ECONOMIC OUTLOOK

Mild Recession in the Baseline

A mild recession is now the most likely outcome for the economy. Slowing economic growth, high inflation, and rising interest rates are a potent combination. Historically, inflationary booms do not end well. In our office’s previous forecast the risk of recession was great enough that our office did two full model runs. The first was for the soft landing, no recession outlook and the second was for the boom/bust recession scenario. The overall assessment of the economy today is not fundamentally different than last quarter, however with inflation holding at or near 40 year highs and the Federal Reserve committed to bringing inflation down, the risks have shifted further. A recession now appears more likely than not.

Just as the timing and nature of this cycle has been different than recent experiences, so too is the expected recession. In broad terms the recession is more technical than fundamental in that the impact on jobs, income, and spending is mild. The recession is driven by declines in residential construction and overall business investment due to high interest rates. Additionally, high interest rates and a strong U.S. dollar will weigh on domestic manufacturing activity and exports.

Real GDP is expected to once again turn negative in the quarters ahead, with job losses beginning next summer. While not severe from a historical perspective, Oregon employment declines 1.2 percent, or a loss of 24,000 jobs. The unemployment rate increases to 5.4 percent by early 2024. Income and spending do not decline outright, at least in nominal terms, but do grow slower than in the soft landing alternative scenario. The declines in business investment and slowdown in personal income and consumer spending are enough to alleviate pressures in the economy, and inflation returns to the Federal Reserve’s target in 2024.

The economic outlook is highly uncertain today. Risks abound. The sharp rise in interest rates this year is akin to taking one’s foot off the gas and slamming on the brakes. The car will shake, skid and even fishtail. The ultimate question is does it end up in the ditch or is the driver able to pull out of it? An economic soft landing remains possible even as the odds have shifted such that a recession is more likely than not. Alternatively, a more severe recession may ultimately be needed if high inflation is more entrenched in the economy than realized.

Note on the Oregon Office of Economic Analysis Forecast Process

Our office, the Oregon Office of Economic Analysis, has a forecast process that incorporates a high level, U.S. macroeconomic forecast from an outside vendor, IHS Markit. There are several reasons for this. One is it keeps some specific forecasts, like the stock market, at arm’s length. Capital gains and the associated tax revenue are an important part of the personal income tax forecast. An outside vendor providing such inputs to our forecast helps maintain objectivity and push back on objections that our office is cooking the books.

Another reason is the macroeconomic forecast includes many more variables than our small office could provide, and that other state agencies lean on in their work. This could include estimates of the fuel efficiency of the vehicle fleet, or more detailed forecasts for interest rates on various financial products and the like.
Even so, these outside forecasts also can fail to notice changes to things that our office does care about. There are times where our office does disagree with and diverge from the national outlook regarding productivity in the wood products industry, or more simply that a national forecast for natural resources employment is driven by oil and gas while here in Oregon it is driven by logging instead.

Our office meets quarterly with our three main advisory groups to vet the reasonableness of the macroeconomic forecast, and the preliminary Oregon forecasts before finalizing the outlook.

Our office and our advisors are willing to push back on certain aspects of the national outlook that we disagree with, however it is a different discussion to throw the entire process away. Today, IHS Markit has incorporated a mild recession as their baseline outlook. The latest Wall Street Journal’s Economic Forecasting Survey shows 63 percent of forecasters expect a recession in the coming 12 months. Our office’s advisors agree. 10 of the 11 current, or past members of the Governor’s Council of Economic Advisors present at our most recent meeting voted to put a recession in the baseline. 15 of 16 members of the DAS Economic Advisors, a group of government analysts and economists, voted to put a recession in the baseline as well.

Given that the consensus of economic forecasters has not called a recession in advance before, and only tend to agree there is a recession once one is already underway this is a bit worrisome. Either the upcoming recession is the most telegraphed in history or everyone is missing something. The Federal Reserve will tell you it’s the later, even as the combination of slowing economic growth, high inflation, and rising interest rates is problematic. For now our office is sticking with our process and incorporating a mild recession in the baseline.

The current Oregon economic and revenue forecast does differ in some meaningful ways from the national outlook. IHS forecasts real GDP to be negative starting this quarter, 2024q4, and job losses to ensue in January 2023. Our office, along with our advisors believes the assessment of risks is right but that the timing is wrong. There is simply too much momentum in the labor market for it to turn so quickly to lead to net job losses in a month or two, even as that is a risk. Initial claims for unemployment insurance in recent weeks remain at or near record lows. As such, the Oregon forecast has slowing employment growth in the near-term but pushes the job losses out until next summer. Oregon job losses are not expected to begin until 2023q3, which is one quarter earlier than our old alternative scenario of the boom/bust that began in 2023q4.

Nature of the Expected Recession

Inflation remains the single most important macroeconomic issue today. In recent months inflation as measured by the Consumer Price Index has held steady around 8 percent. The latest numbers for October, released last week, show the first real signs of slowing, but so far remains a single data point. It will take time for the higher interest rates to continue to slow inflation. The Federal Reserve is looking for convincing evidence that inflation is slowing before adjusting or rethinking policy. A single month of data is not yet convincing.
More problematic are the changes underneath the inflation topline. Even as energy and goods prices slow – gray bars in the chart – the acceleration in service inflation – blue bar in the chart – has offset the improvements leaving total inflation essentially unchanged. In a sense one can think of the energy shock from Russia’s invasion of Ukraine, and the supply chain struggles driving goods inflation as supply shocks to the economy and outside of the Federal Reserve’s control. These price increases are and will slow down and even reverse somewhat. Headline inflation will slow as a result from today’s highs. The underlying inflation trend in the U.S. is not 8 percent. However, service inflation is more likely to be driven by demand, which is under the control of the Fed and monetary policy. The underlying trend in inflation appears to be more like 3 or 4 or 5 percent depending upon how one slices the data, which is well above the Fed’s target.

