

OREGON ECONOMIC AND REVENUE FORECAST

SUMMARY

**State of Oregon
Department of Administrative Services
Office of Economic Analysis**

**March 2007
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EXECUTIVE SUMMARY

March 2007

Oregon Economic Forecast

The fourth quarter 2006 initial estimate of job growth was an increase of 0.3 percent at an annual rate. This is the 14th consecutive quarter of job growth. On a Y/Y basis, jobs increased in the fourth quarter by 2.2 percent. Y/Y growth has been above 2.0 percent since the second quarter of 2004. Total nonfarm jobs in Oregon now stand at 1,716,900.

With fourth quarter growth of 0.3 percent, Oregon has seen 14 consecutive quarters of job gains. However, the last nine months (April to December) have shown some volatility in employment trends, with rate of gains declining. In fact, there has been a steep decline in quarter over quarter (Q/Q) job gains. After adding 23,900 jobs in the first quarter, the next two quarters saw a successive job increase of 6,300 and 6,200. In the latest quarter, the job gain was only 1,300. The rate of the cooling job market was remarkably rapid in the fourth quarter.

The Oregon Office of Economic Analysis (OEA) forecasts employment to rise by 1.2 percent for 2007, a sharp deceleration from 2005 and 2006. The job growth of the first quarter of 2007 is projected to be 1.2 percent, up from a sluggish 0.3 percent growth in the prior quarter.

Manufacturing will decline by 1.5 percent in 2007 and then post a mild decline of 0.1 percent in 2008. 2009 will not see much change from 2008.

Private non-manufacturing jobs will increase by 1.6 percent in 2007, 2.2 percent in 2008, and 2.3 percent in 2009.

Wood product manufacturing is projected to be down 7.0 percent in 2007 and then decline another 1.5 percent in 2008. We expect mild job gains in 2009.

The sector that contains semiconductors, computer and electronic products, will show a slow decline in jobs during the forecast horizon. The job outlook is uncertain with declines of 1.1 percent in 2007 and 0.3 percent in 2008.

Employment in transportation equipment will decline 3.6 percent in 2007. Employment will be flat throughout the forecast horizon.

Construction jobs will increase mildly in 2007. The housing sector slowdown has yet to exert its full impact, but the nonresidential sector has more than offset the loss in housing construction. Job growth will be very mild with a 0.5 percent drop in 2008 before turning up a little with 2.3 percent growth in 2009.

Job loss was evident in the retail and wholesale industries. Transportation services and utilities also lost jobs. Still, we expect that retail trade job growth will be 1.5 in 2007 and a stronger 2.5 percent in 2008, with improving consumer spending. Employment level in this sector will also

be supported by a population increase. Wholesale trade will see some increase in jobs in 2007 followed by job gains of 1.3 percent in 2008 and 1.5 percent in 2009.

Professional and business services will see a slowdown due to the sluggish economy in 2007, whereas health services will see a healthy trend growth. Professional and business services will grow 1.2 percent in 2007, which is a substantial decline from 4.0 percent growth in 2006. The rate of growth will accelerate to 4.1 percent growth in 2008 and 4.4 percent in 2009. This assumes a pickup in economic expansion. Health services grew even during the recession. The robust growth continues in this sector with 2.4 percent in 2007, followed by 2.3 percent in 2008, and 2.4 percent in 2008. This sector is also been supported by robust population increase.

Leisure and hospitality, which includes accommodations and food services, is expected to grow by 2.5 percent in 2007, 2.3 percent in 2008, and 1.9 percent in 2009.

Government employment is expected to increase by 1.5 percent in 2007, followed by growth of 0.8 percent in 2008, and 1.0 percent in 2009. Local government jobs will continue mild growth to meet increasing service demand due to population growth. The biggest uncertainty surrounding local government is the loss of funds from the Secure Rural Schools and Community Self-Determination Act. At this point, local government forecast does not explicitly account for potential employment effect from this loss of funds.

Population growth is expected to be higher than the U.S. average, but slower than the growth experienced in the mid-1990s. Growth will be slightly higher over the next three years than during the recession, with increases of 1.4 to 1.5 percent for each year.

The housing market in Oregon and the U.S. are in the process of working off excesses built in the past couple of years. Building permits and housing starts are sharply down. The last item to join this group is price. While house price appreciation has continued in Oregon, some parts of the country have seen house prices drop. The expectation is for house prices to soften in most regions. Negative wealth effect from lower house values and less mortgage equity withdrawal will dampen consumer spending.

Crude oil prices continue to hover around \$60 a barrel. The global supply is still tight and demand is still growing, particularly from China and the rest of Asia. With OPEC constantly looking for ways to defend a certain price range, oil prices are not expected to move much in the short run. At the same time, geopolitical tensions continue to exist and there is always a room for speculative attacks.

The major risks now facing the Oregon economy are:

- A major slowdown in the U.S economy and a global downturn triggered by the U.S. The U.S. economy has been an important engine of growth for the global economy. If the U.S. economy falters, the whole world will feel the impact. Asia, in particular, will be severely affected by it due to its large exposure to the U.S. economy.

- A hard landing in China. The Chinese economy is growing very fast. Building construction and other business investment are largely responsible for the economic growth. Central government efforts to curb growth have produced minimal success. Limited experience in macro policy making 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. Canada and Asian countries are the major destinations of Oregon's exports. The manufacturing sector will be negatively impacted.
- Geopolitical risks. Uncertainty still surrounds the transition in Iraq. Tensions with Iran and North Korea to a certain degree, and heightened security risks all weigh on businesses and consumers. Disruptions in travel, oil supplies, and consumer confidence could be severe. The drop in business activity could be deeper if this uncertainty persists or if the transition out of 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 transition issues go more smoothly than anticipated and stability in the Mideast provides a stimulus to the economy that is stronger than forecast.
- Inflation and Federal Reserve Bank reactions. A growing economy with surging energy costs is a recipe for inflation. Faster inflation than forecasted may force the Federal Reserve to raise interest rates more quickly and to higher levels. This action could slow the U.S. economy and in turn slow down the Oregon economy.
- A sharp fall of the U.S. dollar. As the dollar depreciates against other foreign currencies, U.S. exports are promoted 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 possible crash in the housing market. The extremely low interest rates and easy lending standards have caused a boom in home refinancing. As this activity matures and interest rates begin to raise, the added boost to consumer spending may slow. Any drop in house price appreciation coupled with a large drop in mortgage refinancing could slow down consumer spending. The Oregon housing market could be adversely impacted by a major housing correction in California. Continued gains in personal income will be needed to keep consumer spending from falling.
- Rising regional energy prices. More businesses may slow production and lay off workers. Natural gas prices have risen the past year but have stabilized since. A geopolitical incident could dramatically disrupt gasoline and natural gas prices. Regionally, electricity generation

has been helped by a deeper snow pack but is still 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 from being pegged to natural gas prices.

