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California Recession and Recovery

The California recession has been one of the most prominent developments in the Twelfth District economy during the 1990s. This is due to the sheer size of the California economy, the spillover effects California has on its neighbor states, and the prolonged and severe nature of California's recession. This extreme distress in a major regional economy has influenced the national economy and attracted the attention of policymakers at all levels of government.

Recently, though, there have been signs that the California recession has bottomed out. With the California economy at a possible turning point, this *Letter* will review the course of the recession—why it matters and why it happened. Of particular importance is the unbalanced nature of the downturn in the California economy, with Southern California suffering a disproportionate share of the job losses. The uneven nature of the California recession sheds some light on competing theories regarding California's economic problems. Furthermore, recent encouraging news from the southern part of the state is evidence that California's hard times are coming to an end.

Why California's recession matters

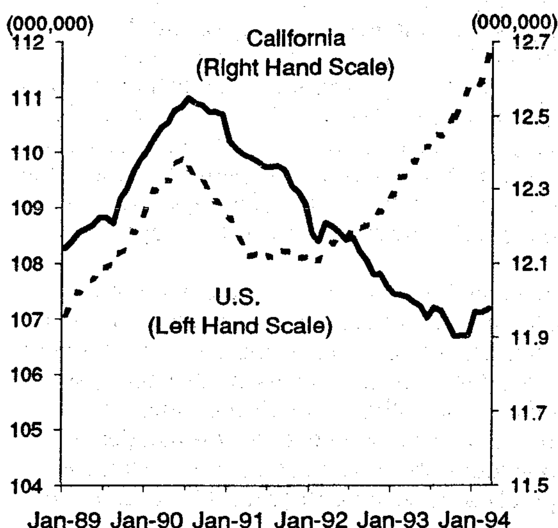
Over the past three and a half years, California has experienced its most prolonged economic contraction since the end of World War II. As shown in Figure 1, payroll employment dropped by 614,000 or about 4.9 percent between its peak in July 1990 and its trough in December 1993. By comparison, the peak-to-trough period for the U.S. was much shorter (July 1990 to February 1992), and the fall in payroll employment was much less severe—only 1.7 percent.

California's recession matters for several reasons. First is the pure human cost of lost wages and financial distress to laid-off workers. Many who kept their jobs also suffered as wages and incomes lagged in a weak economic environment. Furthermore, falling tax revenues had statewide effects, as the state government has had to make up lost revenues with higher tax rates and budget cuts in government services. In addition, several years of tight budgets have hindered the state's ability to make needed investments in public infrastructure and in education. The cost of this underinvestment will be borne by future generations.

The effects go beyond the state. In an accounting sense, California's recession has driven regional and national economic statistics by virtue of its size: Its 12 million jobs account for 61 percent of District employment and 11 percent of the nation's jobs. As a result, California's unemployment rate of 8.6 percent raises the national unemployment rate from 6.2 percent to 6.5 percent.

Beyond the statistical effects of California's weakness, the last three years of the state's recession also have had spillover effects on its neighboring states. A recent *Weekly Letter* (Cromwell 1993) presents evidence on the linkage between California and its neighbor states and suggests that on balance, the California recession resulted in significant job losses in Arizona, Nevada, and Hawaii due to reduced sales of goods and services. Another measure of California spillovers, however, is the out-migration of workers looking for jobs in other states. According to driver's license records, California went from having a net in-migration of 130,000 individuals in 1988 to a net out-migration of 150,000 in 1993 (vis-à-vis the other 49 states).

Figure 1
Payroll Employment (Seasonally Adjusted)



California's problems have attracted the attention of local, state, regional, and national leaders. In trying to determine appropriate policies to address these problems, however, there has been much debate among economists and policymakers as to the nature of California's economic difficulties.

In general, a case can be made that the prolonged, severe California recession was due to large aerospace and defense cutbacks, combined with the bust of an overbuilt commercial real estate market that occurred during a period of national recession. For example, a study by the Center for Real Estate and Urban Economics at U.C. Berkeley suggests that combining the direct and indirect effects on employment, cutbacks in aerospace and defense could easily account for about half of the job losses in the state. Furthermore, the reduction in construction jobs alone accounts for an additional 20 percent of the job loss. Given this view—which I call the "aerospace/shock" view—California should be expected to have a normal cyclical rebound in response to the national economic recovery, the completion of the shakeout in commercial real estate, and an end to (or lessening of) cutbacks in defense and aerospace. Policy responses that are being directly implemented or that are at least consistent with this aerospace/shock view of California's problems include federal aid (for converting military bases to civilian purposes, rebuilding South Central L.A., and responding to recent disasters), regulatory relief for banking institutions in hard-hit areas, and a state policy of avoiding tax increases in favor of "deficit" spending.

A longer-run view of California's problems, however, argues that California is a high-cost place to do business and that the state has lost its competitive position relative to other states and countries. High taxes, government regulation, and red tape are causing firms to flee California, leading to a permanent loss of jobs. Policy responses in line with this "long-run competitive" view range from reducing the burden of workers compensation to reducing regulation and red tape.

Note that the aerospace/shock and long-run competitive views of California's problems are by no means exclusive, and in some cases they are complementary. Indeed, one reason that aerospace and defense cutbacks are disproportionately hurting the California economy is that defense contractors are consolidating and moving their operations to lower-cost states. However, in order to determine which view best explains California's recent economic weakness, we turn to an analysis of the regional pattern of this cycle within California.