The outlook is for inflation to slow, and higher interest rates are a part of that. The challenge for the Fed and therefore the economy is how quickly will inflation slow, and when it does slow, what pace does it slow down to? From today’s vantage point it is unknown just how high interest rates need to go, especially if the Fed is going to thread the policy needle and engineer a soft landing. An additional challenge here are policy lags. Financial markets tend to be impacted immediately from changes in monetary policy, but the impacts on the rest of the economy can take anywhere from 6 to 12 to 24 months to be felt. With interest rates increases this cycle beginning in March 2022, the impacts are only now starting to show a little. The full effects will not be felt until next year, which is one reason why our office has pushed out the recession date relative to IHS.

Today’s potent combination of slowing growth and high inflation makes the Federal Reserve’s job more challenging. Fed Chair Jerome Powell at the November 2nd, 2022 press conference said that the path to the soft landing had narrowed. Chair Powell went on to say that the greater risk was not raising rates high enough to actually bring inflation back to target. The Fed is communicating they are willing to risk a recession to ensure inflation comes down, and ultimately it is this dynamic and forecasters are increasingly expecting.

So far this year the Federal Reserve has raised interest rates nearly 4 percent, going from a zero percent Fed Funds Rate to start the year to the range of 3.75 to 4.0 percent today. Increases of another one percent or so are likely in the months ahead. Back in September the Fed anticipated raising interest rates to the range of 4.5 to 4.75 percent. The Fed will then hold rates at that level into 2024 to cool the economy and inflation pressures ease over time. At the November press conference Chair Powell said that rates would likely be going higher than the September projections. The next set of Fed projections will be released on December 14.

While much of the focus this year has been on the fast pace and size of rate hikes, what matters now is ultimately how high rates go this cycle, the so-called terminal rate, and how long they stay in the restrictive range. It’s this combination of high rates for a period of time that will cool the economy. The Fed is looking to downshift the size of the rate hikes in the coming months from the recent 75 basis point, or 0.75 percent
increases. This downshift will likely be to 50 basis points a meeting and then to 25 basis points a meeting, depending on realized inflation, and the broader set of economic data. Current expectations are the terminal rate will be in the vicinity of 5 percent, up slightly from the Fed’s own projections back in September.

Economically this shift in monetary policy is equivalent to having one’s foot firmly placed on the gas pedal (0 percent interest rates during the pandemic to stimulate the economy) and then immediately slamming on the brakes (the expected 5 percent increase in interest rates over a 12 month period). When slamming on the brakes of a speeding car, skidding is to be expected. Right now housing is in recession and the strong U.S. dollar will weigh on manufacturing and exports. The question is whether the driver of a skidding car pulls out of it or ends up in the ditch. While the actual outcome is still to be seen, odds are that a recession is more likely than not.

High interest rates impact the economy through a few channels. By raising financing costs, higher rates cool demand for personal credit usage, housing, and business loans. Ultimately if firms are undergoing fewer expansion plans or undertaking fewer investments and households are spending a bit less it feeds back into the production side of the economy where businesses need to hire and produce less to meet this lower trajectory of demand in the economy. As higher rates slow consumer spending and business activity they also weigh on equity markets, dampening the wealth effect on the economy. As underlying economic growth slows, so too does overall inflation. Today the greatest impacts of higher rates are seen in equity markets and the single family home segment of the construction industry. Personal and business loans continue to grow at healthy paces. Consumer spending remains strong. Firms have yet to pull back meaningfully on hiring or increase layoffs, even if hiring is slowing off the pandemic reopening highs.

Recession Impacts in Oregon

Unfortunately, recent decades have brought both large recessions like the dotcom bust and extra large recessions like the Global Financial Crisis and pandemic. The average unemployment rate in Oregon since 2000 is 6.6 percent, indicating an underperforming economy with lots of unemployed workers and underutilized capital has been the norm. That is not the case today for the current state of the economy and that is not even the case for the pending recession.

This cycle has been different at every step, and this is expected to continue with a different type of recession than any in recent experience. Current forecasts call for one of the mildest recessions in U.S. history from both a GDP and employment perspective, more akin to the 1960s or 1990 recessions than anything this century. That said, it is still a recession. Jobs will be lost. Some firms will see their sales dry up. Even in a soft landing scenario, there will be economic pain, as Fed Chair Powell says, in bringing inflation back to target.

Historically, Oregon’s economy is more volatile than the typical state. Our recessions tend to be deeper, and our expansions stronger. This volatility is primarily driven by two things. First, migration trends are pro-cyclical as people move more in good economic times than in bad. Second, the state’s industrial structure is more reliant upon goods-producing industries than the nation, which are more volatile than the service-providing industries in part due to their sensitive to interest rates and the fact consumers can time their big ticket purchases to when they have more income and/or feel more confident in their financial situation.

These dynamics are expected to impact Oregon’s economy moving forward, and our office would expect when the dust settles that Oregon’s recession is a bit deeper than the nation’s and then our expansion would similarly be faster as interest rate sensitive sectors revive, and migration flows rebound.
Specifically, Oregon employment losses are expected to total 24,000 jobs on net from 2023q2 to 2024q1, for a 1.2 percent decline overall. Growth resumes 2024q2 and the state regains its lost jobs by the end of the year, marking both a shallow, and short cycle. Over the full forecast horizon, the outlook remains relatively unchanged with little permanent damage or economic scarring from the expected 2023 recession.

In percentage terms, larger job losses are expected in goods-producing industries like construction (-3.2%) and manufacturing (-1.6%), in addition to other sectors directly tied to them like trade, transportation, and warehousing (-2.3%). Furthermore, financial activities are expected to see larger job losses (-3.0%) due to the sharp decline in home sales impacting banks, mortgage lenders, real estate agents, and the like.

On the other side, with household incomes and consumer spending expected to continue to grow, albeit at a slower pace, many consumer-facing service industries are expected to hold up better. Smaller job losses are expected in health care (-1.1%), other services (-1.1%), and leisure and hospitality (-0.9%).

The public sector is expected to see average to slightly above average sized job losses of 1.4%, although the timing between state, local administration, and local education are a bit different and can be masked when combined at the total government level. Given strong public revenues today and sizable reserves, there is clear upside risks to the public sector outlook even as a slowdown in economic activity will result in slower revenues. Back in the early 1990s, Oregon’s General Fund did not decline during that mild recession.

