

## **EXECUTIVE SUMMARY**

**June 2008**

### **Oregon Economic Forecast**

The December 2007 edition of this forecast reported job losses for the third quarter of 2007, the first quarterly loss of jobs in four years. After job number revisions released in late February 2008, the third quarter of 2007 was revised upward for a gain of 0.9 percent. With the most recent quarter coming in at 1.7 percent job growth for the first quarter of 2008, jobs have increased every quarter for the past 19 quarters. But the rate of job growth has definitely slowed. On a year-over-year (Y/Y) basis, jobs increased in the first quarter by 0.9 percent, much slower than the average Y/Y pace of 2.7 percent from 2004 to 2006.

The US economy is very near recessionary conditions. Forecasting firms Global Insight and Moody's Economy.com both state the US economy entered a recession either very late 2007 or this first quarter of 2008. In April, more than half the panelist on the Blue Chip Economic Indicators survey view the US economy as being in recession or soon will be. Jobs in the US have declined the last four months starting with January 2008. Both housing and energy issues are weighing in on financial markets and consumers. With consensus and data essentially agreeing that the US economy is in recession, the question for going forward is now "how long and how deep".

The view for Oregon is similar. Post WWII, Oregon has never failed to follow the US business cycle. The depth and duration of expansions and downturns have been different. The two most recent US recessions, 1991 and 2001, show this difference. In 1991, job losses in the Oregon economy were only 1.6 percent, close to the US average. The story was reversed in 2001 when Oregon lost jobs at a rate of 4.0 percent, higher than the US average. The duration of job loss in Oregon in 1991 was relatively short at around 8 months, while the 2001 downturn stretched into 31 months.

OEA views the current downturn to be closer to the 1991 rather than the 2001 recession. A number of points for this view were expressed in the March 2008 Oregon Economic and Revenue Forecast. The crucial assumptions are: a mild recession for the US economy, a relatively milder downturn in the Oregon housing market (fewer foreclosures, less price depreciations, relatively smaller supply overhang), and continued strength in foreign exports. Oregon is not immune from a US recession as the slowdown in growth and lost jobs in various sectors makes this point evident. But the depth and duration of this downturn should not be as severe as at the start of this decade.

OEA forecasts a decline of 0.6 percent growth for the second quarter of this year. Job growth will essentially be flat for the second half of 2008 with moderate growth for 2009. Annual average job growth is forecasted to be 0.6 percent in 2008 and 0.7 percent in 2009.

The wood products sector is projected to loose jobs at a rate of 5.6 percent in 2008 and 1.7 percent in 2009. As the housing market improves into 2010, wood products jobs should grow 3.8 percent.

Computer and electronic equipment sector will see job declines of 3.1 percent in 2008 and 2.1 percent in 2009.

This will still be a tough year for transportation equipment sector with job losses of 6.7 percent and further losses of 1.4 percent in 2009.

The outlook for metals and machinery manufacturing is for continued growth through 2008 with job increases of 2.6 percent followed by slower pace with job growth of 1.8 percent in 2009.

Employment in food processing is forecast to increase 3.5 percent in 2008 and 1.9 in 2009.

Construction employment is projected to decrease annually by 8.0 percent in 2008 and 2.3 percent in 2009.

Trade, transportation, and utilities sector employment will increase by 0.5 percent during 2008 followed by 0.7 percent growth in 2009.

The information sector, which includes traditional publishers such as newspapers and publishers of software, has slower growth moving into 2008 with a projected job gain of 1.4 percent. Continued slow growth should prevail with job gains of 0.4 percent in 2009.

The financial activities sector is expected to lose 1.9 percent of its workers in 2008 and then a mild addition of 0.7 percent in 2009.

Professional and business services are projected to grow 2.1 percent in 2008 and 2009.

Education and health services will grow 3.9 percent in 2008 and 2.6 percent in 2009. Health services are the underlying growth for this sector.

Leisure and hospitality is projected to grow 3.1 percent in 2008 and 0.6 percent in 2009.

