Washington State Economic and Revenue Forecast

September 2009
Volume XXXII, No. 3

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Prepared by the
Economic and Revenue Forecast Council

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Preface

The Economic and Revenue Forecast Council is required by Chapter 231, Section 34, Laws of 1992 (RCW 82.33.020) to prepare a quarterly state economic and revenue forecast and submit it to the Forecast Council. This report presents the state's economic and General Fund-State revenue forecast. It is issued four times a year.

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Executive Summary

- **It is almost certain the Great Recession of 2007-09 is over and economic activity has stopped declining. It will be a while before output returns to its previous peak because the recovery will be slow. Employment growth will lag the recovery in output, as will the peak in the unemployment rate.**
- **An unprecedented global recovery is under way. Typically nations that lag the U.S. in coming out of recession are returning to growth at the same time or even earlier.**
- **The housing situation has improved in recent months as well. Home prices appear to have hit bottom and have begun to increase. We expect them to improve slowly. Housing starts have started to climb as well coming off their historic lows.**
- **The risk to the outlook is still significant, but downside risks have diminished and are now balanced with upside risks.**
- **Recent data are showing signs of imminent turnaround in the Washington economy. Employment is still declining, but at a reduced pace. Initial jobless claims appear to have peaked. Housing permits and new vehicle registrations have both turned up.**
- **Job losses, however, will continue through the end of the year and the unemployment rate will continue to rise through mid-2010. This is normal since the labor market recovery lags the recovery in activity.**
- **Though residential construction has hit bottom, the correction in non-residential construction has a long way to go.**
- **While the recovery is largely proceeding along the lines of the June economic forecast, revenue-generating activity has been below expected levels.**
- **The September 2009 forecast for the 2009-11 biennium is $29.6 billion, which is $230.9 million less than expected in June. Twenty percent of the forecast reduction is the result of a state Supreme Court decision on Business and Occupation taxes.**

U.S. Economic Forecast

The recession is over but risks remain

With the economy reaching a trough early in the third quarter, the recession now appears to be over. This does not mean that economic activity is back to where it was before the recession started, but rather that it has stopped falling and is now in the process of recovering. Employment will take time to pick up again as it typically lags the upturn in activity. Businesses wait to hire until they are sure demand has returned. Consumer spending remains weak as households have lost nearly one-fifth of household wealth, and the fear of additional job losses remains. Consumer confidence, though improving, remains in recessionary territory. The banking sector is still vulnerable. While large national banks have returned to profitability, regional banks across the country remain vulnerable to deteriorating asset quality because of their disproportionate exposure to a weakening commercial real estate sector. Despite this, there are plenty of positive signs of a turnaround. Home prices have turned up, housing activity is improving and business investment is starting to stabilize. Perhaps the most promising development has been the synchronized global recovery that is under way. Countries in East Asia and some in Western Europe have come out of the recession earlier than the United States, which should provide a boost to our growth through higher exports. Finally, the full extent of the fiscal stimulus package has yet to be felt. Only 19% has effectively gone out through the end of the third quarter.

GDP has been stronger than first anticipated

Real GDP is expected to grow by 3.0% (SAAR) in the third quarter of 2009 (see Figure 1.5), much stronger than the 0.6% originally anticipated in June. Growth is then forecasted to moderate slightly and then gradually increase to 3.7% by the third quarter of 2011. The early part of the recovery will be supported by the first round effects of both the fiscal and monetary stimulus to date. The full impact of the stimulus in the pipeline will be felt sometime around the third quarter of 2010. Real Consumer spending will remain positive but weak, reaching 3.9% (SAAR) growth by the third quarter of 2010 but then moderating in 2011 with an average annual growth rate of 2.4%. Business investment will rebound strongly in the current quarter, largely as a result of inventory restocking and peak in the fourth quarter of this year. Export growth will return much sooner than previously expected and is forecasted to grow 8.1% this quarter due to the global recovery that is now under way.

The labor market lags the real economy

Employment growth typically lags the recovery in activity, and it is no different this time around. While the overall economy returns to growth in the current quarter, employers will continue shedding jobs through the first quarter of next year (see Figure 1.6). Businesses will first meet demand by ramping up excess capacity and increasing workers' hours. Only after they are sure the recovery is going to be sustained will they start adding to payrolls. The unemployment rate is expected to peak in the same quarter at just over 10%.

Washington Economic Forecast

The synchronized global recovery bodes well for Washington

In June we saw the first hints of a turnaround in the state economy. The state's economic performance since then has confirmed that we were on the right track, especially in the critical areas of jobs and housing. It is increasingly clear that we have seen the bottom in housing permits which means we should soon see a pickup in residential construction activity and related employment. Non-residential construction will continue to decline for a couple of years, though. Overall payroll employment is still declining, but the rate of decline slowed in the last five months to a seasonally adjusted annual rate of 1.4% compared to a 6.5% rate of decline during the previous six months. We expect the Washington economy to recover sooner and stronger than the national economy. The synchronized global recovery now underway bodes well for the nation's most trade dependant state. The state's aerospace and software industries have fared relatively well during the recession and are likely to continue to do well once the expansion is under way. Despite continued setbacks to the 787 program, Boeing remains strong and has an extensive backlog of orders. Microsoft is also healthy with a strong balance sheet and growth opportunities. Although recent job cuts at Microsoft have made headlines, the overall number is very small and new hiring at the company has offset much of the loss.

Further employment reductions are expected in construction, aerospace, software and government

The construction sector remains the weakest industry in Washington. We expect construction employment to decline by about 55,100 (26.2%) from its peak in the fourth quarter of 2007 through the third quarter of 2010. The aerospace employment forecast reflects Boeing's announcement that production of the 777 will be cut from seven per month to five in mid-2010. The forecast projects a total reduction of 5,200 (6.1%) aerospace jobs from the peak in the third quarter of 2008 to the end of 2011. In contrast, manufacturing other than aerospace is expected to lose 30,600 jobs (14.3%) from peak to trough. Software employment is expected to decline by 1,400 (2.7%) from the peak in the first quarter of 2009 to the trough in the fourth quarter of 2009, turning positive again in 2010 and 2011. The net reduction in software employment is less than the initial 2,400 layoff assumption due to hiring in other areas. We also expect a decline of 10,400 (2.2%) state and local government jobs from the peak in the fourth quarter of 2008 through the first quarter of 2010.

Positive employment growth will resume in 2010

The forecast calls for Washington average annual non-farm payroll employment to fall 3.5% this year. Average annual employment is expected to grow 0.3% and 2.2% in 2010 and 2011, respectively, as the state economy recovers from the recession. Washington personal income is expected to decline 0.6% in 2009 before returning to positive growth rates of 4.0% and 5.2%, respectively, in 2010 and 2011. We believe the number of housing units authorized by building permit will fall this year to a cyclical low of 15,200 units before recovering to 22,000 in 2010 and 34,200 in 2011. Lower energy prices in 2009 should hold headline inflation in Seattle to just 0.8%. The forecast expects Seattle CPI inflation rates of 1.7% in 2010 and 2.1% in 2011.

Revenue Forecast

The economic recovery is tracking the June forecast but revenues are lagging

The economic recovery forecasted in June is proceeding largely as expected with only minor revisions for September. Revenues are also recovering, but at a slower pace than anticipated. The downward revision to estimated first quarter state personal income outlined in Chapter 2 is a likely contributor to the shortfall. This revenue forecast extends the weaker activity to the end of 2009 but is close to the activity projected in June by the end of the biennium.

The General Fund-State forecast for 2009-11 is $29.6 billion, $230.9 million less than expected in June

Actual General Fund-State revenue in the 2007-09 biennium was $27.7 billion, which was $6.8 million less than expected in the June forecast. The September 2009 forecast for the 2009-11 biennium is $29.6 billion, which is $230.9 million less than expected in June. Of the $230.9 million decrease in the forecast for the 2009-11 biennium, $109.6 million is attributable to weaker forecasted spending by consumers. A decrease of $46.1 million is from recognizing potential B&O refunds and lower collections going forward, as a result of the recent State Supreme Court decision in the HomeStreet case regarding B&O taxes on interest earnings. The remaining $75.2 million forecast reduction was due to actual collection experience during the first two months of this biennium.

FY 2009-11 revenue will be lower than in FY 2007-09

While Washington consumers and businesses are expected to start spending again by the end of the year, the forecasted recovery in state revenues is quite slow. By the end of the forecast period (FY 2011), GF-S revenue is still expected to be below the level of FY 2008. Biennial totals of GF-S revenue were forecasted to contract by 0.7% in the 2009-11 biennium following a meager 0.1% increase in 2007-09.

Chapter 1: U.S. Economy – Current Conditions and Forecast

- **It is almost certain the Great Recession of 2007-09 is over and economic activity has stopped declining. It will be a while before output returns to its previous peak, however, the recovery will be slow. Employment growth will lag the recovery in output, as will the peak in the unemployment rate.**
- **Consumer spending remains weak but it has stopped declining. While households remain tentative about spending, they have shown a willingness to take advantage of deals such as "Cash for Clunkers" and the $8000 first time home buyers credit. Still confidence remains low and households continue to pay down debts and save more.**
- **An unprecedented global recovery is under way. Typically nations that lag the U.S. in coming out of recession are returning to growth at the same time or even earlier.**
- **The housing situation has improved in recent months as well. Home prices appear to have hit bottom and have begun to increase. We expect them to improve slowly. Housing starts have started to climb as well coming off their historic lows.**
- **Initial unemployment claims have peaked, but their rate of decline matches the recoveries in 1991 and 2001, which were slow.**
- **The full impact of the USD 787 billion fiscal stimulus package is yet to be felt. At the end of the third quarter, just USD 63 billion has gone out in tax cuts, and USD 86 billion has been spent.**
- **The risk to the outlook is still significant, but downside risks have diminished and are now balanced with upside risks.**

Current Conditions

The recession is over and the recovery is under way, but risks remain

With the economy reaching a trough early in the third quarter, the recession now appears to be over. This does not mean that economic activity is back to where it was before the recession started, but rather that it has stopped falling and is now in the process of recovering. Employment will take time to pick up again as it typically lags the upturn in activity. Businesses wait to hire until they are sure demand has returned. Consumer spending remains weak households have lost nearly one-fifth of household wealth, and the fear of additional job losses remains. Consumer confidence remains in recessionary territory. The banking sector also remains vulnerable. While large national banks are getting profitable and healthy again, regional banks across the country remain vulnerable to deteriorating asset quality because of their disproportionate exposure to a weakening commercial real estate sector. Despite this, there are plenty of positive signs of the turnaround. Home prices have turned up, housing activity is improving and business investment is starting to stabilize. Perhaps the most promising development has been the synchronized global recovery that is under way. Countries in East Asia and some in Western Europe have come out of the recession earlier than the United States, which should provide a boost to our growth through higher exports. Finally, the full extent of the fiscal stimulus package has yet to be felt. Only 19% has effectively gone out through the end of the third quarter.