Job losses and slower wage growth per worker during a recession and disinflationary period lowers labor-related income, and tax collections, in the years ahead. Comparing labor income this forecast to the previous forecast shows the outlook has been lowered around 2 percent, with larger changes at the depth of the pending recession of around 3 percent.

However, complicating these underlying forecast changes are larger than usual historical income revisions from the U.S. Bureau of Economic Analysis. In particular, non-wage income in Oregon has been revised 5 percent higher in recent years than previously estimated. These upward revisions were predominantly in nonfarm proprietors’ income and dividends, interest, and rent. When the larger amount of non-wage income is combined with the lower wage outlook, it leaves total personal income in Oregon relatively unchanged one forecast to the next, despite the recession, as seen in the dotted black line.

Two important items to note. One is that if overall income is relatively unchanged, that feeds through into the outlook for many consumption-based taxes like the Corporate Activity Tax, Lottery, recreational marijuana, and the like where those changes are likewise mild in nature. If Oregonians have more income than previously believed, it supports stronger consumption than previously believed.
Two is that in terms of personal income taxes, the impacts are actual minimal to nonexistent. Oregonians have already reported their incomes and paid their taxes for 2019, 2020, and 2021. In fact the BEA uses IRS tax return data as part of their revision process. Our office already knows that non-wage income like business income, proprietors income, capital gains, dividends, interest, and rent and so forth have been very strong in recent years. These upward revisions are no surprise. In fact, given the strength reported on tax returns, future BEA income revisions are probably going to be upward as well.

However, the downward trajectory of the light blue line in the chart is that the outlook for non-wage income is due to slightly slower growth every year in the years ahead. This will affect different components of income as part of the overall personal income tax forecast as a result.

**Why a Mild Recession?**

Recent recessions have been characterized by large to massive job losses and an overall lack of aggregate demand (income, spending, and investment). It has taken years for the economy to fully heal. This cycle is expected to be different for three primary reasons: inflation expectations remain well anchored, firms will hoard labor, and household balance sheets are in good shape. Let’s take each in turn.

First, despite the fastest inflation in 40 years, firms, households, and financial markets all indicate they expect inflation to slow in the years ahead. While surveys of future expectations are not the same thing as actual behavior, they do indicate that businesses and households are not yet adjusting their long-term decisions based on today’s high inflation. This likely means that high inflation is not yet entrenched in the economy. If high inflation is not entrenched in the economy then a more mild recession would be needed to wring out inflation. Conversely, should high inflation be more entrenched than realized, or than these surveys indicate, then a more severe recession may ultimately be needed to bring inflation down. But for now, the Federal Reserve and economists will take at least some comfort in these surveys of inflation expectations.

Second, the labor market is tight. It was hard to find workers in the years leading up to the pandemic, and even harder today given the imbalance where there are more job openings than unemployed workers. One basic reason for the tight labor market is simply that most people who want a job, have a job. Employment rates, or the share of Oregonians with a job, are higher today than before the pandemic for all levels of educational attainment.

Another basic reason for the tight labor market is demographics. The Baby Boomer generation has been retiring in recent years and will continue to for the next decade. The inflows of younger workers into the labor market outnumber the retirements, at least in places like Oregon, so the labor force is growing on net. However, the pace of those net gains is slower than it used to be due to both the increase in retirements, and a slowdown in migration and a relatively smaller Gen Z population here in Oregon.
All told, firms that have been desperate to hire workers in recent years will be very reluctant to let go of workers if sales slow a little bit. It would take a large decline in revenue for firms to lay off workers in large numbers. Economists call this labor hoarding, which is something firms have not done in generations in the U.S. but is expected to be back in vogue. Strong business revenues and record corporate profits also provide wiggle room in the budget for firms to retain more workers than they may have in past recessions.

Third, household finances remain strong. Of course a recession would weaken household balance sheets, but given the accumulation of savings during the pandemic, the large wage increases, asset markets that are higher today than before COVID, and relatively lower levels of debt compared to the income gains, the recession weakening would be coming off historic strengths. This would mean, at least in aggregate, that consumer spending would hold up better in the upcoming recession than in recent cycles.

Last quarter our office flagged the possibility for differences across the distribution when it comes to household finances. Given income and wealth inequality in the U.S. and here in Oregon, many of the topline economic data on income and spending are driven by high-income households. The concern was low- and middle-income households could be falling behind due to high inflation and any slowdown in the economy.

Thankfully this does not appear to be the case. New data through the second quarter from both the Federal Reserve\(^1\), and the JP Morgan Chase Institute\(^2\) show that low- and moderate-income households are still doing well financially. Checking account balances remain strong and show no deterioration across the distribution. Net worth for all households is higher today than before the pandemic (gray bars). If we narrow the focus to the most recent two quarters where inflation has been the hottest (blue bars), net worth still rose among low- and middle-income households, while high-income households net worth declined along with equity markets. Our office will continue to monitor these quarterly updates on household finances across the distribution.

Now, one risk here when it comes to household finances is just how strong will they be when the recession does begin. Finances are clearly still strong in recent months. However, with inflation remaining hot, and with the job market expected to slow down before it turns south entirely, what will the financial cushion look like at that point? To the extent household balance sheets are in materially worse shape than they are today, the recession may be more severe than anticipated. However, if finances remain in good shape overall, then a mild recession is much more likely.

**Regional Impacts of Recession**

While every state and local economy is impacted by changes at the macroeconomic level, there are distinct differences over time due to the nature of the cycle, the local industrial mix, and other key factors like demographics and migration trends. Currently, two considerations stand out when discussing the pending recession from a local perspective.

\(^1\) [https://www.federalreserve.gov/releases/z1/dataviz/dfa/](https://www.federalreserve.gov/releases/z1/dataviz/dfa/)

First, to what extent does the local economy have a larger, or smaller, reliance on industries that are expected to be the most impacted in the pending recession. This cycle, exposure to credit-sensitive sectors like construction and manufacturing are more likely to weigh on the local economy, as are having a larger share in trade, transportation, and warehousing, along with financial activities. Conversely, with consumer services expected to perform relatively better, local economies with more jobs in industries like health care, leisure and hospitality, and other service are likely to outperform in the coming 12-24 months. This exposure to the nature of the expected recession next year is shown on the horizontal, or x axis in the scatterplot below. A value greater than 1.0 indicates a higher reliance on more impacted sectors while a value less than 1.0 indicates a smaller reliance on those industries.