- Avian flu. The possibility of a pandemic would be disruptive on the Oregon economy. Besides higher mortality rates than compared to other influenza outbreaks, absenteeism at work could be 20 to 30 percent. Past pandemics (such as the Spanish flu of 1918) erupt quickly and work through the population within 8 weeks.
- PERS and possible state and local government budget shortfalls. The Court upheld major reforms in PERS, and the 2005-2007 biennium appears to need only small additional expenditures. Still, state and local governments may need to increase taxes, reduce services, and/or increase bond financing in the future to cover potential unfunded liabilities for PERS. If increases in unfunded liabilities lead to increased tax rates, this could cause a substantial negative impact on Oregon's economy. To the extent that spending cutbacks hit public safety, education and public infrastructure, the state could suffer longer-term impacts.
- Initiatives, referendums, and referrals. The ballot box brings a number of unknowns that could have sweeping impacts on the Oregon economy. The Oregon Supreme Court has upheld the land use Measure 37. This measure could bring dramatic changes to land use regulation. Claims that were on hold will start moving through the hearing process. At this time, it is uncertain as to the impacts from compensation or lifting of land use restrictions.
- A slowdown in semiconductors, software, and communications. Business equipment spending is still strong at this point, but a major slowdown in capital spending will bring a negative impact to Oregon's manufacturing. Continued outsourcing of manufacturing could slow growth in this region. If research functions are shipped out of the country, Oregon's high technology sector would be harmed.

The major upside opportunities now facing the Oregon economy are:

- Sharp reduction of oil prices. Oil prices have been pushed above market equilibriums by disruptions ranging from geopolitical turmoil to extreme weather. Once these factors settle down and supplies increase, oil prices could fall much further than currently anticipated.
- Recovering business and consumer confidence. The transition out of the war in Iraq could accelerate. Rising confidence can help boost spending and hiring. Spillover effects to the stock market would reinforce the economic recovery.
- Controlled growth of China and India. China and India may successfully manage their economies to be more stable and still strong. This should stabilize commodity price volatility while promoting Oregon exports.

Demographic Forecast

The Census 2000 enumerated 3,421,399 persons in Oregon on April 1, 2000. This is an increase of 579,000 persons or 20.4 percent from the 1990 Census. Oregon's rate of growth between the two censuses was eleventh highest in the nation. During 2000 to 2004 period, however, the population growth rate was slow due to the struggling economy. Economic and population growth have perked up since 2004. Oregon's population estimated to have reached 3,690,500 on July 1, 2006, an increase of 1.6 percent over the 2005 population, up from nearly 1 percent annual growth between 2000 and 2004. Hence, this fast paced population growth is an indicator of Oregon's strong economy. Yet this annual growth rate is far from sustained long-term well over 2 percent annual rate of growth during the early 1990s. Oregon's population is expected to grow at moderately high rate. It is expected to reach 4.071 million in the year 2013, with an annual rate of growth around 1.4 percent.

During the 2006-2013 period, growth in all age groups will show the effects of the baby-boom generation, migration of the working age population and elderly retirees, and demographics impacted by the depression era birth cohort. After a period of slow growth in the past, the elderly population (65+) growth will pick up speed as the baby-boom generation start to enter this age group. The annual growth of the elderly population will reach 5 percent in 2012 when the boomers continue to enter the retirement age. The youngest elderly (aged 65-74) will grow at an extremely fast pace due to the direct impact of baby-boom generation entering the retirement age. The elderly aged 75-84 will shrink in number until 2010 as this group will be dominated by the depression era birth cohort. The oldest elderly (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 diminish through 2013.

As the baby-boom generation matures, once fast paced growth of population aged 45-64 will gradually taper to well below 1 percent rate by 2013. The young adult population, the 18-24 age group, will grow at an average of below 1 percent annually, considerably slower than the rate averaging 1.35 percent between 2000 and 2006. This will ease the pressure on public spending on college education. Children under the age of 5 will grow at moderately fast pace reaching 1.8 in 2010. The K-12 population, the 5-17 age group, will show very slow growth which will translate into slow growth in school enrollments. The 25-44 age group population has reversed the several years of decline trend. The decline was mainly due to exiting baby-boom cohort. This age group has seen a positive growth starting in the year 2003 and will exceed 1.5 percent annual growth by the year 2011.

Revenue Forecast

General Fund revenues will total \$12,733.3 million for the 2005-07 biennium, a \$34.0 million increase from the December forecast and \$1,406.6 million relative to the 2005 Close of Session forecast. A drop in the forecast for personal income tax collections is more than offset by increases in corporate income tax and most other sources of revenue. Including a beginning balance of \$308.5 million, total available resources equal \$13,041.9 million. Excluding legislatively adopted appropriations, the projected ending balance for the current biennium is \$1,397.9 million.