GDP is expected to grow in the third quarter

Real gross domestic product (GDP) declined in the second quarter at a seasonally adjusted annualized rate (SAAR) of 0.7%, the fourth straight quarter of decline. This is the first time GDP has posted negative growth in four consecutive quarters since the Bureau of Economic Analysis (BEA) started keeping track of quarterly data in 1947. Despite this, the decline of 0.7% is a marked improvement over downwardly revised 6.4% drop in the first quarter. It is also widely expected to be the last quarter of decline as the economy begins to recover and effects from the fiscal stimulus take hold. According to Macroeconomic Advisers, a St. Louis based economic research firm, real GDP for the third quarter is tracking at 3.3%. Most of this is due to production for inventory restocking, primarily in the automotive sector. The BEA is expected to release its advance estimate of official third quarter real GDP in late October.

Consumer spending is starting to increase

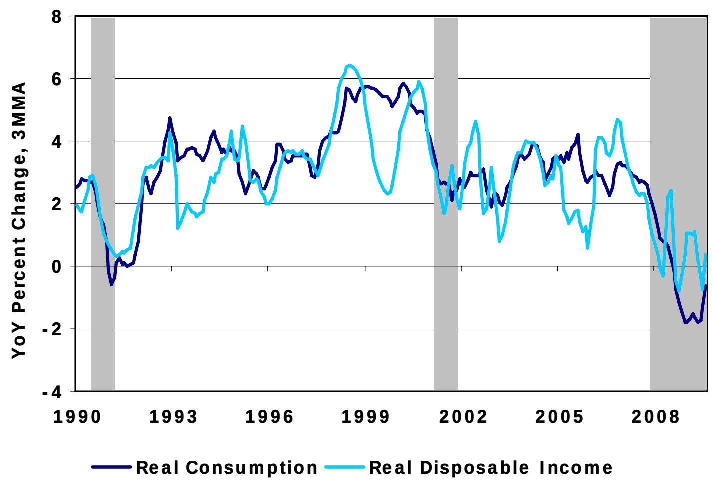
Nominal consumer spending has stabilized and is starting to grow; posting a 0.25% gain in July, followed by a 1.29% increase in August. The most recent increase was boosted by strong sales of light motor vehicles due to the Cash for Clunkers program. Excluding automobiles, consumer spending was still strong with growth of 0.88% in August. Although Real consumer spending, which is spending adjusted for inflation, is down 0.7% since the peak in November 2007, it is now up 0.3% on a year-over-year basis. Real spending has also increased for four straight months, something that has not happened since before the recession began.

Disposable income continues to decline

Continued growth in spending is not guaranteed however. Real disposable income growth has been trending downward (see Figure 1.1). Since its peak in May of last year, real disposable incomes are down 3.7%. Without a moderation in the recent increase in the savings rate, incomes must rise for consumption growth to continue.

Disposable income and consumption and bumping along the bottom

Figure 1.1: Real Consumption and Real Disposable Income



Source: BEA, data through August 2009

Consumer confidence remains weak

Consumer confidence, while off its historic lows, remains weak. The September Conference Board reading shows that people are still pessimistic about their present conditions, but remain hopeful about the future. In fact, the present conditions component hasn't improved since April while the expectations component has increased by almost 50%. Consumers need to start feeling that current conditions are getting better for spending to recover. Our current forecast expects a slow recovery in confidence as the economy recovers.

Regional and local banks remain at risk from commercial real estate

There are lingering worries about the health of the financial sector, although large national banks are returning to profitability and becoming healthy again. Inter-bank lending too has returned to normal and the Ted Spread, which measures the risk premium banks pay to borrow from each other, has returned to pre-crisis levels. However, regional and local banks across the country remain vulnerable due to their disproportionate exposure to the sharp downturn in commercial real estate. The pace of regional bank failures has accelerated, and many more are being added to watch lists. A large number of regional bank failures around the country would lead to a secondary round of credit contraction and further slow the recovery.

A global recovery is under way

While downside risks remain, there are also upside risks in play. A synchronized global recovery is currently underway (see Figure 1.2). This is a result of the over 720 pieces of fiscal and monetary stimuli enacted globally as counted by the ISI group in New York. Countries in East Asia and some in Western Europe have come out of the recession before us. Typically, our trading partners and other countries around the world lag the U.S. in coming out of a recession. The quicker global recovery means exports will kick in earlier in this recovery cycle than in previous recoveries.

Figure 1.2: GDP Growth of Selected Economies

East Asia and parts of Western Europe have returned to growth

		Q/Q, SAAR %	
	GDP share	2009 Q1	2009 Q2
Japan	8.0%	-14.2	3.7
China	6.2%	5.6	16.0
Germany	6.0%	-13.4	1.3
France	4.7%	-5.7	1.2
India	2.0%	7.0	6.5
Korea	1.9%	0.5	9.7
Indonesia	0.8%	3.7	5.3
Taiwan	0.7%	-3.2	9.1
Thailand	0.4%	-7.2	9.6
Hong Kong SAR	0.4%	-14.7	13.8
Malaysia	0.3%	-17.7	13.2
Singapore	0.3%	-12.2	20.7
Philippines	0.3%	-7.1	11.0

Source: IMF, ERFC

Economic activity is picking up in the U.S. as well

Economic activity is showing signs of positive growth in the United States as well. The manufacturing sector has rebounded and is now expanding. The Institute of Supply Management (ISM) Purchasing Manager's Index, which is correlated to strength in manufacturing, indicated growth in August for the first time since January 2008. The August reading of 52.9 was the strongest in over two years. This was followed by a still strong 52.6 in September (see Figure 1.3). The new orders component led the way while inventories declined. This points to continued growth in the sector.

Figure 1.3: Institute of Supply Management Manufacturing Index

Factory output has returned to growth

Source: ISM; data through September 2009

The housing market is improving, albeit slowly

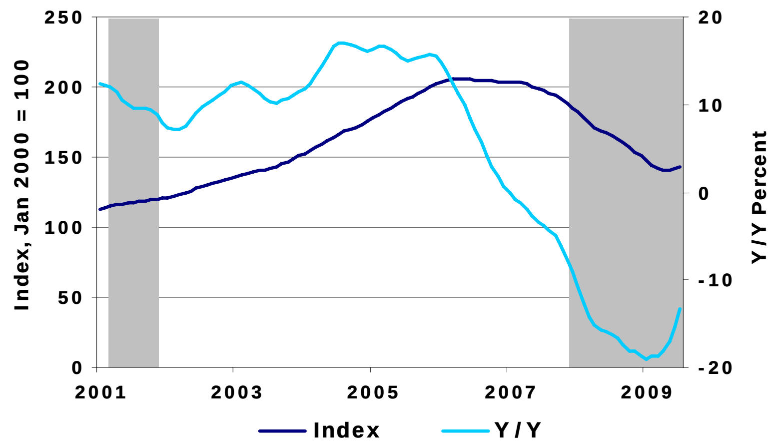
The housing market conditions are beginning to turn around as well. Existing home sales have increased for four consecutive months from April to July, the first time this has happed in five years. In addition, the July increase of 7.2% was the highest monthly percentage increase in total home sales in 23 years. August data show a 2.7% decline from July, but the underlying trend remains upward. The $8,000 tax credit for first time home buyers, historically low interest rates, and improving affordability has helped boost sales. The inventory of existing homes is still above normal, but now at a two year low with an 8.5 month supply at the current sales rate. Housing starts have begun to inch up slowly as well and have averaged about 590,000 starts (annualized) for the past three months. Starts in August were 23% higher than the trough in January but still 30% lower than the year ago levels.

Home prices have are beginning to firm up

Home prices have stopped declining as well (see Figure 1.4). The Case-Shiller 20-city composite home price index increased 0.7% in June and another 1.2% in July, ending a run of 36 straight months of declines. Prices are still down 13% from year ago levels and it will take some time before to get back to the 2006 peak level again. The end of the freefall and some element of stability in home prices bode well both for housing and banking. The so called “toxic assets” on banks’ balance sheets have housing as collateral. Reaching a floor in home prices will allow easier valuation of those assets.

Figure 1.4: Case-Shiller 20-city composite home prices, seasonally adjusted

Home prices are improving



Source: S&P/Case-Shiller, data through July 2009

Initial jobless claims have come down significantly

Initial jobless claims are now well off their peak of 674,000 (SA) reached in March, coming in at 551,000 (SA) for the period ending September 26. While this represents an 18% reduction from the peak it is still significantly higher than the average of 322,000 (SA) claims from 2005-07. It will take some time before the labor market returns to pre-recession levels, but the recent drop in claims is an early indication that activity is moving in the right direction.

The impact of policy stimuli will continue to be felt in the recovery

The impact of fiscal stimulus will continue to be felt as the recovery starts to gain traction. The majority of The American Recovery and Reinvestment Act (ARRA) funds, commonly known as the $787 billion federal fiscal stimulus, have yet to be spent. The Fed will also move very slowly to reduce the size of its balance sheet and tighten the money supply. We don't expect interest rate hikes until late in the next year.