Second, just as Oregon is more volatile than the nation, some local economies are more volatile than the state. Such volatility leads to deeper local recessions, and stronger local expansions. On the vertical, or y axis in the scatterplot, this volatility is measured looking at annual job growth across counties from 2000 to 2019 compared to statewide growth. A value greater than 1.0 indicates local employment is more volatile than the state, while a value less than 1.0 indicates local employment is more stable than the state.

Combined, these two measures show in advance which local economies in Oregon have the most exposure to the upcoming recession from an industrial mix perspective, and while local economies tend to be more volatile in recent decades. Of course past experience is no guarantee of future performance, but these patterns are indicative of the possible impacts.

What stands out is that many of the state’s urban areas are most at risk. This includes the Bend (Deschutes County) and Medford (Jackson County) metro areas, along with the Portland suburbs (Clackamas, Columbia, and Washington counties). Other metro counties like Lane (Eugene MSA), Linn (Albany MSA), Josephine (Grants Pass MSA), and Multnomah (Portland MSA) are right about the statewide figures (1.0 on the chart) and are historically a bit more volatile.
Among rural areas, Crook County (Prineville) is part of the fast-growing Central Oregon region, while Gilliam County has a very high share of local jobs in transportation and warehousing, an industry expected to see above-average declines as consumers continue to shift back into services and away from goods.

Most other counties in Oregon have less reliance on the most affect industries and have historically been a bit more stable than the state over recent business cycles.

Again, past experience is no guarantee of future performance. Every recession is a bit different and therefore impacts local economies differently as well. In thinking through how some of the macro changes will impact local economies across the state, it may help identify some risks or issues to watch. And to the extent local economies under- or overperform relative to these expectations will be an important topic to research in the years ahead.

**Avoiding a Recession is Still a Possibility**

It is not a foregone conclusion that the economy will enter into a recession. The current assessment of the economy remains largely unchanged from last quarter when the odds favored a soft landing compared to the boom/bust. Today those relative odds have shifted as there has been no fundamental deterioration in the economy. Make no mistake, the risks are real. However the exact path the economy takes remains unknown. Plus every single month the economy does not fall into recession means that jobs, income, and spending all increase. These are the economic measures most Oregonians care about the most in terms of their personal situation.

The case for the soft landing is if you squint, you can make a convincing case that nearly all of the data is starting to turn in such a way that makes the soft landing possible, even if it is not the most plausible outcome, or at least not yet. Keep in mind that the near-term path of the economy looks pretty similar regardless of if the economy is headed for recession or a soft landing. Economic growth, including jobs, wages, and spending need to slow to bring inflation down, but they would also slow in a recession.

The most important data point is the just released October inflation data. As noted previously the underlying details to inflation are worrisome, and the slowing in October is just a single month. However should the expected process of stabilizing or declining goods and energy prices plus slowing in service inflation play out a bit faster, it would allow the Federal Reserve more room to breathe as they search for the right pace and level of interest rates. Doing so would mean a lower probability of tightening too much and sending the economy into recession.

Additionally, part of the ongoing strength in inflation has been the strong household finances that allow consumers to pay higher prices. There has not been any demand destruction of note to date when it comes to consumers, outside of homebuying. Even so, household finances are shifting away from extraordinary to normal. Labor income is slowing some as job growth slows off the pandemic reopening highs, and average hourly earnings are likewise starting to slow just a little. While wage growth is an important economic measure of well-being, wage growth noticeably larger than productivity gains is inflationary. A slowdown in wages to something more sustainable with the Federal Reserve’s target is needed. The data is clearly not there yet, but is beginning to move in that direction.

Besides current income, the wealth effect of a down stock market this year and soon-to-be declines in home equity dampen households’ ability to spend as well, which will help slow inflation. The risk here is that as household finances swing away from exceptional strength and back toward normal dynamics that they don’t stop there but deteriorate even further, negatively impacting the economy.
Another data point that is starting to turn in such a way to slow inflation is the shift in consumer spending. Goods remain 20% above the pre-pandemic trend in nominal terms, but has more or less been moving sideways in recent quarters and no longer surging ahead. This relative slowing in goods spending takes some pressure off supply chains and goods inflation. The long anticipated shift back into services is happening at the same time. Now, the increase in service spending has been inflationary as well given the tight labor market and rising price of inputs. However a rebalancing of spending back toward pre-pandemic patterns should better stabilize prices in the future, hopefully. Note that the nearby charts of U.S. consumer spending include the pending recession in them. Nominal spending continues to increase even in a mild recession, while real, or inflation-adjusted spending temporarily stalls out.

**Labor Market Starting to Cool**

Perhaps nowhere is a slowdown more needed than in the labor market. Strong job growth and employment prospects are vital to economic health. However there is a difference between a strong and tight labor market and an overheating labor market. Given wage growth is clearly outstripping productivity gains, it is inflationary today. A slowing in wage growth (and an increase in business investment and productivity) is needed for underlying inflation to return to the Fed’s target as wage growth provides households their baseline ability to spend.

Encouragingly the data, especially the Oregon data, does appear to be turning in such a way that a slowdown in the labor market and wage growth is not just possible, but likely. Let’s start first with job openings. In August there were 1.6 job openings in Oregon for every unemployed Oregonian looking for work. Clearly labor demand (number of jobs that firms are looking to fill) is outstripping labor supply (number of available workers) which ultimately leads to the faster wage growth.

Better labor market balance could come from relatively fewer job openings or a large increase in unemployment. The Federal Reserve’s outlook is the former. This is sometimes referred to as the Waller view, named after Fed Governor Christopher Waller. In a speech earlier in the pandemic, Mr. Waller outlined how there could be a decrease in job openings which brought better balance and slower wage growth and inflation without a sizable increase in unemployment. So far this is playing out at least a little bit. Back in March there were 1.9 job openings in Oregon for every unemployed Oregonian. More progress and better balance is needed, but movement in the right direction is still movement in the right direction.

