henry Hub averaged $1.90 per MMBTU from 1990 through 1999.

Extremely Cold Winter A Major Reason for Natural Gas Price Increases

Factors responsible for the increase in U.S. natural gas prices include unseasonably cold winter weather in 2000-2001, low inventories going into the winter heating season, increasing demand for natural gas by electricity generators, and general economic growth. According to an article in the *Wall Street Journal,* November and December 2000 were the coldest, on average, for the nation as a whole in 105 years of recordkeeping by the National Climatic Data Center.[4] In contrast, the two previous winters were among the warmest in history. Industry analysts estimated that the average temperature was 21 percent below the 10-year average for the first six weeks of

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[1] Federal Reserve Bank of San Francisco, Economic Letter 2001-04, *Economic Impact of Rising Natural Gas Prices,* February 9, 2001.

[2] "California's Gas Pains Are Hardly Natural," Allan Brady, 12/31/00, *The Dismal Scientist,* website: http://www.dismal.com.

[3] The "spot price" is the price of natural gas for delivery that day.

[4] "Snowball Effect: Weather Chills Economy," *Wall Street Journal*, January 29, 2001.

winter (mid-November through December) and 35 percent below the comparable period for 1999.[5] With relatively low prices in 1998 and 1999, and mild winters in recent years, natural gas inventories were low going into winter. Supplies of natural gas cannot adjust rapidly. It generally takes at least one year to drill enough new wells to bring significant quantities of natural gas to market. The increase in demand in the winter of 2000-2001, coupled with a relatively fixed short run supply, sent prices spiraling upward.

Natural Gas Production Increasing

Since natural gas production is a largely deregulated industry, the higher U.S. prices have a "silver lining." The FRBSF letter cites statistics showing that U.S. natural gas well drilling activity has increased substantially in response to the higher prices. The increase in the number of wells will increase supplies. However, even with the increased natural gas production, prices may still rise this year because demand for natural gas by electrical power plants is strong.

Small Overall Economic Growth Impacts Expected

The FRBSF letter also includes its assessment of the likely impacts of higher natural gas prices on the economies of western states in the 12th Federal Reserve District.[6] The industries most affected by higher natural gas prices are those that use it as a major component of their production process such as agriculture, food processing, chemical manufacturing, and paper production. However, for most industries and consumers, the impacts of higher natural gas prices should be relatively small. The FRBSF letter notes that the western states consume less energy per capita than the rest of the U.S. Expenditures for the western states average less than 1 percent of their combined gross state product. According to the FRBSF letter, assuming that natural gas prices stay at their high levels throughout 2001 implies economic impacts no greater than those of the Asian financial crisis of 1997.

[5] Quoted from the Federal Reserve Bank of San Francisco Economic Letter 2001-04 cited above. Original source: *Natural Gas Daily.*

[6] The Twelth Federal Reserve District includes nine western states. California dominates these western states, with about 60 percent of the District's employment, income, and gross state product.

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