Forecast

Our forecast was made with information available through mid September

Our national economic forecast was made in the second week of September when some of the data referred to in the current conditions section were not available to us. In particular, we did not have the BEA's revisions to second quarter real GDP and its components. Nor did we have any of the August data on housing, personal income, and labor market conditions. Nevertheless, events have unfolded mostly along the lines we had anticipated.

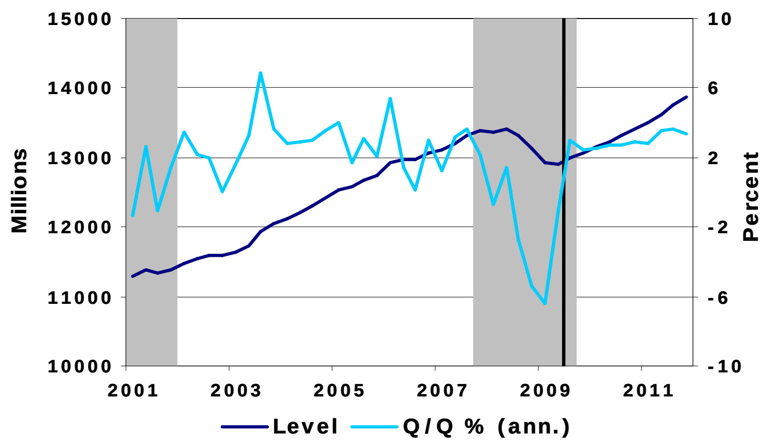
Much of what we said in our June forecast remains true. Our national forecast still projects a recession trough in the third

There have been few surprises since our last forecast

quarter of the current year, followed by a gradual or U-shaped, rather than V-shaped, recovery. Even though it is off its bottom, consumer confidence still remains weak. There is significant idle capacity in the economy both in product and labor markets, and business investment is very weak. We are now seeing signs that a housing correction is under way. The automotive sector has been temporarily boosted by the federal Cash for Clunkers program as many people took advantage of the generous rebates. Large national banks are now returning to profitability although regional and local banks' exposure to commercial real-estate is a growing problem.

Figure 1.5: Real GDP growth forecast

Real GDP is forecasted to turn positive in 2009 Q3



Source: Bureau of Economic Analysis, ERFC

GDP has been stronger than first anticipated

Real GDP is expected to grow by 3.0% (SAAR) in the third quarter of 2009 (see Figure 1.5), much stronger than the 0.6% originally anticipated in June. Growth is then forecasted to moderate slightly and then gradually increase to 3.7% by the third quarter of 2011. The early part of the recovery will be supported by the first round effects of both the fiscal and monetary stimulus to date. The full impact of the stimulus in the pipeline will be felt sometime around the third quarter of 2010. Real Consumer spending will remain positive but weak, reaching 3.9% (SAAR) growth by the third quarter of 2010 but then moderating in 2011 with an average annual growth rate of 2.4%. Business investment will rebound strongly in the current quarter, largely as a result of inventory restocking and peak in the fourth quarter of this year. Export growth will return much sooner than previously expected and is forecasted to grow 8.1% this quarter due to the global recovery that is now under way.

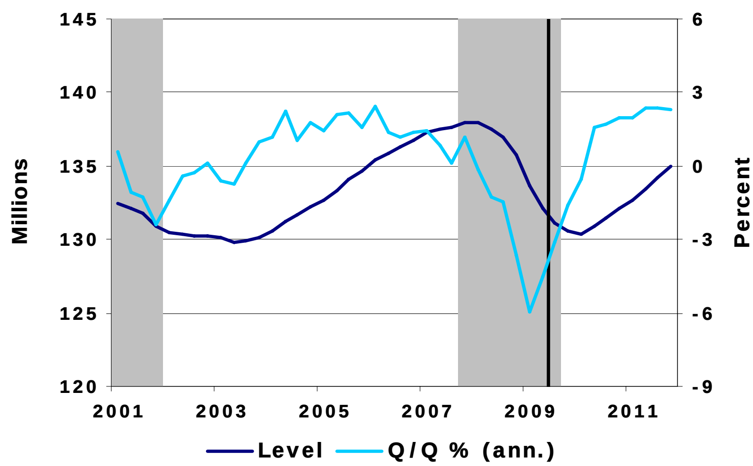
The labor market lags the real economy

Employment growth typically lags the recovery in activity, and it is no different this time around. While the overall economy returns to growth in the current quarter, employers will continue shedding jobs through the first quarter of next year (see Figure

1.6). Businesses will first meet demand by ramping up excess capacity and increasing workers' hours. Only after they are sure the recovery is going to be sustained will they start adding to payrolls. The unemployment rate is expected to peak in the same quarter at just over 10%.

Job losses will continue into the recovery

Figure 1.6: U.S. non-farm payroll employment forecast



Source: Bureau of Labor Statistics, ERFC, actual data through 2009 Q2

Households are paying down debt and saving more

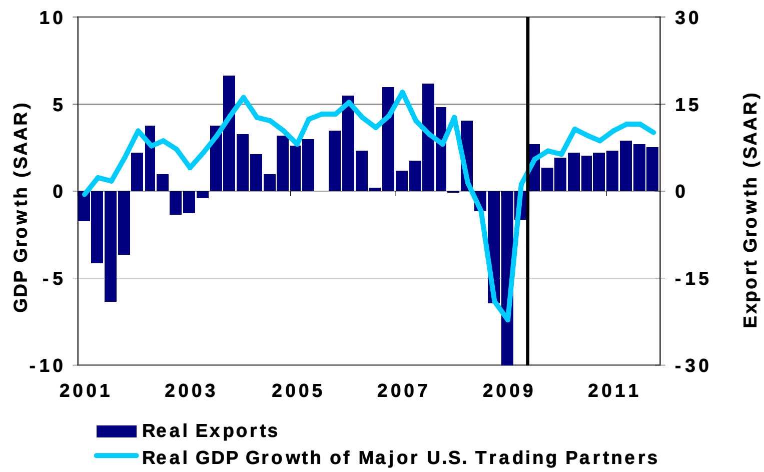
The trend of household de-leveraging is expected to continue. With employment growth lagging in the recovery and net worth only now beginning to turn around, consumers have shied away from spending out of credit. This has also been compounded by the recent tightening of standards recently that is only beginning to ease. Households are paying down their debt, spending much more frugally, and saving more. The rate of saving out of disposable income had declined from about 8% in the early 1990s to under 2% by 2005. Savings remained low through the first quarter of 2008 averaging just 1.8%. In sharp contrast to that the savings rate peaked at 6% in May before coming back down to 4.2% in July. Our forecast expects the savings rate to remain positive over the entire forecast horizon, but moderating to around 2.5% in 2011, as the economic recovery takes hold, and household net worth starts to improve.

The global recovery under way will provide a boost to our national recovery

The concerted global recovery currently under way is forecasted to continue through 2011. Instead of providing a boost late in the recovery, this will help U.S. exports contribute positively to GDP in the near term as well (see Figure 1.7). Whereas the lag in our trading partners' recovery typically weighs down our recovery from recession, this time around it will help us pull out stronger. Real GDP growth of our major trading partners is forecasted to be just over 1.5% (SAAR) by the end of this year and gradually growing to 2.6% (SAAR) by the end of 2011. U.S. exports will get a near term boost growing about 8% (SAAR) in the current quarter before settling down and gradually reaching that level again in the middle of 2011.

As GDP increases around the world, so will our exports

Figure 1.7: U.S. export growth and GDP growth of major U.S. trading partners*



Source: WISER, Global Insight, ERFC, actual data through 2009 Q2

*Major trading partners as defined in the ERFC Composite GDP Index of Major U.S. Trading Partners, which includes a total of 45 countries

Housing has improved but will take some time to fully recover

Despite the bottoming in housing, it will be a while before we see a full recovery, since the sector is coming off such a low base. The recent increase in home prices provided a floor that buyers needed to feel confident enough to make a purchase. Historically low interest rates have also helped, although the effect of this on purchases has been offset somewhat by the tightening of loan standards. The interest rate on conventional 30-year mortgages will stay low throughout the forecast reaching 5.75% by the fourth quarter of 2011.

Excess supply and foreclosures will continue to put a damper on the demand for new housing

There is still a considerable overhang of excess housing supply which will put a limit on new construction. Foreclosures are still a problem and only adding to the number of available houses. Single family housing starts hit bottom in the first quarter of 2009 at an annual rate of just 358,000. Starts for multi-family homes have just now hit bottom and we expect third quarter numbers to come in at just under 10,000 units (annual rate). Single-family starts will continue to improve and reach levels seen in 2000-01 (about 1.25 million annually) by the end of 2011. Multi-family starts meanwhile, will improve but remain weak reaching just 20,000 (annual rate) by the end of the forecast period.

Non-residential construction will recover slowly

The recovery in non-residential construction will be much slower than that in residential. This sector held up after housing construction peaked but plummeted once the recession began.

Non-residential fixed investment in structures dropped an incredible 43% (SAAR) in the first quarter of this year followed by a 15% (SAAR) drop in the second quarter. We expect this contraction to continue through all of 2010 return to growth no sooner than late in 2011.

Forecast by Fiscal Year

FY 10 is now expected to have positive growth

The forecast by fiscal year, presented in Table 1.1, appears worse in 2010 than the forecast by calendar year described above, because the fiscal year starts and ends two quarters earlier than the calendar year, and we are projecting a slow recovery from the current recession. Real GDP is expected to decline by 2.3% (SAAR) in FY 2009, remain mostly flat in 2010 with a 0.3% growth rate, before picking up in 2011 at a 2.8% rate. In contrast, calendar year 2010 is expected to show real GDP growth of 2.4%, followed by 3.1% growth in 2011.