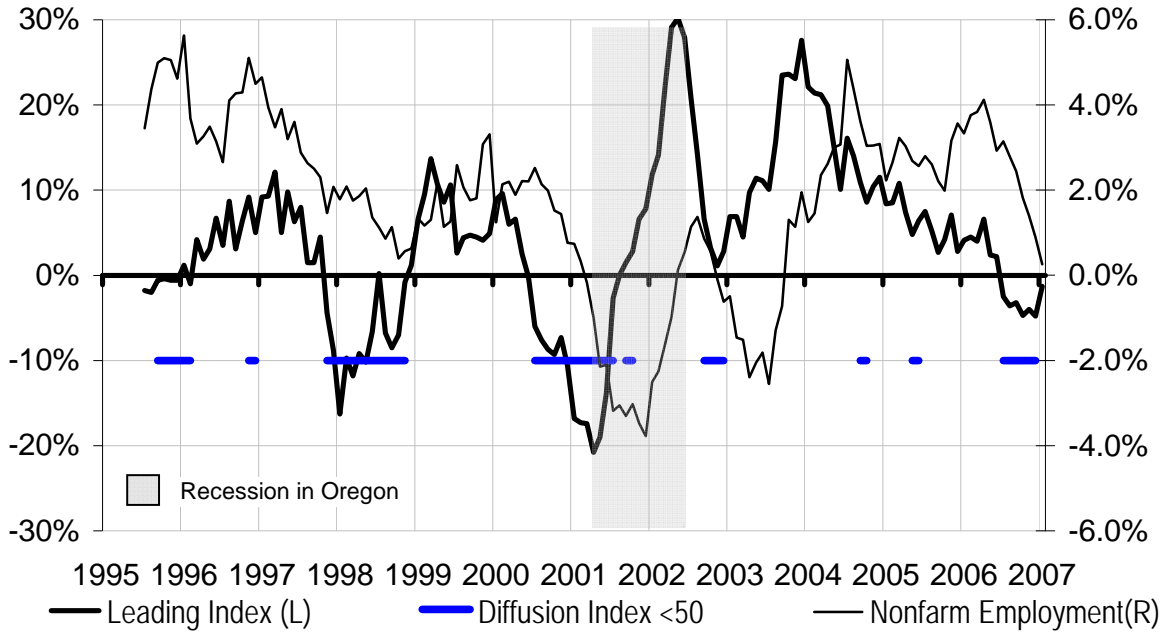
For the 2007-09 biennium, General Fund revenues will total \$12,666.8 million, including a net reduction of \$1,406.6 million resulting from personal and corporate kicker distributions. Including a \$1,397.9 million beginning balance carried forward from 2005-07, total available resources will equal \$14,000.4 million, a \$34.1 million increase from the prior forecast. This figure includes a negative \$64.3 million adjustment for anticipated cash flow management actions that was not factored into the December 2006 forecast. General Fund revenues will total \$15,675.9 million in 2009-11, a 23.8 percent increase from 2007-09. General Fund revenues will rise 11.9 percent to \$17,541.1 million in 2011-13.

Lottery revenues will total \$1,082.7 million for the 2005-07 biennium, a \$4.1 million increase from the December forecast. Compared to the May 2005 forecast, on which the current biennial budget was based, projected available resources have increased \$154.7 million. Excluding appropriations, the expected ending balance is \$59.2 million.

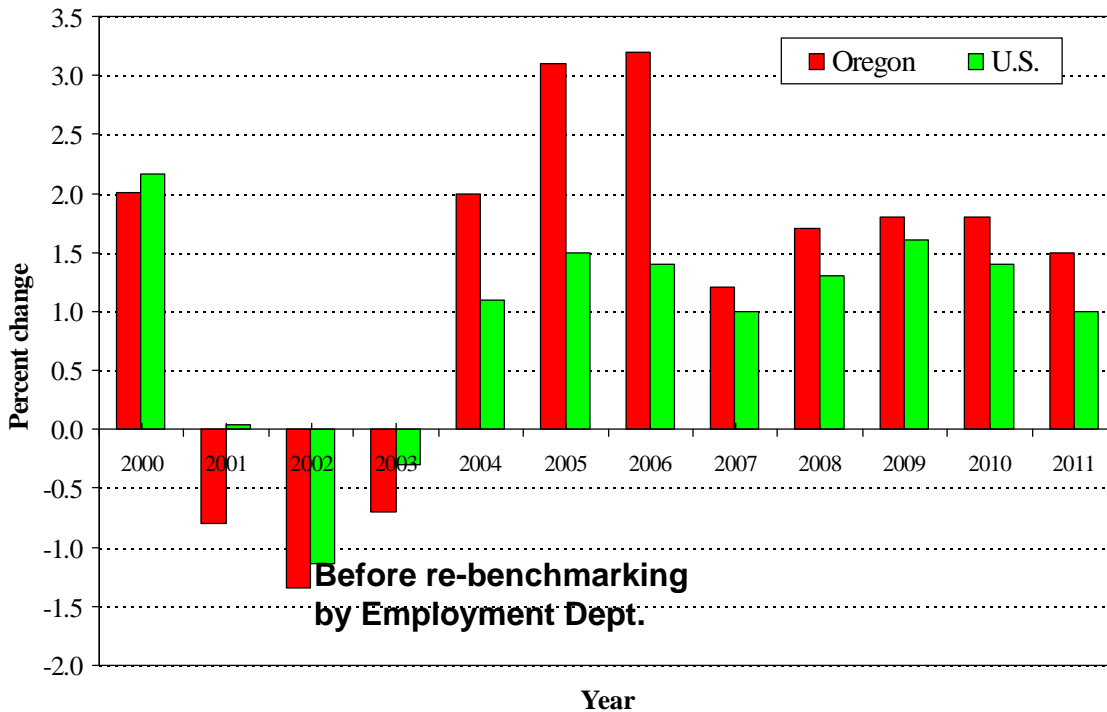
Lottery earnings will total \$1,239.5 million for the 2007-09 biennium, a \$3.8 million decrease from the prior forecast. A slightly higher balance carried over from the current biennium, as well as higher expected interest earnings, offset the drop in earnings and increase total available resources \$1.8 million to \$1,306.2 million. Earnings in 2009-11 will equal \$1,376.6 million, while total resources total \$1,381.1 million. Expected video sales growth will push earnings up to \$1,521.9 million in 2011-13, with resources reaching \$1,527.9 million