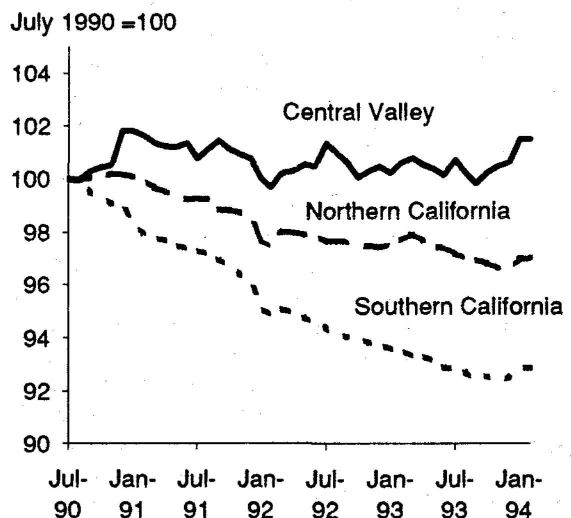
Regional imbalance

One striking feature of the most recent national recession (July 1990–March 1991) was its regional imbalance, with most of the job losses concentrated in the Northeast and California. Likewise, *within* California, the recession hit regions unevenly (see Figure 2). The most striking aspect of the regional breakdown is the concentration of job losses in the southern part of the state. Of the 614,000 jobs lost statewide, 543,000 or almost 90 percent of these jobs were lost in the southern part of the state which suffered a 7.5 percent decline in employment. The Los Angeles–Long Beach area suffered the worst, with a loss of 461,000 jobs for a decline of 11.1 percent, or 75 percent of the job losses in the state.

Northern California fared worse than the Central Valley and was closer to the average loss for the state. Employment fell by 101,000 jobs for a loss of 3.4 percent. The declines were led by losses of 48,000 in San Francisco (5.1 percent), 34,000 in San Jose (4.1 percent), and 24,000 in Oakland (2.8 percent). The losses in Northern California, however, accounted for only 16 percent of the net loss in the state.

The Central Valley region of California performed better than the average for California, but did not completely escape the recession. Employment in the region showed up an down variation, but on balance was flat, increasing 0.6 percent over the period. Sacramento, however, showed a decline

Figure 2
Northern, Southern, Central Valley California Employment Trends



of 11 percent for a loss of 69,000 jobs, reflecting a contraction in state government.

The salient point of this regional breakdown is that Los Angeles accounted for three-quarters of the jobs lost in California during its recession. The story of the California recession is therefore to a large extent the story of Los Angeles County. While the "long-run competitive" view accounts for some aspects of the L.A. recession, the "aerospace/shock" view probably is a better explanation for Los Angeles.

For example, Los Angeles County accounted for 60 percent of the state's aerospace jobs at the start of the recession. Aerospace employment in L.A. then dropped by 85,000 over the period, a decline of 42 percent. While the rest of California also suffered from aerospace cutbacks—a loss of 51,000 jobs or 37 percent—Los Angeles bore the brunt of the aerospace bust due to its concentration on the industry and accounted for 63 percent of the aerospace jobs lost in the state.

The construction bust—associated with overbuilt commercial real estate—also affected Los Angeles disproportionately. At the start of the recession, Los Angeles had an office vacancy rate of 18 percent due to an office construction boom fueled by money from large commercial banks, insurance and pension funds, and overseas investors. Construction activity, rents, and real estate values, however, then fell precipitously as demand for office space weakened relative to the newly added supply. Construction employment fell by 36,000, a decline of 27 percent. Construction activity in the rest of California was also weak, with employment declining 18 percent, but less so than in Los Angeles. For example, in San Francisco the vacancy rate never exceeded 14 percent due to building construction limits, and construction employment declined by 5,800 jobs or 18 percent.

Competitive aspects of the Los Angeles business environment also have received attention. These long-run competitive problems, however, existed before the recession as well, and the job losses associated with the outward migration of firms are small relative to the size of the job losses in the recession. Furthermore, statewide policies that affect competitiveness should not disproportionately affect the Los Angeles area—although some environmental regulations are specific to the Los Angeles area. On balance, the competitive issues are important, but more for determining long-run growth than for explaining the California recession.

Signs of recovery

At the end of 1993, anecdotal information began to suggest that the California economy was beginning to bottom out. In particular, the Central Valley was reported to be expanding, Northern California was turning around, and Southern California was bottoming-out, with the exception of Los Angeles. The regional employment data at that time, however, were not consistent with that story. The Central Valley was flat, and job losses were still reported for *both* Northern and Southern California.

Newly revised employment data, however, show that statewide employment reached a trough in December 1993 and has now grown by 43,000 since December 1993, for an annual rate of 1.3 percent. The growth in early 1994 has been led by construction (up at a 7.3 percent annual rate) and trade (3.5 percent annual rate). Most other industries posted only modest gains, and the manufacturing sector continues to lose jobs (largely in aerospace).

Most impressive has been the broad spread of this regional performance. Employment is up not only in the Central Valley and in Northern California, but also in Southern California and even in Los Angeles, where employment has grown since November 1993. In particular, between November 1993 and February 1994, employment in Los Angeles grew by 20,000 reflecting growth in construction (2,500), nonaerospace manufacturing (5,400), trade (3,600), and services (9,400). Aerospace employment, however, continues to fall.

These signals are encouraging but preliminary. Continued weakness in aerospace suggests that any "cyclical" rebound will be constrained. Further attention to California's competitive position also is needed for long-run growth. As these issues are addressed, however, we can hope that current predictions of anemic growth will prove to be pessimistic.

Brian Cromwell
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Reference

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