FY 10's weakness continue to come from weakness in construction

Much of the weakness in real GDP in FY 2010 can be explained by a continued contraction in construction, which also contributed to the decline in FY 2009. Real residential fixed investment is expected to decline by another 7.7% after dropping by 23.1% the previous fiscal year. Real non-residential fixed investment, which dropped by 10.7% in FY 2009 is expected to decline by another 9.9% in FY 2010. Real consumption is projected to rebound to a 1.1% growth rate after dropping by 1.2% in FY 2009.

Construction will start improving in FY 11, lead by residential

In FY 2011, real residential fixed investment is expected grow a robust 19.2%, although off very low levels. Real non-residential investment is expected to return to positive territory as well with a 5.5% growth in FY 2011. This too will be off a very low base and will only bring investment back to FY 2005 levels. Real consumption will continue its positive growth in FY 2011 increasing to 2.7%. Housing starts are expected to surpass the 1 million mark again increasing to 1.1 million in FY 2011, up 51.9% from FY 2010.

Risks to the Forecast

Downside Risks (10%)

Downside risks

Downside risks have diminished further since our June forecast, and are now balanced with upside risk.

Double-dip recovery

There is a risk of a double-dip, or "W-shaped" recovery, where economic activity sags in the fourth quarter of 2010. This can happen if by the middle of next year consumer spending and confidence fail to recover as we expect them to.

Banks remain at risk

The biggest risk still remains the health of the nation's banking system – especially regional and local banks, now that the larger national banks appear to be making their way back to health. If the FDIC's efforts at recapitalizing these banks fail, we will see a second round of credit contraction, and slowdown in economic activity.

Inflation might start to become a concern

Fears of deflation have eased. But with the amount of liquidity that has been pumped into the economy, there is always a risk of inflation. However, inflation expectations are "well anchored," which means the risk of inflation is low, even with the injection of liquidity. If expectations become "unanchored" and we get an uptick in inflationary pressures, then the Federal Reserve may be compelled to raise interest rates earlier than planned, further slowing the recovery.

Bad Policy similar to the depression era

Policy errors could also slow down the recovery. One of the mistakes from the depression era was an early withdrawal of stimulus. Economic stimulus takes time to have its full effect. Another problem could result from policy uncertainty that slows down business decision making. To be effective, policy must be clear, swift and sustained.

Upside Risks: (10%)

Upside Risks

Downside risks have diminished, but upside risks remain small. There is a chance that the recovery becomes stronger than forecasted

Strong global recovery

A sharper than expected global rebound could occur. Already our trading partners are recovering sooner than first anticipated which will help our recovery. Increased growth around the world will only add to our growth potential.

Commercial real estate recovers

The downturn in commercial real estate is less severe than expected allowing smaller regional banks to remain healthy.

Confidence returns sooner

Consumer and business confidence returns earlier than expected. It is hard to predict when market psychology changes following a crash, and what triggers that change. Our baseline expects a gradual return of confidence at the same pace as the economy. If confidence returns quicker, the recovery will come quicker.

Inflation remains low

Commodity prices do not strengthen too fast as the recovery gets underway, putting upward pressure on inflation.

Good Policy

Good policy could also spur increased growth.

Table 1.1 Fiscal Years

U.S. Economic Forecast Summary

Forecast 2009 to 2011

	2004	2005	2006	2007	2008	2009	2010	2011
Real National Income Accounts (Billions of Chained 2005 Dollars)								
Real Gross Domestic Product	12,079.9	12,458.9	12,827.6	13,082.6	13,373.6	13,071.1	13,108.5	13,470.1
% Ch	3.7	3.1	3.0	2.0	2.2	-2.3	0.3	2.8
Real Consumption	8,397.8	8,683.0	8,943.9	9,207.2	9,349.9	9,214.7	9,312.0	9,562.0
% Ch	3.5	3.4	3.0	2.9	1.5	-1.4	1.1	2.7
Real Nonresidential Fixed Investment	1,223.4	1,313.3	1,400.6	1,490.1	1,590.1	1,420.0	1,278.9	1,349.7
% Ch	4.9	7.3	6.6	6.4	6.7	-10.7	-9.9	5.5
Real Residential Fixed Investment	703.4	753.9	770.5	649.9	511.0	392.8	362.5	432.1
% Ch	11.5	7.2	2.2	-15.7	-21.4	-23.1	-7.7	19.2
Real Personal Income	10,058.8	10,375.6	10,718.8	11,148.2	11,283.2	11,104.5	11,035.5	11,310.1
% Ch	2.7	3.1	3.3	4.0	1.2	-1.6	-0.6	2.5
Real Per Capita Income ($/Person)	34,405	35,168	35,997	37,079	37,177	36,249	35,672	36,208
% Ch	1.8	2.2	2.4	3.0	0.3	-2.5	-1.6	1.5
Price and Wage Indexes								
U.S. Implicit Price Deflator, PCE (2005=1.0)	0.957	0.984	1.016	1.040	1.074	1.091	1.100	1.118
% Ch	2.2	2.8	3.2	2.4	3.3	1.6	0.8	1.6
U.S. Consumer Price Index (1982-84=1.0)	1.861	1.917	1.990	2.041	2.117	2.146	2.159	2.196
% Ch	2.2	3.0	3.8	2.6	3.7	1.4	0.6	1.7
Employment Cost Index (Dec. 2005=1.0)	0.955	0.980	1.005	1.038	1.072	1.096	1.108	1.123
% Ch	2.9	2.6	2.5	3.3	3.3	2.3	1.0	1.4
Current Dollar National Income (Billions of Dollars)								
Gross Domestic Product	11,512.0	12,247.9	13,047.1	13,714.3	14,347.4	14,303.8	14,481.7	15,075.3
% Ch	6.2	6.4	6.5	5.1	4.6	-0.3	1.2	4.1
Personal Income	9,631.0	10,211.9	10,887.3	11,593.0	12,120.3	12,114.9	12,139.8	12,641.4
% Ch	4.9	6.0	6.6	6.5	4.5	0.0	0.2	4.1
Employment (Millions)								
U.S. Civilian Labor Force	146.8	148.2	150.4	152.4	153.7	154.6	154.4	155.4
Total U.S. Employment	138.3	140.4	143.1	145.5	146.1	142.9	139.2	140.5
Unemployment Rate (%)	5.82	5.32	4.83	4.53	4.95	7.57	9.85	9.56
Nonfarm Payroll Employment	130.47	132.47	135.02	136.97	137.76	134.63	130.72	132.43
% Ch	0.3	1.5	1.9	1.4	0.6	-2.3	-2.9	1.3
Manufacturing	14.33	14.29	14.20	14.03	13.71	12.73	11.63	11.45
% Ch	-3.7	-0.3	-0.6	-1.2	-2.3	-7.2	-8.6	-1.5
Durable Manufacturing	8.88	8.96	8.98	8.91	8.69	7.94	7.12	7.05
% Ch	-3.6	0.9	0.3	-0.8	-2.5	-8.6	-10.4	-1.0
Nondurable Manufacturing	5.45	5.33	5.23	5.12	5.03	4.79	4.51	4.40
% Ch	-3.8	-2.1	-2.0	-2.1	-1.8	-4.7	-5.8	-2.4
Construction	6.84	7.13	7.57	7.69	7.47	6.75	5.86	5.61
% Ch	2.2	4.3	6.1	1.7	-2.9	-9.6	-13.2	-4.2
Service-Producing	108.73	110.45	112.59	114.54	115.83	114.38	112.55	114.69
% Ch	0.7	1.6	1.9	1.7	1.1	-1.3	-1.6	1.9
Miscellaneous Indicators								
Oil-WTI ($ per barrel)	33.8	48.8	64.3	63.4	96.8	70.1	69.5	74.0
Personal Saving/Disposable Income (%)	3.5	2.4	1.8	2.2	1.9	3.7	3.9	2.9
Auto Sales (Millions)	7.6	7.6	7.8	7.7	7.6	5.4	5.8	6.7
% Ch	-4.2	1.0	2.3	-1.3	-1.3	-28.5	6.1	16.9
Housing Starts (Millions)	1.945	2.016	2.036	1.546	1.133	0.648	0.710	1.079
% Ch	12.5	3.7	1.0	-24.1	-26.7	-42.8	9.5	51.9
Federal Budget Surplus (Billions)	-405.9	-325.3	-248.0	-200.2	-438.6	-901.0	-1,231.4	-1,096.4
Net Exports (Billions)	-540.3	-672.5	-770.1	-743.6	-721.0	-516.3	-466.1	-530.8
3-Month Treasury Bill Rate (%)	0.96	2.21	4.06	4.89	2.89	0.56	0.33	1.37
10-Year Treasury Note Yield (%)	4.29	4.23	4.59	4.76	4.14	3.29	3.68	3.92
Bond Index of 20 G.O. Munis. (%)	4.79	4.50	4.45	4.30	4.56	4.97	4.63	4.83
30-Year Fixed Mortgage Rate (%)	5.92	5.78	6.20	6.35	6.18	5.57	5.26	5.44

Table 1.2
Forecast Analysis
Comparison of Forecasts for 2009-11

Forecast Date	2008				2009				2010				2011	
	Feb.	June	Sept.	Nov.	Mar.	June	Sept.	Nov.	Feb.	June	Sept.	Nov.	Mar.	June
U.S.														
Percent Growth, 2009:2-2011:2														
Real GDP	6.3	6.8	6.0	4.6	5.1	5.0	5.7							
Implicit Price Deflator	3.7	3.3	4.1	4.3	3.1	3.9	3.4							
Average Rate, 2009:3 to 2011:2														
3 Month T-Bill Rate	4.07	3.99	3.97	2.05	0.91	0.83	0.85							
Mortgage Rate	6.66	6.75	6.75	5.84	5.17	5.32	5.35							