Oregon Index of Leading Indicators

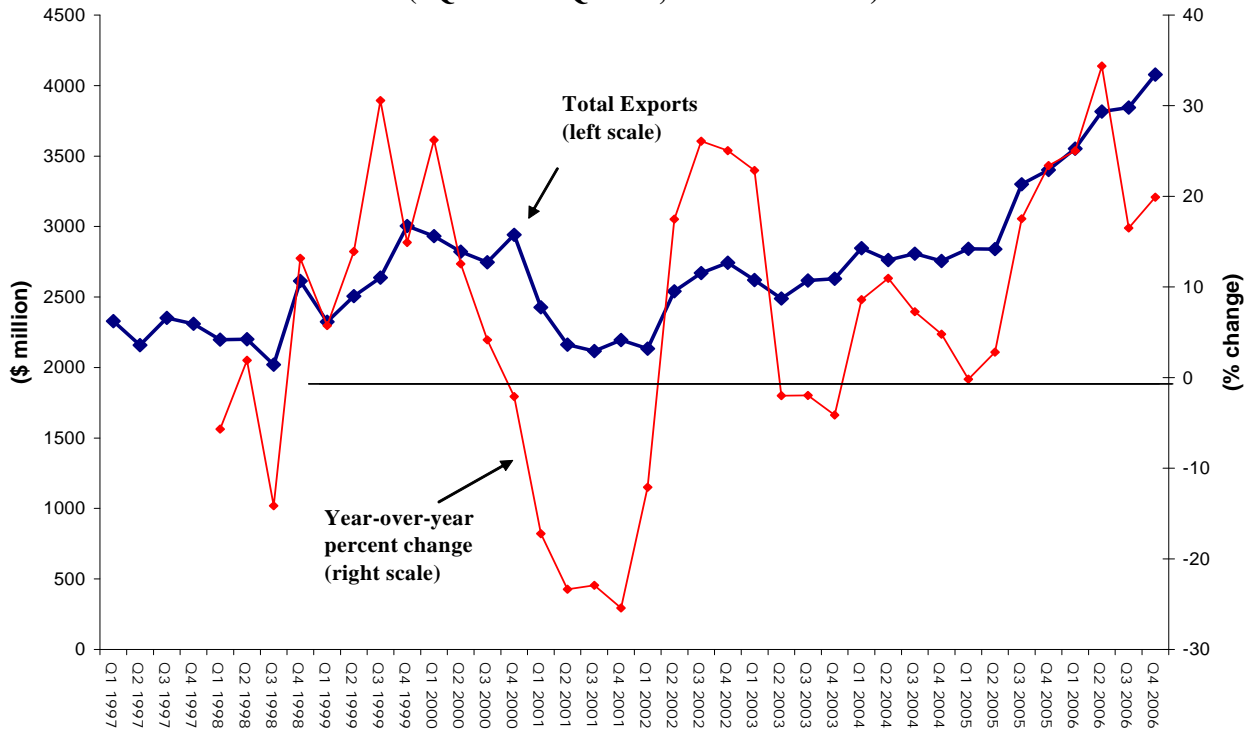
(Six Month Annualized Percent Change, through Jan. '07)



Percentage Change in Employment 2000 – 2011



Oregon's Total Exports
(1Q 1997 - 4Q 2006, current dollars)



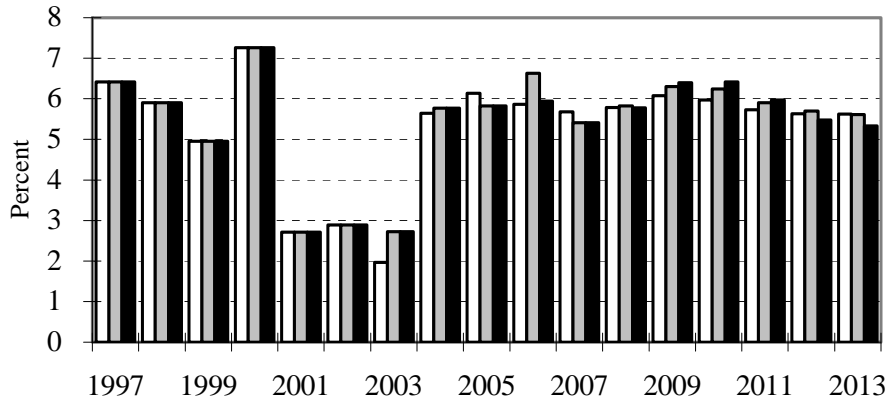
Forecast Comparison (Percent Change)

| Employment | 2007 | 2008 | 2009 |
|------------------------|--------------|-------------|-------------|
| Baseline | 1.2 | 1.7 | 1.8 |
| Pessimistic | (0.2) | 1.2 | 1.2 |
| Optimistic | 2.1 | 2.2 | 2.1 |
| Personal Income | | | |
| Baseline | 5.4 | 5.8 | 6.4 |
| Pessimistic | 3.9 | 5.2 | 5.8 |
| Optimistic | 7.0 | 6.9 | 6.4 |