The government sector will increase by 1.7 percent in 2008 and 0.7 percent in 2009. State government employment is expected to increase by 1.0 percent in 2008 and 0.2 percent in 2009. Local government employment is expected to increase by 1.8 percent in 2008 and 1.0 percent in 2009.

### **Forecast Risks**

The forecast projects a slowing Oregon economy in 2008 which continues into the first half of 2009 with mild growth in the second half. This outlook faces heightened risks for a much deeper downturn in 2008 and 2009.

With the national economy going through a slowdown in the first quarter of 2008, the risks are higher from any disturbances that could throw the economy off track. The same major drag for the slowdown, a slowing housing market, could hurt the economy further when it is most susceptible. The credit crunch and the ensuing instability in the global financial market bring added uncertainty. Businesses are nervous about potential repercussions from the turmoil in the financial markets across

the world. Any geopolitical disruptions during this time would be more harmful than when the economy is stronger.

Despite good headline inflation numbers, inflation pressures still exist. The Fed continues to warn about a potential flare-up in inflation pressure. The expectation is that the softening economy will ease inflation pressures. However, sharply higher oil and gasoline prices coupled with a sharp rise in food prices will add inflationary pressure. A weaker dollar may contribute to price pressure through a run-up in import prices.

The housing market in Oregon and the U.S. continue to work off excesses accumulated in the past housing boom. Building permits and housing starts are sharply down. In fact, both have declined more than expected. With declining sales, home prices are coming down at the national level. While house price appreciation has continued in Oregon, some parts of the country have seen house prices drop substantially. House prices will continue to soften in most regions. Negative wealth effect from lower house values and less mortgage equity withdrawal will dampen consumer spending. There is a risk that the housing market may deteriorate worse than expected.

The subprime mortgage problem has led to bankruptcies and huge write-offs in the financial industry. While the credit squeeze continues for some borrowers, short-term financing through the commercial paper market has begun to stabilize. Stricter lending standards also limit credit access, but qualified borrowers continue to enjoy stable financing.

Record oil prices remain a substantial risk. So far, the world economy has withstood the attack of high oil prices remarkably well. Still, there is no question that high oil prices are a significant threat to the already soft U.S. economy.

A variety of factors could disrupt oil supplies, and higher energy prices cannot be ruled out. Crude oil prices continue to hover around record levels. The global supply is still tight, and demand is still strong, particularly from China and the rest of Asia. Geopolitical tensions continue to exist, and there is always room for speculative attacks. There is an indication that current oil prices are being partly supported by speculators.

The federal stimulus checks should mildly boost growth in the second half of 2008. But risks remain that once the stimulus checks are over, the economy will sink back into very low growth or recession in 2009.

We will continue to monitor and recognize the potential impacts of these risk factors on the Oregon economy. We have identified the major risks now facing the Oregon economy in the list below:

- *Contagion of the credit crunch and financial market instability.* The current instability in the financial market is weighing on business confidence, which may lead businesses to change their capital spending plans. The central banks are ready to inject more money to alleviate short-term credit problems, and their measures have been successful so far. At the same time, the Fed has lowered interest rates to stimulate the economy.
- *A further worsening in the housing market.* Low interest rates and easy lending standards have aided a boom in home purchases and mortgage refinancing. With the subprime mortgage problem spreading and tighter lending standards in place, the mortgage market is not as

conducive to residential real estate activity as in the past. Any drop in house price appreciation coupled with a large drop in mortgage equity withdrawal will slow down consumer spending. The Oregon housing market could be adversely impacted by a major housing correction in California and the rest of the nation. Continued gains in employment and personal income will be needed to keep consumer spending from falling. The federal fiscal stimulus package should help alleviate the slower consumer spending.