Table 1.3 Fiscal Years

Forecast Comparison

Forecast 2009 to 2011

	2007	2008	2009	2010	2011
U.S.					
Real GDP					
September Baseline	13082.6	13373.6	13071.1	13108.5	13470.1
% Ch	2.0	2.2	-2.3	0.3	2.8
June Baseline	11379.9	11655.0	11472.6	11412.8	11732.1
% Ch	2.0	2.4	-1.6	-0.5	2.8
Implicit Price Deflator					
September Baseline	1.040	1.074	1.091	1.100	1.118
% Ch	2.4	3.3	1.6	0.8	1.6
June Baseline	1.160	1.197	1.219	1.232	1.257
% Ch	2.4	3.2	1.8	1.1	2.0
U.S. Unemployment Rate					
September Baseline	4.53	4.95	7.57	9.85	9.56
June Baseline	4.53	4.95	7.56	9.91	9.72
Mortgage Rate					
September Baseline	6.35	6.18	5.57	5.26	5.44
June Baseline	6.35	6.18	5.53	5.18	5.46
3 Month T-Bill Rate					
September Baseline	4.89	2.89	0.56	0.33	1.37
June Baseline	4.89	2.89	0.56	0.37	1.29

Chapter 2: Washington Economy – Current Conditions and Forecast

- **The September economic forecast is very similar to the June forecast. As expected, the recession in Washington probably ended in the third quarter of 2009, about the same time as the turning point in the U.S. economy.**
- **The end of the recession does not mean the good times are back, only that the decline in the economy has stopped. A full recovery is a long way off. The recession was the deepest since the Depression and the recovery will be slow.**
- **Recent data are showing signs of an imminent turnaround in the state economy. Employment is still declining, but at a reduced pace. Initial jobless claims appear to have peaked. Housing permits and new vehicle registrations have both turned up.**
- **Job losses, however, will continue through the end of the year and the unemployment rate will continue to rise through mid-2010. This is normal since the labor market recovery lags the recovery in activity.**
- **The modest job cuts expected in aerospace and software will have minimal impact. The biggest cuts have been in construction, non-aerospace manufacturing, trade, and employment services – mainly temporary help.**
- **Though residential construction is nearing bottom, the correction in non-residential construction has a long way to go.**
- **Personal income growth is suffering from the loss of jobs as well as weaker wage growth and declining hours.**
- **Seattle inflation, which had been remaining ahead of national inflation, will be moderate due to the weak economy and lower energy costs.**

Current Conditions

The synchronized global recovery bodes well for Washington

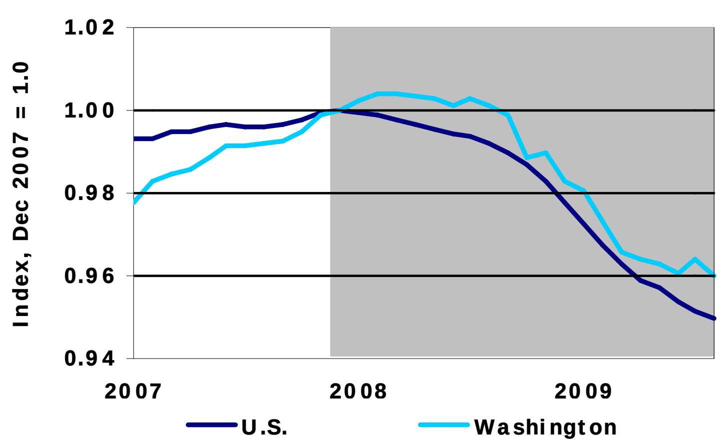
In June we saw the first hints of a turnaround in the state economy. The state's economic performance since then has confirmed that we were on the right track, especially in the critical areas of jobs and housing. It is increasingly clear that we have seen the bottom in housing permits which means we should soon see a pickup in residential construction activity and related employment. Non-residential construction will continue to decline for a couple of years, though. Overall payroll employment is still declining, but the rate of decline slowed in the last five months to a seasonally adjusted annual rate of 1.4% compared to a 6.5% rate of decline during the previous six months. We expect the Washington economy to recover sooner and stronger than the national economy. The synchronized global recovery now underway bodes well for the nation's most trade dependant state. The state's aerospace and software industries have fared relatively well during the recession and are likely to continue to do well once the expansion is under way. Despite continued setbacks to the 787 program, Boeing remains strong and has an extensive backlog of orders. Microsoft is also healthy with a strong balance sheet and growth opportunities. Although recent job cuts at Microsoft have made headlines, the overall number is very small and new hiring at the company has offset much of the loss.

Washington job cuts are subsiding

Washington employment, although still declining, appears to be stabilizing, and stabilizing faster than U.S. payroll employment (see Figure 2.1). Though the state's economy lost 12,400 jobs in August, this followed an increase of 9,400 in July. As noted above, the rate of decline in Washington employment has slowed considerably since March, much more so than in U.S. employment. Washington was late in entering this recession; it now seems likely we will emerge earlier and stronger.

Figure 2.1: U.S. and Washington payroll employment

Washington employment bottoming out sooner than U.S. employment



Source: BLS, WA State ESD, August 2009

The biggest employment decline has been in construction.

Employment in construction has been particularly hard-hit during the current downturn. Losses in this sector have accounted for a third of the total decline in employment since the peak despite making up only six percent of total employment. Many of these jobs are lost for good as we do not expect a return to the levels seen during the housing bubble. While we expect to see job losses through most of next year, the losses appear to be moderating. The past five months averaged a decline of 1,700 jobs which is much better than the 4,100 average job losses during the previous six months. One bright spot in construction is in heavy and civil engineering which is benefiting from stimulus spending on infrastructure. This construction subsector, while small, has grown in each of the last three months.

Manufacturing is also suffering, but don't blame Boeing

Next to construction, the sector most hard-hit during this recession is non-aerospace manufacturing. Aerospace employment has not been a major contributor to the employment decline in this recession. On the contrary, it has been a stabilizing influence. Manufacturing employment is down nearly 11% from its peak in February 2008. Aerospace employment is down only 3.5% while other manufacturing employment is down 13.9%. The biggest percentage drop has been in wood products employment, which fell more than 30% as housing collapsed. Manufacturing employment appears to be stabilizing. In the last five months manufacturing employment declined at an average rate of 1,200 per month which is a significant improvement over the 3,300 per month during the previous six months.

Retail trade employment and professional and business employment have fallen sharply

Among the services-producing industries, two sectors accounted for about 80% of the net job loss during the recession to date: retail trade and professional and business services. The financial crisis and collapse of consumer confidence affected nearly every aspect of retail trade, but especially motor vehicles and the housing related subsectors (furniture and home furnishings stores and building material and garden supply stores). Overall retail trade has shown almost no change in the last few months after dropping precipitously at the end of last year and early this year. Professional and business services employment has also been virtually flat in recent months after very steep declines. Most of the reduction in this sector has been in employment services (mainly temporary help) which firms tend to cut before their own staff.

The unemployment rate is stabilizing

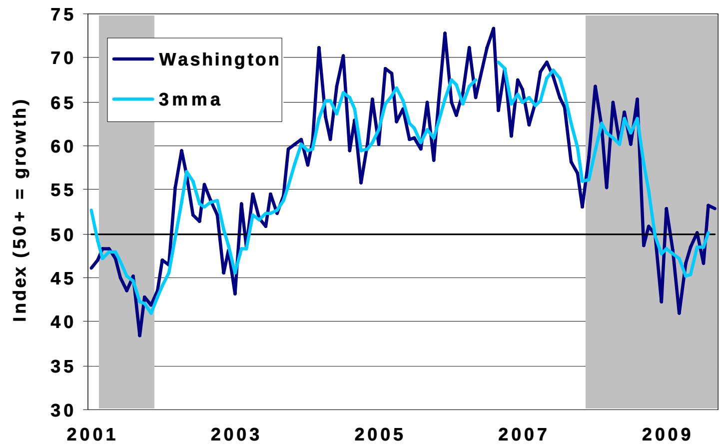
The unemployment rate in Washington edged up in August to 9.2% from a revised 8.9% in July. The unemployment rate has been essentially unchanged since the end of the free-fall stage of the recession in March when it reached 9.1%. While the number of payroll jobs has continued to decline since March, employment in the household survey, which figures into the unemployment rate calculation, has risen slightly since then, nearly matching the increase in the labor force. There are a number of differences between the two measures of employment. One is that employment in the household survey includes the self-employed while payroll employment does not.

Washington's purchasing managers signal growth

In another indication that the state's economy is turning, National Association of Purchasing Managers Western Washington Index moved above 50 in August and September (see figure 2.2). Values above 50 indicate expansion while values below 50 indicate contraction. This is a fairly noisy series, but the three-month moving average is also above 50 in both August and September for the first time since last October.

Figure 2.2: Washington Purchasing Manager's Index

The Purchasing Management Index rises above 50



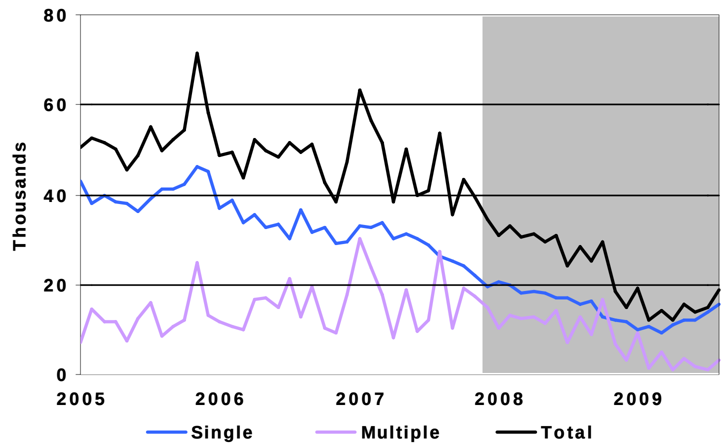
Source: NAPM-WW, September 2009

Housing construction has finally reach a trough

It also appears that Washington housing construction has finally turned the corner. We continue to believe that the second quarter will turn out to be the bottom in the number of housing units authorized by building permits. While multi-family permits continue to bounce along the bottom, single-family permits have increased in four of the last five months and they were essentially unchanged in the other month (see figure 2.3).