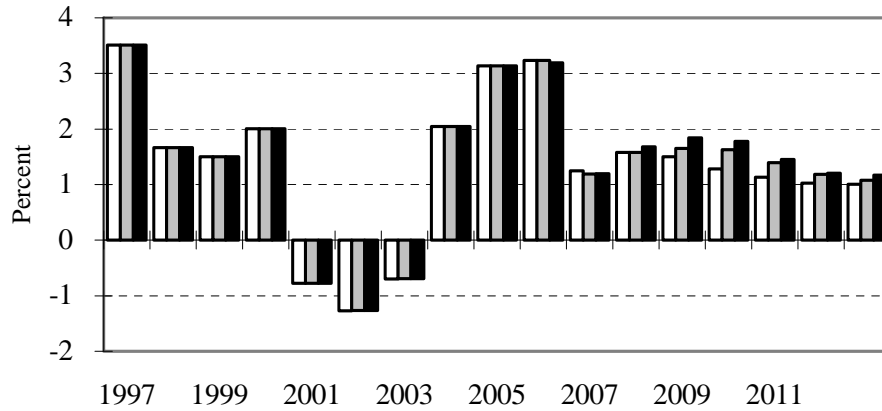
COMPARISON OF LAST THREE FORECASTS

Sep 2006
 Dec 2006
 Mar 2007

PERSONAL INCOME GROWTH



EMPLOYMENT GROWTH



General Fund Resources

2005-07 Biennium

| General Fund (Millions) | COS Forecast | Dec 2006 Forecast | Mar 2007 Forecast | Change from December | Change from COS 2005 |
|---------------------------------------|-------------------|----------------------|----------------------|-------------------------|-------------------------|
| Beginning Balance | \$325.8 | \$308.5 | \$308.5 | - | (17.3) |
| Personal Income Tax | 10,124.0 | 11,088.7 | 11,010.7 | (77.9) | 886.7 |
| Corporate Income Tax ¹ | 500.0 | 775.1 | 815.1 | 40.0 | 315.1 |
| Other Revenues ² | 702.7 | 835.6 | 907.5 | 71.9 | 204.8 |
| Total GF Resources | \$11,652.5 | \$13,007.8 | \$13,041.9 | 34.0 | 1,389.3 |
| Proj. Expenditures³ | 11,538.5 | 11,643.9 | 11,643.9 | - | 105.4 |
| Ending Balance | 114.0 | 1,363.9 | 1,397.9 | 34.0 | 1,284.0 |

Notes: 1 Corporate income tax figure includes Corporate Multistate taxes.
 2 Other Revenues include Insurance, Cigarette, and Liquor taxes.
 3 Includes \$4.9 million in TANS interest expense.

2005-07 Kicker Analysis

Personal Income Tax

| | |
|---------------------------|------------|
| COS Estimate ¹ | \$10,826.7 |
| 2% Threshold | \$216.5 |

Current Forecast \$11,918.2

Amount of Projected Kicker \$1,091.5

Percent of 2006 Liability 21.7%

Median refund: \$271 Average refund: \$633

Corporate Income Tax

| | |
|--------------|---------|
| COS Estimate | \$500.0 |
| 2% Threshold | \$10.0 |