A key labor market concept is the so-called Beveridge Curve which looks at the relationship between job openings and unemployment. Generally speaking, firms are looking to fill more positions in a strong economy, and it is harder to find workers at the same time because most individuals who want a job are able to find one.
During the pandemic this relationship has broadly held up as before, however what is concerning is it appears to have shifted up, or shifted out as seen in the light blue dots when compared to the gray dots. What this would indicate is that for any given level of job openings, there will be higher unemployment in the economy than there was before the pandemic. One possibility is that this is a timing issue, or something the pandemic temporarily disrupted. Another possibility is something is fundamentally broken in the economy, or that the natural rate of unemployment has increased.

Encouragingly, the data so far this year in Oregon (dark blue dots) has brought the Beveridge curve about halfway back to the pre-pandemic patterns. This is exactly the Waller view in that job openings are declining and unemployment is not increasing. The U.S. data so far in 2022 shows less progress than does the Oregon data, although it has moved in the same direction

More encouraging is that labor matching in the economy – the speed at which unemployed workers are able to find a job, and firms looking to hire are able to do so – does not appear to be permanently broken in recent years.

The nearby chart looks at the job finding rate in the economy based on how many job openings and unemployed workers there are. It compares the actual job finding rate with the expected rate based on historical patterns. There was a clear breakdown earlier in the pandemic. This was likely due to the shutdowns, the virus itself, lack of in-person schooling and childcare, and federal aid including enhanced unemployment insurance benefits, however the data in recent months is now back to the expected patterns as seen in 2019. This is a stepdown in labor matching or efficiency relative to earlier last decade, but so far the 2022 numbers look very similar to the 2018 or 2019 numbers.

This job matching work is based on a 2020 Fed paper from Ahn and Crane³, which was updated more recently by the San Francisco Fed⁴ discussing the current state of the economy. Our office created an Oregon version to better gauge the local labor market.

Finally, new Fed research from Cheremukhin and Restrepo-Echavarria⁵ helps shed light on some of the changes in job openings and the economy in recent years. As the authors detail, when businesses hire workers they are either hiring someone who is unemployed and looking for work, or they are hiring a worker away from another firm, or poaching – a term the authors use. These are different segments to the labor market and have different impacts on job openings, wage growth, the unemployment rate and so on.

What the authors find nationally, and our office has recreated using Oregon data, is that the surge in job openings in recent years is due to more poaching. This has a few implications. First it means that the labor matching process, as discussed above, is not broken and unemployed workers are able to find jobs. Second, workers who switch jobs tend to see larger wage gains than those that stay at their jobs. As such, the higher rate of workforce turnover during the pandemic, including the higher rate of worker quits today as workers switch jobs, helps lead to both faster overall wage gains and inflationary pressures, and firms to advertise more openings to fill their newly vacant positions as workers leave for other opportunities. This is a distinct process from the possibility that unemployment is more structural in that the workers lack the skills needed for the available jobs, or that there is a geographic mismatch between openings and the unemployed, etc.

The decline in job openings so far this year, both nationally and here in Oregon, is coming from the poaching component and not the unemployed portion. This is encouraging that unemployed workers are still able to find jobs quickly, and that overall workforce churn may be slowing as well. As discussed in previous forecasts our office has hoped that the higher rate of worker quits, and job switching would lead to an overall better labor match. This could be in terms of skillset, geographic location and hours worked. At a minimum job switching typically is at least for higher pay. These temporary changes in the labor market, moving from one job to another, can be disruptive from a productivity standpoint. After a period of training or getting acquainted at a new place of work, the expectation is productivity will pick back up. A cooling in the labor market, where more workers are in better financial and workplace positions could be beneficial for the overall economy.

**Alternative Scenarios**

The baseline outlook is our forecast for the most likely path for the Oregon economy. As with any forecast, however, many other scenarios are possible. Historically the combination of slowing economic growth, high inflation, and rising interest rates is problematic and a mild recession appears more likely than not. However it is still possible the economy avoids a recession, or that a more severe recession is ultimately needed to bring inflation down. The two alternative scenarios below are not the upper and lower bounds of all outcomes. Rather, these alternative scenarios are modeled on realistic assumptions that are somewhat more optimistic or pessimistic than the baseline. For the revenue implications of the alternative scenario see page 29.

**Optimistic Scenario: The Soft Landing**

The shifts in the data that are just underway continue, albeit a bit faster than in the baseline. In particular the slower pace of inflation in October continues through the end of the year. The Federal Reserve is able to keep its foot on the brakes but no longer slam down on the pedal. The Fed Funds rate still drifts higher, into the mid-4 percent range, but at a slower pace.

Overall the economy does slow, particularly the goods-producing industries. Construction and finance are in for some job losses. Manufacturing, and trade, transportation, and utilities likely will as well. However, economywide job losses are avoided as service-providing industry gains offset the weak goods. As Fed Chair Powell says, there will still be economic pain in bringing inflation back to target. As a result of the softer, slower labor market, the unemployment rate increases to 4.6 percent, compared with 5.4 percent in the baseline. This
increase is primarily due to fewer job openings and a slightly longer search time needed to find work. Income growth and consumer spending are stronger than in the baseline.

### Alternative Scenario

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<tr>
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### Pessimistic Scenario: Moderate Recession

While a mild recession makes sense from today’s perspective, when the economy does enter into recession it may play out differently. Consumers may pull back larger than anticipated. Firms may lay off more workers than they expect. High inflation may be more entrenched in the economy than currently believed, forcing the Fed to hold interest rates higher for longer. The end result is not a mild recession but a moderate one closer to the typical or average sized recession the economy has experienced.

In the pessimistic scenario in Oregon, job losses are more severe and the recession lasts longer than under the baseline. Employment declines 4 percent, compared to 1.2 percent in the baseline, or a total of 80,000. Employment bottoms out in mid-2025 and does not return to peak until mid-2027. The unemployment rate spikes to 8.2 percent. Income and spending do turn negative in 2024 and 2025.

### Construction and Housing Outlook

Last quarter our office made two substantive changes to the construction and housing outlook by including declines in both new housing starts and in home prices. This quarter these declines are now expected to be more severe. Oregon housing starts are forecasted to decline 19 percent, and home prices will fall 14 percent.