Figure 2.3: Washington housing units authorized by building permits, seasonally adjusted annualized rate

Single-family housing permits are improving



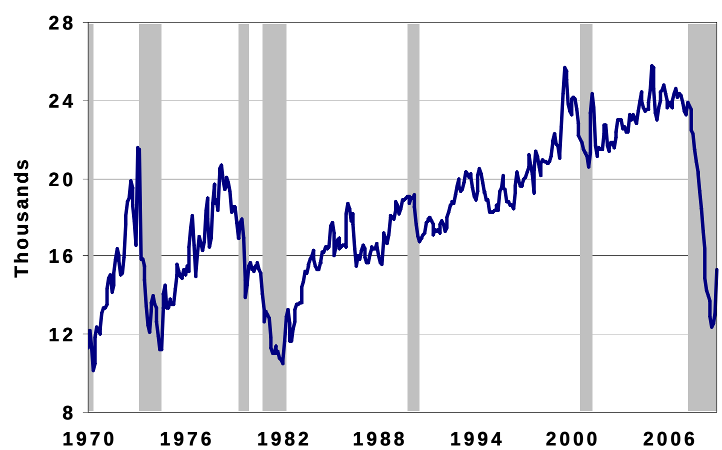
Source: U.S. Census Bureau, August 2009

Car and truck sales have experienced a record decline

The number of new car and truck registrations in Washington has started to rebound as well (see Figure 2.4). Even before the Cash for Clunkers program, it appeared the number of new vehicle registrations had finally stopped falling, reaching a trough of 12,300 registrations in May. Since then, with a boost from the federal program, the number has increased 45% to 18,800 in August. While this growth is impressive, it comes off a historically low base. New vehicle registrations in Washington are still almost 20% lower than the average of the past decade.

Figure 2.4: Washington new car and truck registrations, seasonally adjusted, 3-month moving average

Registrations were increasing even before "Cash for Clunkers"



Source: WA State DOL, August 2009

Job losses are hurting personal income

Weakness in personal income in Washington continues to weigh on the local economy. According to the Bureau of Economic Analysis, personal income in the state declined 1.5% in the first quarter of 2009. We believe, based on data the BEA has yet to incorporate in their estimates, that decline was actually 5.3%. This follows a 5.4% decline in the fourth quarter of last year. Large reductions in employment are the main reason for the personal income declines, but wage rates and non-wage income such as proprietors' income and property income are also declining.

Seattle inflation has slowed

Inflation, as measured by the Seattle Consumer Price Index, remains weak. Consumer prices rose at only a 0.6% seasonally adjusted annual rate from June to August. Core inflation was also low at 0.8%. So far this year (December 2008 to August 2009) core inflation is rising at only a 0.8 % rate and overall inflation only 1.1%. The tame performance of inflation in Seattle is due to shelter costs which have flattened out this year as the housing market collapsed.

Washington State Forecast

Washington will once again outperform the U.S.

We now again expect Washington to outperform the nation in the recovery. Our state's economy is more trade intensive than others, and will be helped relatively more than others as a result of the global economic recovery. Boeing's order book, while full, has been vulnerable to cancellations and deferments. With a recovery in East Asia and Western Europe, the financial condition of a large portion of its customers will start to get repaired. Microsoft's balance sheet remains quite healthy, and from all accounts its launch of Windows 7 in October is expected to be a success.

The revisions to the economic forecast in September are minimal

The September revision to our Washington economic outlook has been minimal, compared to June. The rate at which employment is declining has slowed in recent months, much more so than in the national economy. During the last five months the state has lost jobs at a 1.4% annual rate compared to 6.5% during the six months prior to that. The state's economy will continue to shed jobs through the end of this year - with a peak-to-trough decline of 137,000 jobs. To date we have lost 130,000. Manufacturing and construction job losses will trough later than the overall economy. Manufacturing is expected to lose jobs into early 2010, while construction will lose jobs into late 2010.

Positive employment growth will resume in 2010

On an annual average basis, Washington nonfarm payroll employment grew 0.9% in 2008 despite declines in each of the last three quarters of the year. On a Q4 to Q4 basis employment declined 1.1%. The forecast calls for Washington average annual nonfarm payroll employment to fall 3.5% this year. Average annual employment is expected to grow 0.3% and 2.2% in 2010 and 2011, respectively, as the national economy recovers from the recession. The Q4 over Q4 growth rates forecast for nonfarm payroll employment for 2009, 2010, and 2011 are respectively, -3.0%, 1.6%, and 2.5%.

Personal income will rebound in 2010.

Washington personal income growth fell from 8.1% in 2007 to 3.9% in 2008. Personal income is expected to decline 0.6% in 2009 before returning to positive growth rates of 4.0% and 5.2%, respectively, in 2010 and 2011

Calendar 2009 will be the bottom for housing

After three years in excess of 50,000 per year, the number of housing units authorized by building permit fell to 47,400 in 2007 and 28,900 in 2008. The forecast projects permits will fall again this year to a cyclical low of 15,200 units before recovering to 22,000 in 2010 and 34,200 in 2011.

Seattle inflation will remain moderate

Inflation, as measured by the Seattle CPI, increased to 4.2% in 2008 from 3.9% in 2007. Core inflation (excluding food and energy) declined slightly to 3.4% in 2008 from 3.5% in 2007. Lower energy prices in 2009 should hold headline inflation in Seattle to just 0.8%. The forecast expects Seattle CPI inflation rates of 1.7% in 2010 and 2.1% in 2011.

Washington State Forecast Assumptions

The economic forecast is on track

The state forecast reflects the new national forecast which, for the first time in more than a year, shows no significant change from the previous forecast. The Washington economy has also behaved very much as expected in the June forecast. Washington employment growth during the last several months has been very close to the assumption made in June and housing appears to be turning around as expected. The only significant surprise at the state level is a revision to the level of personal income early this year. The lower income in the first quarter, evident in both the national and state data, is due to a collapse in stock option and bonus income that was missed in the initial estimate.

Further employment reductions are expected in construction, aerospace, software and government

In addition to reflecting the new national forecast, the state construction forecast reflects the positive impact of the stimulus infrastructure spending on Washington construction employment. Even with the stimulus spending, the construction sector remains the weakest industry in Washington. We expect construction employment to decline by about 55,100 (26.2%) from its peak in the fourth quarter of 2007 through the third quarter of 2010. The aerospace employment forecast reflects Boeing’s announcement that production of the 777 will be cut from seven per month to five in mid-2010. The forecast assumes a total reduction of 5,200 (6.1%) aerospace jobs from the peak in the third quarter of 2008 to the end of 2011. In contrast, manufacturing other than aerospace is expected to lose 30,600 jobs (14.3%) from peak to trough. Software employment is expected to decline by 1,400 (2.7%) from the peak in the first quarter of 2009 to the trough in the fourth quarter of 2009, turning positive again in 2010 and 2011. The net reduction in software employment is less than the initial 2,400 layoff assumption due to hiring in other areas. We also expect a decline of 10,400 (2.2%) state and local government jobs from the peak in the fourth quarter of 2008 through the first quarter of 2010.

Washington Payroll Employment

The aerospace reductions are mild by historical standards

Aerospace employment will decline over the next couple of years, but the reductions will be quite moderate compared to other aerospace downturns. In January Boeing announced company-wide employment reductions of 10,000 of which more than half were expected to be in Washington State. Not all the reductions will result from layoffs. Some of the cuts will be through attrition and some will be contract employees. This initial round of cuts is not expected to affect production. In April Boeing said it would reduce monthly production of the 777 to five from seven starting in June 2010. This is in spite a Boeing Commercial Airplanes contractual backlog of more than seven times expected 2009 revenues. Boeing did not indicate the number of job cuts that would result from the 777 production cut. Our forecast calls for a decline of about 5,200 aerospace employees from the third quarter of 2008 through mid-2011. The 5,200 reduction assumed in the forecast does not include an additional reduction of 1,200 contract workers. While these cuts are significant, they pale in comparison to the last aerospace downturn during which Washington lost a total of 52,000 aerospace jobs.

The software layoffs are unusual, but moderate

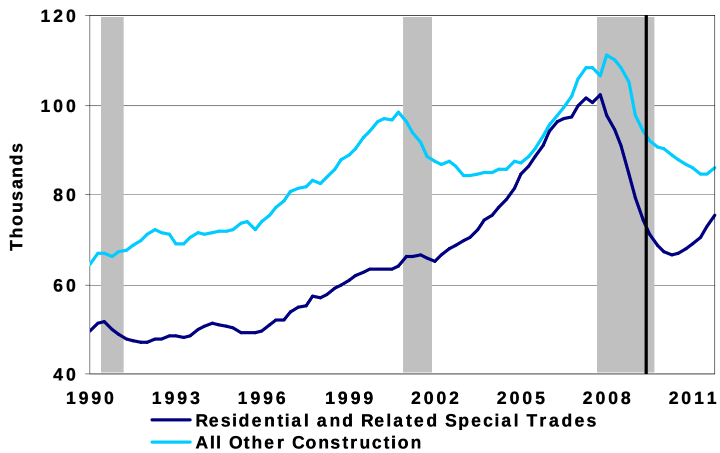
Microsoft also announced layoffs in January amounting to about 5,000 company-wide. This is Microsoft's first mass layoff. During the last recession software employment leveled of but did not decline as continued hiring at Microsoft offset cuts at other software firms. The upcoming Microsoft layoffs will not all be in Washington State and they will continue to hire in some positions so the net loss for Washington software employment will be much less than the 5,000 announcement. The forecast projects a net reduction in Washington software job loss of about 1,400 from the peak in the first quarter of 2009 to the trough in the fourth quarter of 2009. . The net reduction in software employment is less than the initial 2,400 layoff assumption due to hiring in other areas. Positive growth will return in 2010, accelerating during the year. By 2011 we expect a strong recovery in software employment.