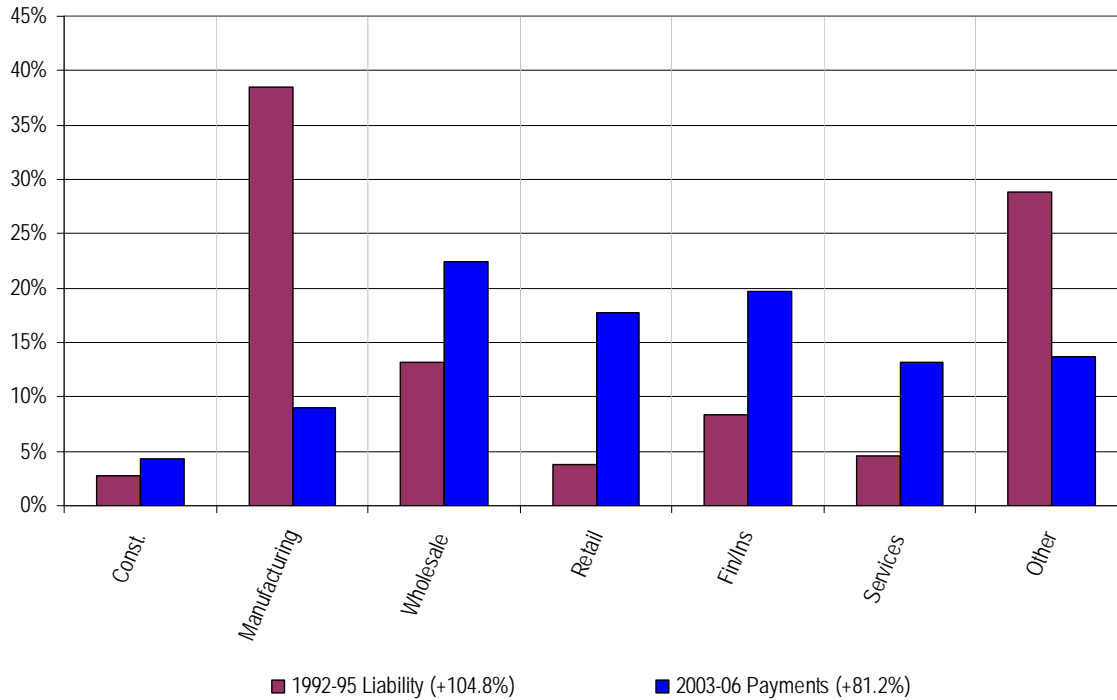
Current Forecast \$815.1

Amount of Projected Kicker \$315.1

Percent of 2007 Liability 66.8%

1 Includes All GF Less Corporate Income Tax

Contribution to Growth in Corporate Payments/Liability

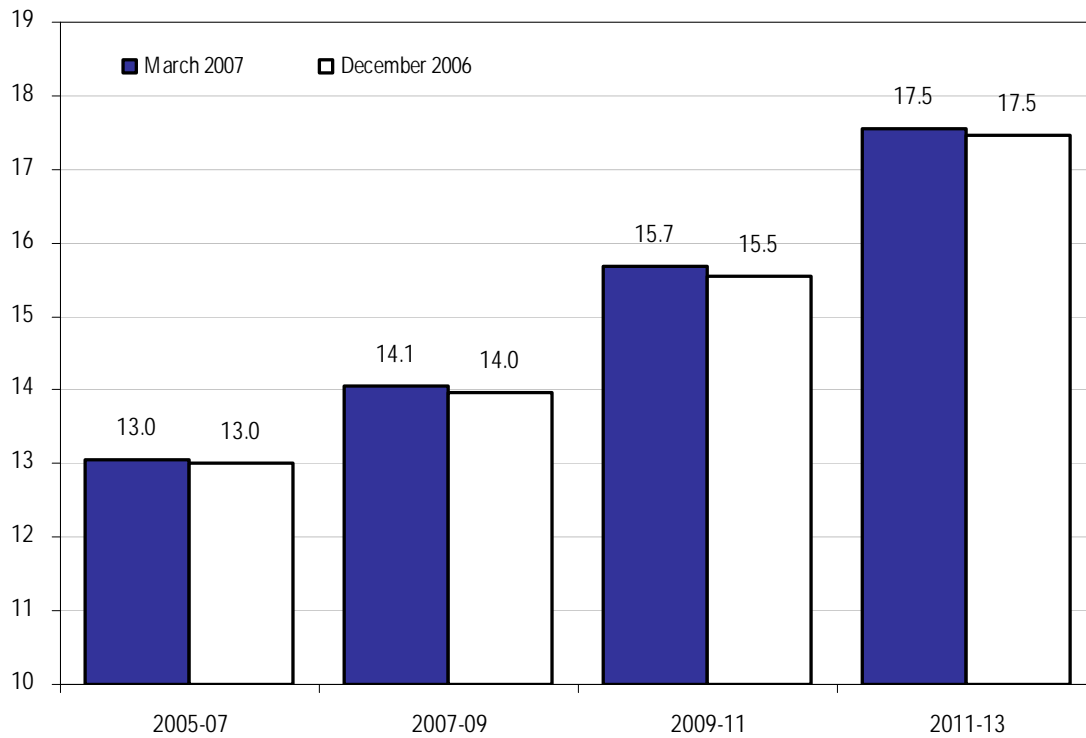


2007-09 General Fund Resources

| (Millions) | Dec 2006 Forecast | Mar 2007 Forecast | Change |
|---|----------------------|----------------------|---------|
| Beginning Balance | \$1,363.9 | \$1,397.9 | \$34.0 |
| Structural Revenues | | | |
| Personal Income Tax | \$12,274.8 | \$12,235.8 | -\$39.0 |
| Corporate Income Tax | \$839.0 | \$949.3 | \$110.3 |
| All Other Revenues | \$861.3 | \$888.4 | \$27.2 |
| Gross GF Revenues | \$13,975.0 | \$14,073.4 | \$98.4 |
| Total Kicker Refunds/Credits | -\$1,372.6 | -\$1,406.6 | -\$34.0 |
| Net GF Revenues | \$12,602.4 | \$12,666.8 | \$64.4 |
| Administrative Actions¹ | | -\$64.3 | -\$64.3 |
| Net Available Resources | \$13,966.3 | \$14,000.4 | \$34.1 |

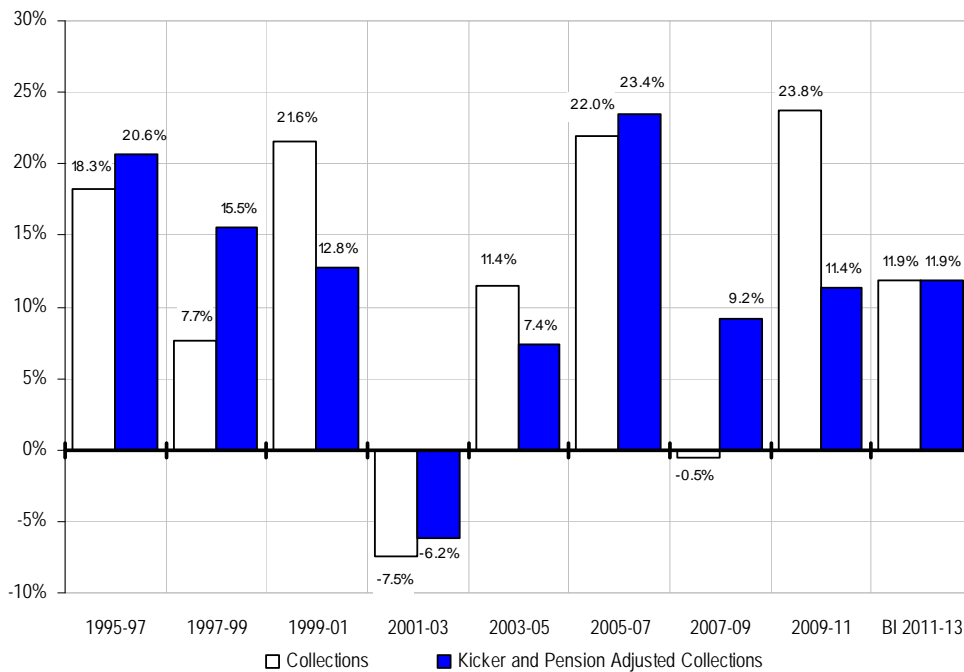
¹ Reflects cost of cashflow management actions, exclusive of internal borrowing.

Comparison of General Fund Resource Forecasts (\$Billions)