- *Loss of federal timber payments to Oregon counties.* A one year extension of federal timber payments will expire at the end of fiscal year 2007. Thirty-one counties would be affected by the loss of \$282 million in funding, especially impacting Douglas and Lane counties. Loss of public services could have adverse impacts on economic activity.
- *A major deceleration in the U.S economy and a global downturn triggered by the U.S. slowdown.* The U.S. economy has been an important engine of growth for the global economy. Thanks to a strong global economy, the chances are lower that the U.S. slowdown will set off a global downturn. The rest of the world is growing nicely even with a soft U.S. economy, but if the U.S. economy falters even more, the whole world will surely feel the impact. Asia in particular will be severely affected due to its large exposure to the U.S. economy.
- *A sharp fall of the U.S. dollar.* Depreciation of the dollar against foreign currencies promotes U.S. exports as U.S. products become more price-competitive (or less expensive). Oregon's manufacturing sector has a large dependency on international markets. If the U.S. dollar falls too quickly, this could harm Oregon's trading partners because the lower dollar makes imports more expensive to U.S. consumers. As U.S. trading partners export less to the U.S., their economies may weaken and lower their demand for Oregon products. In the end, a controlled lowering of the U.S. dollar is most beneficial to the Oregon economy.
- *A sharp and major stock market correction.* This would slow consumer spending. Lower stock prices could also limit the ability of businesses to raise necessary capital in the equity markets.
- *A hard landing in China.* The Chinese economy is growing very fast. Building construction and other business investments are largely responsible for this economic growth. Inflationary pressure is strong. The central government's efforts to curb growth have produced minimal success. Limited experience in macro policymaking may result in an undesirable set of policy measures. A major slowdown in China will hurt most Asian economies, along with commodity-exporting countries, including Canada. Given that Canada and Asian countries are the major destinations of Oregon's manufacturing exports, the manufacturing sector would be negatively impacted.
- *Geopolitical risks.* Uncertainty still abounds in Iraq. Tensions with Iran and heightened security risks weigh on businesses and consumers. Disruptions in travel, oil supplies, and consumer confidence could be severe. The drop in business activity could deepen if this uncertainty persists or if the transition out of the Iraq war goes badly for the U.S. The winding down of military expenses will not greatly impact Oregon. There is also an upside risk that the transition will go more smoothly than anticipated, and stability in the Mideast will provide a stronger than forecasted stimulus to the economy.

- *Inflation and Federal Reserve Bank reactions.* A growing economy with surging energy costs is a formula for inflation. Even with a slowing economy, higher inflation than forecasted may force the Federal Reserve to raise interest rates more quickly and to higher levels. This action could further slow the U.S. economy and in turn slow down the Oregon economy as higher interest rates hurt consumers and businesses.
- *Rising regional energy prices.* More businesses may slow production and lay off workers. A geopolitical incident could dramatically disrupt gasoline and natural gas prices. Regionally, electricity generation is subject to weather patterns and natural gas prices. As demand surpasses the available capacity of hydro generation, electric generation may move towards natural gas-powered turbine engines. Higher electricity prices could result because they are pegged to natural gas prices.
- *Initiatives, referendums, and referrals.* Generally, the ballot box brings a number of unknowns that could have sweeping impacts on the Oregon economy.

## **Demographic Forecast**

Oregon's estimated population on July 1, 2007 reached 3,745,455. That was an increase of 1.5 percent over the 2006 population. The recent growth since 2005 is considerably higher than the 1.1 percent annual average growth rate between 2000 and 2005. Overall, population change since 2000 is much lower than the rate of growth of well over 2.0 percent during the early 1990s. Oregon's population will continue to grow at a moderately high rate in the near future. Based on the current forecast, Oregon's population will reach 4.165 million in the year 2015 with an annual rate of growth of 1.3 percent.

Oregon's economic condition heavily influences the state's population growth. Its economy determines the ability to attract job seekers from other states and beyond. As Oregon's total fertility rate remains below the replacement level, long-term growth comes from net in-migration. Working-age adults come to Oregon as long as we have good economic and employment situations. The net migration during the 1980s, which included a major recession, contributed to 22 percent of the population change. On the other extreme, net migration accounted for 73 percent of the population change during the booming 1990s. This share of migration declined to 57 percent in 2002. As a sign of modest economic gain, the net migration will account for nearly 64 percent of the population change in the near future.