The key reason why is that mortgage rates have continued to surge throughout the year and homeownership affordability continues to worsen. Increases in mortgage rates is to be expected during a tightening cycle when the Federal Reserve is raising interest rates. However mortgage rates have increased considerably more than other financial products like U.S. treasuries. Investors are demanding even more of a premium than they used to for mortgages. This widening of the spread is not due to potential foreclosure risk with home prices declining, but due to pre-payment risk. For borrowers taking out a mortgage around 7 percent today, many can expect to refinance into a lower rate in the years ahead as the Fed eases off the brakes and cuts interest rates once inflation slows. As such, investors will likely only earn that 7 percent on the loans for a year or three and therefore demand more of a premium to compensate for this pre-payment risk. Note that this spread between mortgages and treasuries has started to lessens a little in recent days, following the softer October CPI print.
As discussed last quarter, this rapid rise in mortgage rates has essentially cut affordability in half, shrinking the pool of potential homebuyers considerably. Such a sharp change in the market is now expected to have deeper, and longer impacts on new construction that previously forecasted.

Overall, housing starts in Oregon are expected to decline 19 percent from 2021 to 2023. It is very important to note that as of this fall, housing starts have not actually declined noticeably. They are off their peaks, and down a little, but in the grand scheme of things so far Oregon housing starts are more stable than declining. This relative strength in recent months is due to the fact that as new detached single family permits have fall 20-25 percent, new multifamily permits have surged to offset those declines. While multifamily construction is expected to remain stronger in the year ahead, a continued surge is unlikely, leading to an expected overall decline in housing starts in Oregon. Housing starts pick up strongly by mid-2024 and increase moderately over the entire forecast horizon.

This slowdown in new construction is not as large as the affordability crunch alone would suggest. This is due to both the undersupply of housing already in the state, which means demand outstrips supply, limiting further declines, and the strong underlying demographics of housing demand this decade as the Millennials age into their 30s and 40s. Even so, the slowdown in new construction likely adds to the undersupply problem in the short term. For more on addressing Oregon’s housing shortage, particularly the workforce needs to approve, inspect, and build more units, please see our office’s previous report6.

Looking forward, housing starts will pick back up for three reasons: population growth, underlying demographics, and improving affordability. Population growth should be rebounding this year and next following the slowdown during the pandemic. See last quarter’s forecast7 for more on the expectations for the soon-to-be-released 2022 population estimates. The underlying demographics and increase in household formation in recent years keeps housing demand high. And affordability will improve as well, reviving housing demand and therefore new construction activity along with it.

The challenge is the improvements in affordability will be coming off the worse affordability in recent memory. Today, the monthly mortgage payment to the bank, as a share of income is worse than it was at the peak of the housing bubble back in the mid-2000s. Sales and starts will revive as affordability improves. There are three things that will bring better affordability over the coming 18 months.

First will be ongoing income growth. Yes, incomes will slow in a recession, but not turn negative. A typical year’s worth of income growth is equivalent to about a 40 bps, or 0.4 percent reduction in the mortgage rate in terms of affordability. Afterall, higher incomes mean one can afford a larger monthly payment in dollar terms, even if it remains the same percentage of household income or expenses. Expected income growth accounts for about a quarter of the improvement in affordability needed to get back to the historical range.

Second will be price declines. During the earlier parts of the pandemic, the record low interest rates were essentially capitalized into higher home prices. With the surge in rates this year, prices need to decline given

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6 https://oregoneconomicanalysis.com/2022/09/20/addressing-oregons-housing-shortage-workforce-needs/
7 See PDF pg 15 (report pg 11) https://digital.osl.state.or.us/islandora/object/osl%3A998248/datastream/OBJ/view
affordability is so out of line. Overall our office expects home prices in Oregon to fall 14 percent between summer 2022 and summer 2024. The majority of the declines will happen in the first year, or right now, followed by some slower and smaller declines in late 2023 and early 2024. These price declines account for another quarter of the improvement in affordability needed to get back to the historical range.

Third will be mortgage rate declines. While higher for longer has been the right view of Federal Reserve policy and interest rates in the past year, the fact that interest rates spreads have widen to such a degree means there is room for mortgage rates to fall in the quarters ahead, if financial markets calm. Beginning in 2024, and 2025 the Fed is expected to take its foot off the brake and cut interest rates as well. Declining mortgage rates from 7 percent today to 5 percent in 2025 will account for the other half of the improvement in affordability needed to get back to the historical range.

A key item to keep in mind is that every household’s housing affordability is slightly different. Every household has slightly different incomes, credit scores, down payments, other debt and the like. So as affordability begins to improve a little, it will price more potential buyers back into the market. And once most potential buyers are able to again buy or sell at realistic affordability, overall sales, prices, and starts will revive.

Ultimately the combination of rising incomes, declining home prices, and falling mortgage rates will bring ownership affordability back and revive the market. Each of these three key factors may adjust more, or less than anticipated. Each factor can contribute more, or less to the overall improvements. For example, a home price decline of around 25 percent would bring affordability back down to the historical range overnight. Or a drop in mortgage rates back to 5.5 percent would bring affordability halfway back, and so forth.

While there is no question that new detached single family housing is important, it is also a small share of the overall construction industry. In the years leading up to the pandemic, new detached single family housing accounted for just 20 percent of overall construction spending. So if multifamily activity remains strong, and remodeling and repairs holds up relatively well given home equity is larger and the housing stock is aging, it means the fallout from the sharp decline in detached single family activity is more limited than realized. Plus nonresidential and public works will be picking up in the years ahead. This is especially the case once the federally funded infrastructure projects get underway mid-decade. Plus construction is an industry where firms have been discussing labor shortages for the better part of a decade. Businesses will not be looking to lay off workers unless they absolutely have to.

The bottom line is our office is now forecasting overall construction employment in Oregon to decline 3.2 percent from early 2023 through mid-2024. Such declines are more than twice the declines the overall labor market will experience. However given the sharp decline in affordability and new detached single family construction, the industrywide changes are mild.