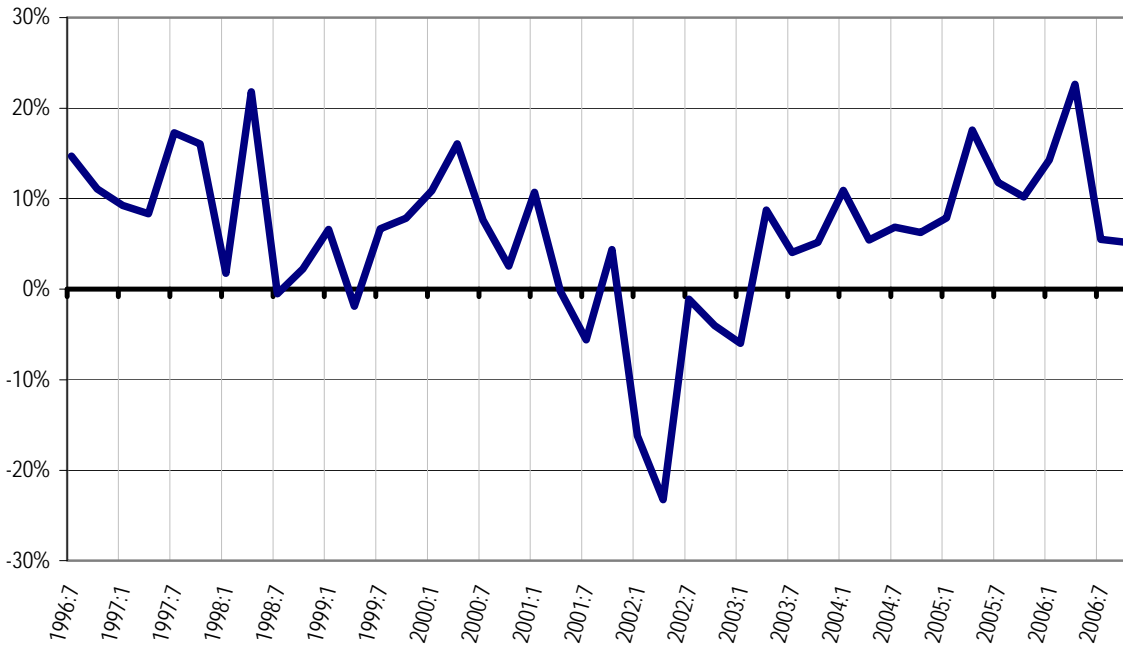


Biennia following 2003-05 do not include projected beginning balances

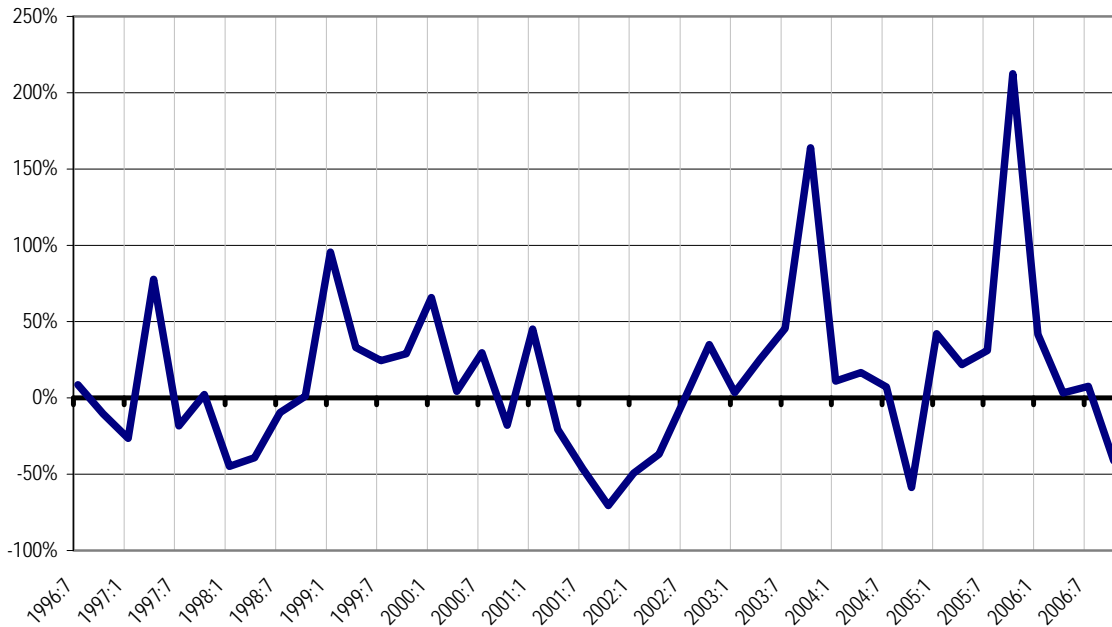
Biennial Growth in General Fund Revenue



Personal Income Tax Collections
(Quarterly, Year-over-year percent change)



Corporate Income Tax Collections
(Quarterly, Year-over-year percent change)



Lottery Resources

(Millions of Dollars)

2005-07 Biennium

| (Millions) | Dec 2006 | Mar 2007 | Change from 2005 COS | |
|--------------------------------|------------------|------------------|----------------------|-------------|
| | Forecast | Forecast | Amount | Percent |
| Beginning Balance | \$0.0 | \$0.0 | - | |
| Earnings | | | | |
| Traditional Games | \$144.2 | \$146.4 | 2.1 | 1.5% |
| Video Lottery | \$907.7 | \$909.6 | 1.9 | 0.2% |
| Anticipated Actions | \$26.7 | \$26.7 | - | |
| Other Resources ¹ | \$5.1 | \$5.1 | - | 0.0% |
| Total Resources | \$1,083.9 | \$1,087.9 | 4.1 | 0.4% |
| Allocations | \$1,026.8 | \$1,028.8 | 2.0 | 0.2% |
| Discretionary Resources | | | | |
| | \$57.1 | \$59.2 | 2.1 | n/a |

Note: Some totals may not foot due to rounding.

1. Includes interest earnings and reversions.

Lottery Resources

(Millions of Dollars)

2007-09 Biennium

| (Millions) | Dec 2006 | Mar 2007 | Change from Dec | |
|--|------------------|------------------|-----------------|--------------|
| | Forecast | Forecast | Amount | Percent |
| Beginning Balance | \$57.1 | \$59.2 | 2.1 | 3.6% |
| Earnings | \$1,228.6 | \$1,224.8 | (3.8) | -0.3% |
| Administrative Actions ³ | \$14.7 | \$14.7 | (0.0) | |
| Other Resources ¹ | \$4.0 | \$7.5 | 3.5 | 87.5% |
| Total Resources | \$1,304.4 | \$1,306.2 | 1.8 | 0.1% |
| Dedicated Distributions² | 649.6 | 646.6 | (3.0) | -0.5% |
| Available for Appropriation | \$654.8 | \$659.6 | 4.8 | 0.7% |