Construction will bottom out in the third quarter of 2010

Construction has experienced the most severe employment decline of any industry in Washington during this recession. Figure 2.6 (below) separates total construction employment into two parts: residential is comprised of residential building and related special trades while non-residential is comprised of non-residential building and related trades plus heavy and civil engineering construction. In the 1990-91 recession, residential construction declined but non-residential did not. In the 2001 recession it was the other way around. Non-residential construction declined sharply but residential construction held steady. In this cycle, residential construction employment peaked first but now both are in a steep decline. We expect residential

Figure 2.5: Washington construction employment

Residential construction employment will begin to recover soon, other construction much later



Source: WA State ESD actual data through 2009Q2, ERFC Forecast

construction employment to bottom out in the second quarter of 2010. Non-residential construction employment will continue to decline for another year, bottoming out in the second quarter of 2011. The decline in non-residential construction would have been even more severe without the stimulus funding for infrastructure investment. The forecast expects overall construction employment to decline through the third quarter of 2010, a thirteen-quarter peak-to-trough drop of 55,100 or 26.2%. An initially modest recovery is expected to pick up steam during 2011 as both housing and nonresidential construction eventually revive.

The WAMU purchase and financial-real estate meltdown reduced financial activities employment

Financial activities employment has been in decline since the first quarter of 2006, three years ago. Employment is down 11,300 (7.2%) since then. Unsurprisingly, credit intermediation and related activities, a victim of the meltdown in the financial markets, accounts for most decline, falling by 9,100 (16.1%). Most of Washington Mutual's headquarters staff have been laid off during 2009 as a result of their purchase by JPMorgan. Branch and retail banking staff were not much affected. Financial activities employment is expected to decline through the third quarter of 2010 with a total peak-to-trough decline of 15,200 (9.7%). Healthy growth is expected to resume in 2011.

Retail trade employment is down due to weak demand, but will recover sharply in 2010

Employment in retail trade peaked along with the overall economy in the first quarter of 2008. The decline since then has been precipitous. Initially the weakest retail trade sectors were those most closely connected to the housing market: furniture and home furnishings, and building materials and garden supplies. These turned down nearly two years ago as housing went into decline. The freezing-up of credit and collapse of consumer confidence since last fall have affected the entire spectrum of consumer spending. The largest declines are in motor vehicle dealers, furniture and home furnishings stores, and building materials and garden supplies. We think the third quarter of this year will prove to be the bottom for retail trade employment. The forecast expects a peak to trough decline of 18,300 jobs overall, about 5.5%. The rebound should also be strong as pent-up demand is released. The forecast assumes a 2.6% jump in retail trade employment during the first year of the recovery.

The professional and business services sector is strongly pro-cyclical

The large declines in the last two years will reverse in 2010 and 2011

Professional and business services had been one of Washington’s strongest sectors in recent years but during the recession it has also experienced the largest percentage employment decline of any of the services-producing sectors. Employment in professional and business services peaked in the second quarter of 2008 and fell 23,700 (6.7%) since then. More than half the overall decline was in employment services (largely temporary help) which shed 13,500 jobs (27.1%). Employers prefer to cut temporary help before their own staff. In fact, employment services peaked in early 2007. The forecast expects employment in professional and business services to continue to decline through the third quarter of 2009. The peak to trough decline is expected to reach 23,900 (6.8%). Strong growth is expected to resume in this highly pro-cyclical industry once the recovery takes hold in 2010 and 2011. Professional and business services will also benefit greatly from the recently enacted stimulus. The additional $2 billion going to the Hanford cleanup effort will mostly affect employment in waste management and remediation services, a component of professional and business services.

Tight budgets are forcing cutbacks in state and local government employment

State and local government employment tends to be more stable than other sectors of the economy. It also tends to lag other sectors through the business cycle. Employment grew throughout the last recession but the protracted slowdown in the state’s economy continued to put pressure on state and local governments’ budgets long after the recession ended. State and local government is one of the two sectors (the other being construction) that stands to benefit disproportionately from the federal stimulus package. Nevertheless, we expect a decline of

10,400 (2.2%) state and local government jobs from the peak in the fourth quarter of 2008 through the trough in the first quarter of 2010. Without the stimulus payments, state and local governments would have had to make far more severe cuts in jobs. As was the case in the last recession, the downward pressure on state and local budgets will persist long after the recession is officially over. We do not expect any significant rebound in state and local government employment until late in 2011.

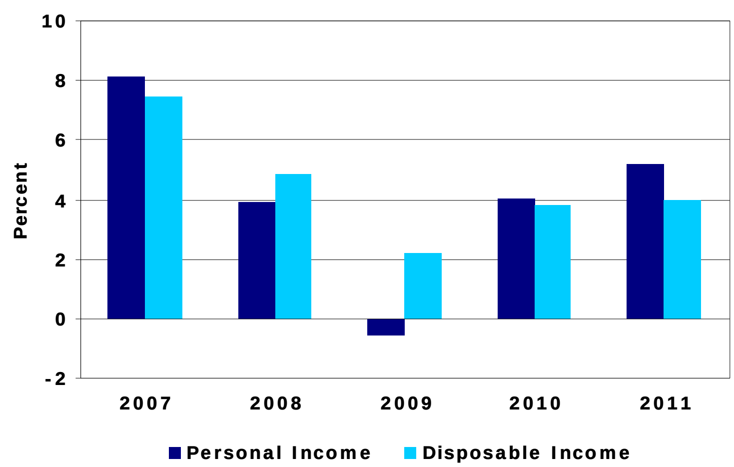
Washington Personal Income

Washington personal income is suffering from job losses, slow wage growth, and declines in other non-wage sources of income, but recover in 2010

The one significant negative surprise since our last forecast in June was the discovery that wages were much weaker in the first quarter of this year than the initial data had indicated. This was probably due to a collapse in stock option and bonus income which would not have been picked up in the initial survey but would have been included in the more complete data that are now available. Washington's personal income growth is likely to be negative in calendar year 2009 for the first time since 1949. The tax cuts and increased transfer payments in the stimulus package will keep disposable personal income growth slightly positive in 2009, however (see figure 2.6).

Disposable personal income growth will remain positive in 2009 thanks to tax cuts

Figure 2.6: Washington personal income growth



Source: BEA actual data through 2007, ERFC Forecast

Personal income growth should recover in 2010 and 2011

The severe decline in employment is the main reason for weak income growth this year, but growth in average annual wages will also be weak. Not only is the depressed economy putting downward pressure on hourly wage growth, but average hours are also declining, further reducing average wage growth. Non-wage income growth is also very weak. Proprietor's income is declining even faster than wage and salary disbursements in 2009 as is property income (dividends, interest, and rent). Partially offsetting these negative factors are transfer payments, which are rising rapidly. Transfer payments automatically increase in recessions as unemployment compensation rises. Transfers are being further boosted in this downturn by the stimulus package which is supplementing unemployment compensation as well as other transfer payments such as increased food stamp benefits and additional payments to social security recipients. This year should be the low point for Washington personal income growth. As the economy begins to recover in 2010 and picks up steam in 2011, most components of personal income will also revive, the main exception being unemployment compensation which should come down as job growth picks up.

WA personal income growth will outperform the national average

Going forward, we expect Washington personal income growth to continue to outperform the national average. The reasons for optimism include the resurgent economies around the world, particularly in Asia, as well as the relative stability in our high wage industries, aerospace and software. As a result of these strengths, we have increased our Washington personal income growth forecast over the next four quarters from 2.6% to 3.8%.

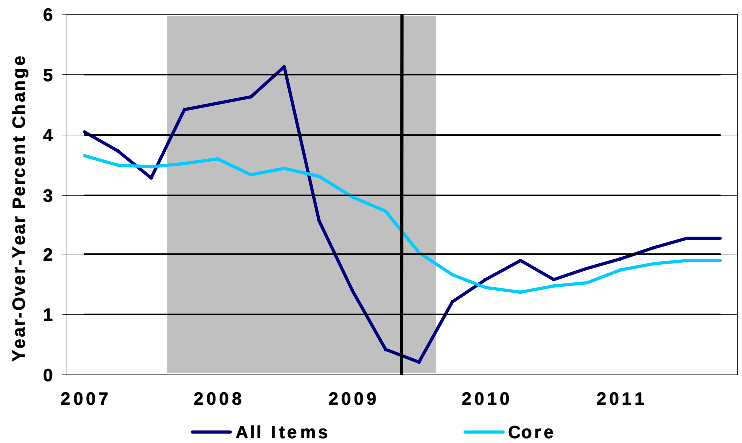
Seattle Consumer Price Index

Shelter costs have flattened out, reducing inflation

Local consumer prices tend to rise faster than the national average when the local economy is relatively strong. They rise slower than the national average when the local economy is relatively weak. After trailing the U.S. in 2003, 2004, and 2005, Seattle inflation moved ahead of the national average in 2006, 2007, and 2008 as the local economy outpaced the U.S. economy. The stronger inflation in Seattle compared to the U.S. city average during the last few years was mostly due to shelter costs, in particular, rent and owners' equivalent rent. These components weakened considerably in the first six months of 2009. As a result, core inflation (excluding food and energy) in Seattle averaged only 0.8% (annual rate) during the first six months of 2009 compared to 3.6% for all twelve months of 2008. High vacancy rates should continue to put downward pressure on rents which will help keep inflation in check. On an annual average basis, energy costs should also be significantly lower this year than last year, putting additional downward pressure on headline inflation this year. As the economy begins to recover and energy prices stabilize, inflation will remain moderate in Seattle as well as elsewhere in the U.S. given the considerable slack that will persist in the economy for some time (see figure 2.7).

Figure 2.7: Seattle CPI inflation

The weak economy and lower energy costs are holding inflation down.