**Oregon’s Agricultural Economy**

This year, the Oregon Legislature passed HB 4002 (2022) which establishes maximum hour and overtime compensation requirements for agricultural workers. The law goes into effect starting in 2023. Moving forward, our office will analyze and monitor the economic and labor market data to assess any impacts from the law.
office will work to incorporate these changes, if any, in the broader context of the state’s agricultural economy. In advance of the law going into effect, and the lagged data available to begin to assess any impacts, our office has been highlighting the importance of agriculture to the state’s economy. In recent quarters we have dug into farm employment, income, and sales at the state and county, in addition to international exports. This quarter we will discuss how ag fits in with the broader food economy in the state and how Oregon compares nationally.

Oregon’s food economy overall employs 270,000 workers today, or about 14 percent of the state’s total workforce. It accounts for 4-5 percent of state GDP in the past handful of years. More than one-third of these workers – nearly 100,000 – are in the production, processing, and distribution segments of the food economy. It is here where Oregon has a distinct comparative advantage, and a growing share of the national market.

However, most of us only really interact with the fourth segment of the food economy: food services. The majority of the food economy jobs are in services including restaurants, supermarkets, specialty food and beverage stores, food carts, and the like. While these services garner the national and international attention, and satisfy our tastebuds, they play a lesser role in terms of the actual economic impact and what makes Oregon unique from an industrial structure perspective. This is partially because food services are largely driven by population and consumer spending patterns. Even as Oregon is home to award-winning brewers and chefs, residents of other states go out to eat as well, and likewise have a lot of food service jobs.

Where Oregon’s food economy differs from other states is on production and processing. Oregon’s location quotient for food production in 2021 is 2.8, meaning the concentration of agricultural jobs is nearly three times what it is nationwide. This is primarily driven by crops (grains, fruits, vegetables, etc) and fishing. Over the past decade, the state’s growth in food production is being driven not just by overall economic growth, but also a regional shift, or increase in regional competitiveness. Using a shift-share analysis, the growth in food production in Oregon is 60% regional competitive effect.

Additionally, Oregon’s location quotient for food processing is 1.4, meaning the local concentration 40% larger than in the average state. Here the drivers of growth are a bit more balance looking through a shift-share lens but still important to note and highlight local successes. 41 percent of the growth in the past decade is due to overall economic growth, 26 percent due to a change in industry mix, and 33 percent due to the regional competitive effect.

Compare those figures with the food distribution and food service segments where just 5-10 percent of the growth is due to the regional competitive effect, with the bulk due to broad national, and industry trends.
Among distribution and services, local trends essentially mirror national trends over the past decade, which is one reason why Oregon’s location quotients are at or at least closer to 1.0.

Looking forward for Oregon’s food economy there will be both a step back in terms of near-term losses during the pending recession next year, and long-term growth. Numerically, much of that growth will come from food services, which still have not fully recovered to their pre-pandemic levels, but eventually will. The exact strength of that growth in food services will largely be tied to population growth. However our office’s forecast also includes long-term growth in food manufacturing, and a more stable outlook for food production. The key for the local economic impact will be to maintain these strengths in production and processing as Oregon has done in recent decades.

As the agricultural worker overtime law come into effect, our office will work with other state agencies to gather and analyze the available data. Future quarterly forecasts will include updates to the underlying ag economy, when available, and any such analysis of the impacts of the new law that goes into effect next year.

Longer-Term Forecast Risks

The economic and revenue forecast is never certain. Our office will continue to monitor and recognize the potential impacts of risk factors on the Oregon economy. Although far from comprehensive, we have identified several major risks now facing the Oregon economy in the list below:

- **U.S. Economy.** While Oregon is more volatile than the nation overall, the state has never missed a U.S. recession or a U.S. expansion. In fact, Oregon’s business cycle is perfectly aligned with the nation’s when measuring peak and trough dates for total nonfarm employment.
- **Housing Affordability.** New housing supply has not kept pace with demand in either the ownership or rental markets. Oregon has underbuilt housing by 111,000 units in recent decades⁸. To the extent home prices and rents rise significantly faster than incomes, it is a clear risk to the outlook. Worse housing affordability hurts Oregonians as they need to devote a larger share of their household budget to the basic necessities. Furthermore, while not the baseline outlook, worse affordability may dampen future growth as fewer people can afford to live here, lowering net in-migration, and the size of the labor force in the years ahead.
- **Global Spillovers.** The international list of risks seems to change by the day. Right now there is an ongoing war in Europe, and the risk of war in Southeast Asia has been uncomfortably high in recent years. Longer-term concerns regarding commodity price spikes in Emerging Markets, or the strength of the Chinese economy – the top destination for Oregon exports – are top of mind.
- **Federal Fiscal Policy.** Changes in national spending impact regional economies. In terms of federal revenues, spending, and employment Oregon is generally in the middle of the pack across states. Oregon does see larger impacts related to land management and forest policies, including direct federal employment. Oregon ranks below average in terms of military-dependent industries and lacks a substantial military presence within the state.
- **Climate and Natural Disasters.** While the severity, duration, and timing of catastrophic events like earthquakes, wildfires, and droughts are difficult to predict, we know they impact regional economies. Fires damage forests with long-term impacts, and short-term disrupt tourism. Droughts impact our agricultural sector and rural economies to a greater degree. Whenever Cascadia, the big earthquake, hits, we know our economy and infrastructure will be crippled. Some economic modeling suggests that

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Cascadia’s impact on Oregon will be similar to Hurricane Katrina’s on New Orleans. Longer-term issues like the potential impact of climate change on migration patterns are hard to predict and generally thought to be outside our office’s forecast horizon. Even so, it is a reasonable expectation that migration flows remain strong as the rest of the country becomes less habitable over time.

- Initiatives, Referendums, and Referrals. Generally, the ballot box and legislative changes bring a number of unknowns that could have sweeping impacts on the Oregon economic and revenue picture.

**Extended Outlook**

Oregon typically outperforms most states over the entire economic cycle. This time is no different, however the expectations are that the relative growth advantage may be a bit smaller than it has been historically. The primary reason being slower population, and labor force growth than in decades past. Our office is a bit more bullish on Oregon’s economic and population growth than IHS Markit is, but our office overall agrees with the relative patterns nationwide. From 2022 to 2027, IHS expects Oregon’s real GDP growth to rank 23rd fastest among all states, while employment growth ranks 18th fastest, and population gains are the 16th fastest.