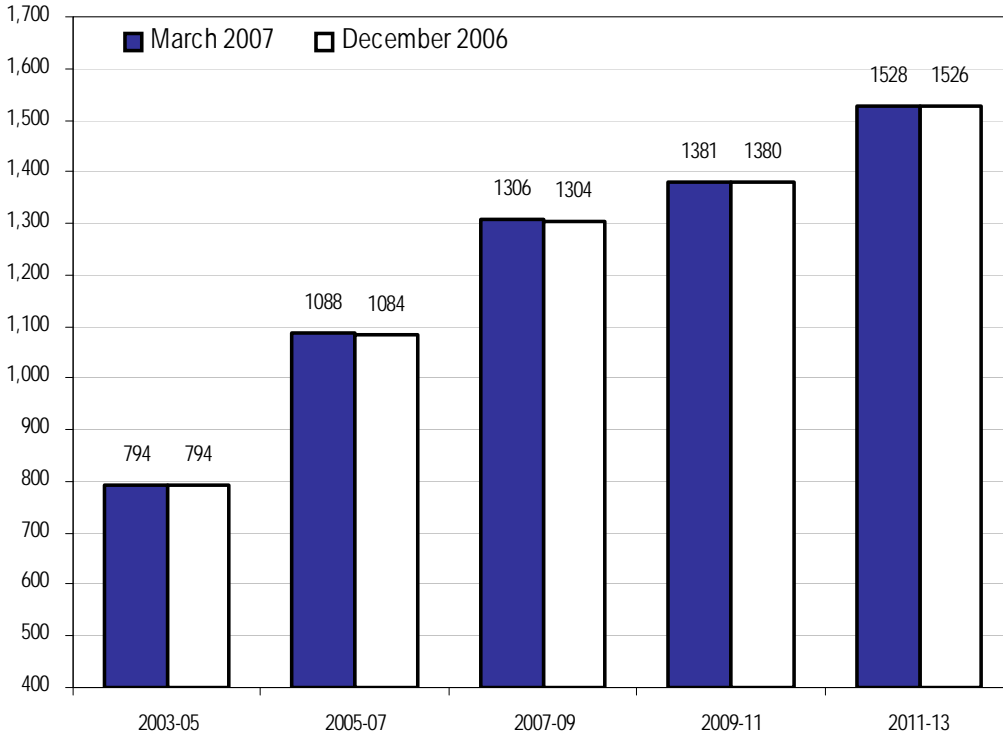
Note: Some totals may not foot due to rounding.

1. Includes interest earnings and reversions

2. Includes Education Stability Fund, Parks and Natural Resource Fund, and Debt Service.

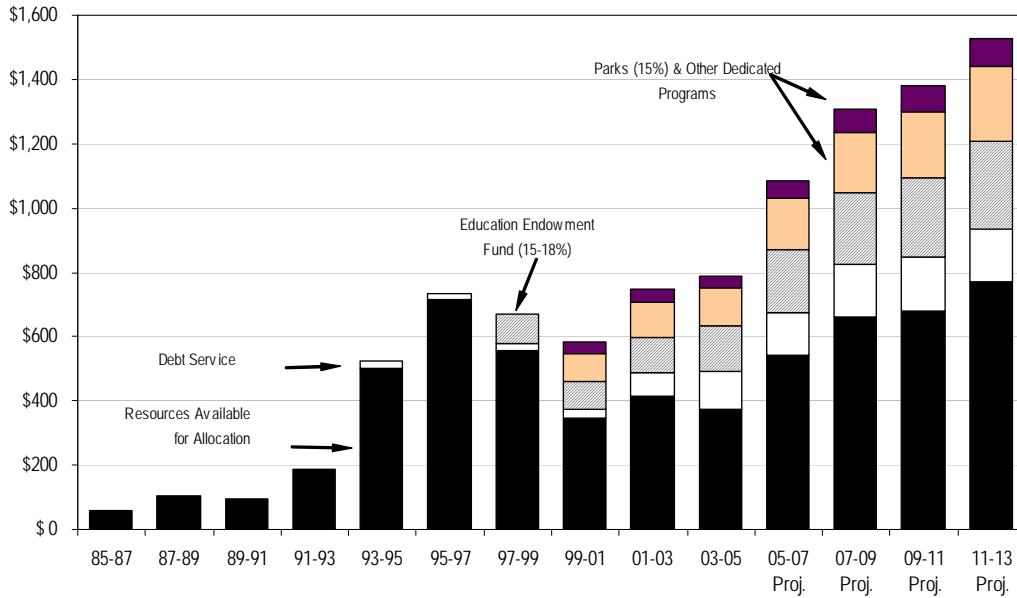
3. Represents impact of expected change to video retailer commission rate structure.

Comparison of State Lottery Resource Forecasts (\$Millions)



Biennia following 2007-09 do not include projected beginning balances

State Lottery Resources (\$Millions)



2 Percent Surplus Kicker History

| Biennium | Tax Year | Personal | | Corporate | |
|----------|----------|--------------------------|------------------|--------------------------|-----------|
| | | Surplus / (Shortfall) | Credit Refund | Surplus / (Shortfall) | Credit |
| 1979-81 | 1981 | (141.0) | none | (25.1) | none |
| 1981-83 | 1983 | (115.2) | none | (109.9) | none |
| 1983-85 | 1985 | 88.7 | 7.7% | 13.4 | 10.6% |
| 1985-87 | 1987 | 224.2 | 16.6% | 6.8 | 6.2% |
| 1987-89 | 1989 | 175.2 | 9.8% | 36.2 | 19.7% |
| 1989-91 | 1991 | 185.9 | suspended | (23.0) | none |
| 1991-93 | 1993 | 60.1 | none* | 17.9 | suspended |
| 1993-95 | 1994/5 | 162.8 | 6.3% | 167.0 | 50.1% |
| 1995-97 | 1996/7 | 431.5 | 14.4% | 202.7 | 42.2% |
| 1997-99 | 1997/8 | 167.3 | 4.6% | (68.6) | none |
| 1999-01 | 2000 | 253.6 | 6.0% | (43.9) | none |
| 2001-03 | 2002 | (1,249.4) | none | (439.5) | none |
| 2003-05 | 2004/5 | (401.3) | none | 101.1 | 35.9% |

Dollar figures in millions

*1991-93 personal surplus was less than 2%

Data Source: Legislative Revenue Office, Office of Economic Analysis