Source: BLS actual data through 2009Q2, ERFC Forecast

Washington Building Permits

Housing construction has nowhere to go but up

The number of housing units authorized by building permits fell an astounding 77% from 60,800 (SAAR) at the peak in the fourth quarter of 2005 to 13,900 in the second quarter of 2009. Only once, in the first quarter of 1982, were permits lower. On a per capita basis, the second quarter of 2009 was easily the worst on record. Initially the weakness in housing was confined to the single-family market. Multi-family permits held up well through most of 2008, buoyed by strong net in-migration into Washington. Multi-family permits plummeted after the credit markets seized up in September 2008. While the initial plunge in multi-family permits was likely caused by the inability to finance these projects, the timing was fortuitous as the deepening of the recession late last year and early this year caused a spike in vacancies. We believe that the second quarter of 2009 will turn out to be the bottom for housing permits (see figure). But the recovery in housing will continue to be hampered by oversupply, poor consumer confidence, and difficulty arranging financing.

Forecast by Fiscal Year

Personal income growth will remain weak through FY

Nominal personal income growth slowed to just 0.9% in FY 2009 from 6.8% in FY 2008 and 8.0% in FY 2007. The slow down in growth is mostly due to declining employment but average wage growth has also slowed as had income from non-wage sources such as dividends, interest and rent. The forecast expects another very weak year in FY 2010 with income growth of only

1.5%. Nominal person income growth is expected to bounce back to 4.8% in FY 2011 as the economy recovers.

No positive annual average job growth is expected until FY 2011

Washington non-farm payroll employment fell 1.8% on an annual average basis in FY 2009, following four years of growth in excess of 2%. The sharpest declines were in construction which fell 11.5% and manufacturing which fell 5.5% but services-producing industries were also down 0.5% in FY 2009. We expect another 2.1% decline in FY 2010 followed by a modest 1.6% rebound in FY 2011. On an end-of-period basis (second quarter of 2008 to second quarter of 2009) employment fell 4.0% during FY 2009. Employment is expected to inch up 0.2% this fiscal year on an end of period basis, followed by growth of 2.1% during FY 2011.

Housing permits will turn around in FY 2011

The number of housing units authorized by building permits in Washington plummeted 48.0% in FY 2009 to 19,700 units following declines of 6.1% in FY 2007 and 25.0% in FY 2008. Permits in FY 2009 were off more than 63% since the cyclical peak in FY 2006. Single-family permits fell 43.8% in FY 2009 to 13,000 units and multi-family units fell 54.5% to 6,700 units which was the lowest multi-family count in at least 40 years (our data begin in FY 1969). Rising vacancies and financing difficulties will further depress multi-family permits in FY 2010 to a new record low of 2,100 units. However we think we have seen the bottom in single-family construction and expect a modest improvement in FY 2010, picking up steam in FY 2011. The forecast for total housing units authorized by building permits is for a 10.1% decline in FY 2010 to 17,700 units followed by a 56.1% increase in FY 2011 to 27,600 units. While the FY 2011 increase seems large, it is only because it is following a very low base in FY 2010. Housing construction will remain below the underlying demographic demand for new housing throughout the forecast.

Seattle inflation rate will be moderate

Inflation in the Seattle metropolitan area, as measured by the consumer price index for all urban consumers, fell to 2.4% in FY 2009 from 4.2% in FY 2008. Energy costs, which fell 9.6% in FY 2009 after soaring 11.3% in FY 2008, accounted for most of the improvement in headline inflation but core (excluding food and energy) inflation also improved from 3.5% in FY 2008 to 3.1% in FY 2009. A further decline in energy costs in FY 2010 and a generally weak economy should produce even more moderate inflation in the future. The forecast expects the Seattle CPI to grow 1.2% in FY 2010, and 1.8% in FY 2011.

Table 2.1 provides a fiscal year summary of the state economic indicators.

Alternative Scenarios

In accordance with state law, the Washington State Economic and Revenue Forecast Council also adopted an optimistic forecast and a pessimistic forecast in September 2009. In addition to the official optimistic and pessimistic forecasts, the staff has prepared a forecast based on the opinions of the Governor's Council of Economic Advisors (GCEA).

The optimistic scenario projects a strong "V" shaped national recovery.

Optimistic (10% probability). In the optimistic scenario, the rapid response of the Federal Reserve to the crisis in financial markets, coupled with the Treasury's "rescue" plan, Congress' stimulus package, and help from central banks abroad work, and limit the downside. There is no additional economic stimulus above the level in the baseline, but the primary difference is that the wheels of stimulus start to achieve traction more quickly. In addition, the standard optimistic scenario assumption of stronger total factor productivity growth is also in place. This allows lower inflation and stronger income growth over the long term—but in the short term, a stronger economy means that inflation is higher in the optimistic scenario than in the baseline (particularly in commodities). The stronger sales pace in the optimistic scenario requires less of an inventory reduction than in the baseline, with demand recovery trimming inventories back to desirable levels. With credit again flowing late this year, business fixed investment rebounds 7.2% in 2010, after suffering a severe 16.6% contraction in 2009. The downturn in residential investment is also less severe in the optimistic scenario, with housing starts making a sharper recovery during the second half of 2009 and rising above 1.0 million units in 2010. The optimistic scenario also assumes faster growth in the rest of the world than does the baseline. These assumptions produce more of a "V" shaped recovery rather than the more gradual "U" shape assumed in the baseline forecast. After falling 1.0% in the second quarter, real GDP undergoes a sharp turnaround, climbing 5.0% in both the third and fourth quarters of 2009.

This scenario also assumes higher growth in key Washington industries

In addition to reflecting the impact of the stronger U.S. forecast on the state economy, the optimistic Washington forecast assumes aerospace employment begins to grow again, rather than continue to decline slightly as in the baseline. Software employment also turns around sooner and grows faster than in the baseline forecast. After a weak first half of 2009, Washington's wages grow faster than in the baseline and the strong regional economy raises Seattle CPI inflation above the baseline forecast in the optimistic scenario in spite of stronger productivity growth. The initial level of Washington personal income is higher in the optimistic scenario and population growth is stronger. Finally, construction employment bottoms out in the fourth quarter of 2009, three quarters sooner than the trough in the baseline forecast, and the subsequent recovery is much stronger. By the end of the 2009-11 biennium, Washington nonagricultural employment is higher by 114,300 jobs than in the baseline forecast and Washington personal income is $17.2 billion higher.

The pessimistic scenario envisions a" W" shaped recovery with a relapse in 2010.

Pessimistic (10% probability). The pessimistic scenario is more than a recession, but not quite a depression. The simulation assumes that the financial crisis worsens, prolonging the economy's deepest and longest downturn since the Great Depression. The recession is W-shaped and lasts 11 quarters. Credit markets remain clogged, both domestically and across the world. Without access to credit, domestic spending contracts and the housing market falls into an even deeper hole. The pessimistic scenario assumes that the downward spiral in financial markets continues into 2010. The risk premia paid by banks, known as the TED spread, widens again to more than 100 basis points. The spread between 30-year fixed mortgage rates and the 10-year Treasury note yield also remains wider than normal through 2010. Oil prices are lower over the short run in this scenario because world demand is falling. As a result, bottom-line inflation is lower. Core inflation is also lower because demand is so weak. In this scenario, the housing recession drags on. Housing starts begin to turn around from record-low levels—just as in the baseline—but the rebound is sluggish. The weakness in housing undermines consumer confidence. This, along with the drop in wealth associated with falling home prices and a slowdown in job growth, causes consumers to retrench sharply. Capital spending is also weaker, as firms respond to a bleaker outlook by scuttling long-term projects. Foreign economic growth is lower, which cuts into export growth. After a brief recovery in the second half of 2009, real GDP drops over the first three quarters of 2010. Employment drops for 11 straight quarters with the U.S. economy losing 8.2-million jobs.

The pessimistic scenario also assumes lower growth in key Washington industries

At the state level, the decline in aerospace employment is much more severe than in the baseline and continues throughout 2011. The decline in software employment is also more severe than in the baseline forecast and there is no strong recovery in the second half of 2010 and 2011 as in the baseline forecast. In this scenario data revisions show that the initial level of Washington personal income is lower than was assumed in the baseline. Population growth is also slower in this scenario. Construction employment continues to fall rapidly through mid 2011 rather than flattening out in mid 2010. Seattle inflation is lower than in the baseline forecast and the weak economy also depresses Washington wage growth below the rate of growth in the baseline forecast. By the end of the 2009-11 biennium, Washington non-agricultural employment is 108,700 lower than in the baseline forecast and Washington personal income is $21.3 billion lower.

Governor's Council of Economic Advisors (GCEA). In the GCEA scenario, the U.S. and state forecasts were adjusted to match the average view of the Council members.

The GCEA scenario expects less real GDP growth but more inflation

At the national level, the Governor's Council members expect slightly less real GDP growth in both FY (fiscal year) 2010 and FY 2011. Despite the expectation of weaker real growth, the Council members expect somewhat higher inflation in both years. The higher inflation is, at least in part, explained by their assumption of higher oil prices. The Council members' mortgage interest rate forecast is also slightly higher than the baseline forecast.

For Washington, the GCEA expects weaker near-term personal income

The GCEA scenario for Washington is quite similar to the baseline forecast. Their overall employment forecast is virtually identical to the baseline forecast in both FY 2010 and FY 2011. Their housing permit forecast is also virtually identical to ours in FY 2010 but slightly lower in FY 2011. The main difference between our forecast and the average view of the Council members is the near-term real personal income forecast. The Council members expect a decline of 0.5% in FY 2010 compared to our 0.7% increase. This is partially due to their higher inflation outlook. The difference between their nominal income forecast and ours is narrower, 0.6% compared to 1.5%. The GCEA also expects somewhat stronger income growth, both real and nominal, in FY 2011 than is projected in our baseline forecast which partially offsets the lower growth in FY 2010. Still, the average level of nominal personal income in the GCEA scenario is 0.7% lower than in the baseline forecast which is the main reason their assumptions produce a lower revenue forecast. At the end of the 2009-11 biennium Washington non-agricultural employment is 1,900 higher in the GCEA forecast than in the baseline forecast but Washington personal income is $1.2 billion lower.

Table 2.2 compares the alternative forecasts with the baseline forecast.