Growth in all age groups will show the effects of the baby-boom and their echo generations during the period of 2007-2015. It will also reflect demographics impacted by the depression era birth cohort combined with migration of the working age population and elderly retirees. After a period of slow growth in the past, the elderly population (65+) growth has picked up in pace and will surge as the baby-boom generation starts to enter this age group. The annual growth of the elderly population will exceed 3.0 percent during the forecast horizon as the boomers continue to enter retirement age. The youngest elderly (aged 65-74) will grow at an extremely fast pace due to the direct impact of the baby-boom generation entering retirement age. The elderly aged 75-84 will shrink in numbers until 2009, as the depression era birth-cohort will dominate this group. The oldest elderly (aged 85+) will continue to grow at a moderately high rate due to the combination of cohort change, continued

positive net migration, and improving longevity. However, the annual growth rate will continue to taper as the depression era small birth cohort transitions from the younger age group.

As the baby-boom generation matures, the once fast-paced growth of population aged 45-64 will gradually taper to nearly a 0 percent rate by 2012. The young adult population (aged 18-24) will grow at an average of 0.3 percent annually, considerably slower than the rate averaging 1.1 percent experienced between 2000 and 2007. This will ease the pressure on public spending on college education. Children under the age of five show a high rate of growth after a slow growth period in the recent past. The K-12 population (aged 5-17) will show very slow growth which will translate into slow growth in school enrollments. The 25-44 age group population has reversed the several year trend of decline. The decline was mainly due to the exiting baby-boom cohort. This age group has seen positive growth starting in the year 2003 and will approach 1.4 percent annual growth by the year 2011.

### **Revenue Forecast**

The forecast for General Fund revenues for the 2007-09 biennium is \$13,016.7 million, an increase of \$91.2 million from the March 2008 forecast. The increase is the product of unique circumstances in personal income taxes, rather than an indication of stronger-than-expected economic conditions. In the absence of these countervailing receipts, the forecast would be down slightly. Including the beginning balance of \$1,436.7 million, total available resources amount to \$14,091.9 million, a decline of \$46.9 million from the Close of Session forecast. The projected ending balance for 2007-09 equals \$143.0 million, \$114.2 million above the March 2008 forecast.

Total General Fund revenues will increase 20.7 percent to \$15,706.3 million in 2009-11. Personal income tax growth of 23.4 percent, which will raise collections to \$13,952.1 million, is due in part to the \$1.084 billion kicker rebate distributed in the prior biennium. In addition, the sunset of the Bush tax cuts in 2011 are expected to have a short-run positive impact on personal income taxes, particularly through capital gains realizations. Corporate income taxes will grow 9.1 percent to \$881.8 million, an inflated rate of growth due to the accelerated depreciation allowed by the Economic Stimulus Act of 2008. All other revenues will reach \$872.3 million, mildly below the prior biennium's level.

General Fund revenues will total \$17,708.1 million in 2011-13, an increase of 12.7 percent from the prior period. For the 2013-15 biennium, General Fund revenues will equal \$20,013.1 million, a 13.0 percent increase from the prior biennium.

Projected lottery earnings will total \$1,339.3 million, an increase of \$9.0 million from the prior forecast. The gain was split evenly between traditional projects and video lottery. Including the beginning balance and other earnings, total available resources equal \$1,417.5 million.

During the Special Session in February 2008, the legislature increased the lottery fund allocation to the State School Fund by \$20.0 million. The current forecast for the ending balance in the Economic Development Fund is \$11.7 million.

Lottery earnings are expected to grow 2.6 percent to \$1,374.5 million for the 2009-11 biennium. The weak growth is the result of an absence of administrative savings for the biennium, compared with \$60.9 million in the current biennium. Video lottery earnings will increase 8.8 percent, while traditional products will decline slightly. Total available resources will amount to \$1,390.7.

Lottery earnings will amount to \$1,553.8 million in 2011-13, a 13.0 percent increase over the previous biennium. Including interest earnings, available resources will total \$1,559.8 million. For the 2013-15 biennium, lottery earnings will climb to \$1,740.9 million while available resources will equal \$1,746.9 million.