Over the extended forecast horizon our office has identified four main avenues of growth that are important to continue to monitor: the state’s dynamic labor supply, the state’s industrial structure, productivity, and the current number of start-ups, or new businesses formed.

**Labor Supply.** Oregon has typically benefited from an influx of households from other states, including an ample supply of skilled workers. Households continue to move to Oregon even when local jobs are scarce, as long as the economy is equally bad elsewhere, particularly in California. Relative housing prices also contribute to migration flows in and out of the state. For Oregon’s recent history – data available from 1976 – the labor force in the state has both grown faster than the nation overall and the labor force participation rate has typically been higher.

The good news today is that Oregon’s labor force has never been larger, and the labor force participation rate is now higher than it was before the pandemic began. Even in this sometimes noisy, and unrevised data, the strength of Oregon’s labor market is clear.

Moving forward, overall labor force participation rates will decline, simply due to the aging of the population. As more Baby Boomers enter into their retirement years, the share of all adults working or looking for work will fall as a result. As such, comparing Oregon’s participation rates against a demographically-adjusted measure is important. Here, too, the current strength of the Oregon’s labor market is evident, and encouraging.

The challenge moving forward is twofold. First, is overall population growth and whether that rebounds as expected in the years ahead. Second, whenever the next recession (or two) does come, maintaining a high participation rate and not seeing larger numbers of discouraged workers drop out of the labor force like they did following both the dotcom and housing busts. It was only once the economy became strong again in the late 2010s and early 2020s have some of those losses begun to be regained.
Industrial Structure. Oregon’s industrial structure is very similar to the U.S. overall. However, Oregon’s manufacturing industry is relatively larger, and weighted more toward semiconductors and wood products, compared to the nation which is more concentrated in transportation equipment (aerospace, and automobiles).

However, industries like timber and high-tech, which have been Oregon’s strength in both the recent past and historically, are now expected to grow the slowest moving forward. Productivity and output from the state’s technology producers is expected to continue growing quickly, however employment is not likely to follow suit. Similarly, the timber industry remains under pressure from both market based conditions and federal regulations. Barring major changes to either, the slow growth to downward trajectory of the industry in Oregon is likely to continue.

With that being said, certainly not all hope is lost. Those top industries in which Oregon has a local concentration at least twice the national average comprise approximately 4 percent of all statewide employment. Slower growth moving forward is not a weight, but rather more of a lack of a boost.

Many industries in which Oregon has a larger concentration that then typical state are expected to perform quite well over the coming decade. These industries include management of companies, food and beverage manufacturing, published software along with some health care related firms.

The state’s real challenges and opportunities will come in industries in which Oregon does not have a relatively large concentration. These industries, like consulting, computer system design, financial investment, and scientific R&D, are expected to grow quickly in the decade ahead. To the extent that Oregon is behind the curve, then the state may not fully realize these gains if they rely more on clusters and concentrations of similar firms that may already exist elsewhere around the country.

Capital and Productivity. Ultimately, the economy’s industrial structure combined with capital will result in increasing productivity. Higher productivity allows firms to produce and sell more products, and pay higher wages to its workers. Capital can come in many different forms including financial, natural, physical, human, and social. All can help raise firm productivity, benefiting the economy more broadly.

Today, the economy desperately needs better productivity, which has been sluggish this century. Early in the pandemic, productivity perked up as firms had to make due with reduced workforces at the same time consumer demand remained strong. However, as employment has rebounded, these productivity increases not only have not held, but have eroded. The current outlook for productivity is more or less back to the pre-pandemic trend, if not slightly below it. Increasing the stock and use of Oregon’s capital would boost the economy overall.
New Business Formation. New businesses are generally considered the primary source of innovation. New ideas, products, and services help propel future economic growth. Unfortunately in the decades leading up to the pandemic, start-up activity was declining. New businesses as a share of all businesses were at or near record lows in 2019. Employment at start-ups follow a similar pattern.

To the extent the low levels of entrepreneurship continue, and R&D more broadly is not being undertaken, slower productivity gains and overall economic growth is to be expected. However, to the extent that larger firms that have won out in today’s marketplace are investing in R&D and making those investments themselves, then the worries about the number of start-ups today is overstated. It can be hard to say which is the correct view. That said, actual, realized productivity in the economy has been sluggish in recent decades.

Encouragingly, new business applications during the pandemic actually accelerated, stopping the long-run decline. Applications from what Census calls high-propensity business with planned wages, which are the most likely to eventually turn into real firms that employ workers, have been higher in 2021 and so far in 2022 than back in 2019. New business applications of all other types, including self-employment, are up even further.

These gains provide some hope for future economic growth should some of these new firms bring new ideas, products, and efficiencies to market. Even if the per firm probability of success remains the same, having more ping pong balls in the lottery increases the overall probability that a few will survive and succeed tremendously.

Oregon Income Relative to U.S. One long-standing concern for some policymakers and analysts had been Oregon’s relatively low income and wage compared to the rest of the nation. Encouragingly, the strong economic growth last decade did translate into meaningful increases in Oregon’s per capita income and average wage. Today Oregon’s per capita income relative to the U.S. is at its highest point since the dotcom bust two decades ago, and the state’s average wage is at its highest relative point since the timber industry restructured and the mills started closing in the early 1980s.
Oregon’s median household income in recent years has reached historic highs, even after adjusting for inflation. More importantly, it now stands 2.6 percent higher than the U.S. overall as of 2021. In recent years, this marks the first time in more than 50 years that Oregonian incomes for the typical household or family are higher than the nation. The fact that the strong regional growth translated into more money in the pockets of Oregonians, and regained the ground lost decades ago is one of the most important economic trends in recent generations. The microdata for the 2021 American Community Survey was just released. In the coming months our office will dig deeper into these income trends across regions, ages, and races and ethnicities. The next round of good income data will come from the 2022 American Community Survey which will be released in mid-September 2023.