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The Bay Area Economy

The Meltdown isn't Over

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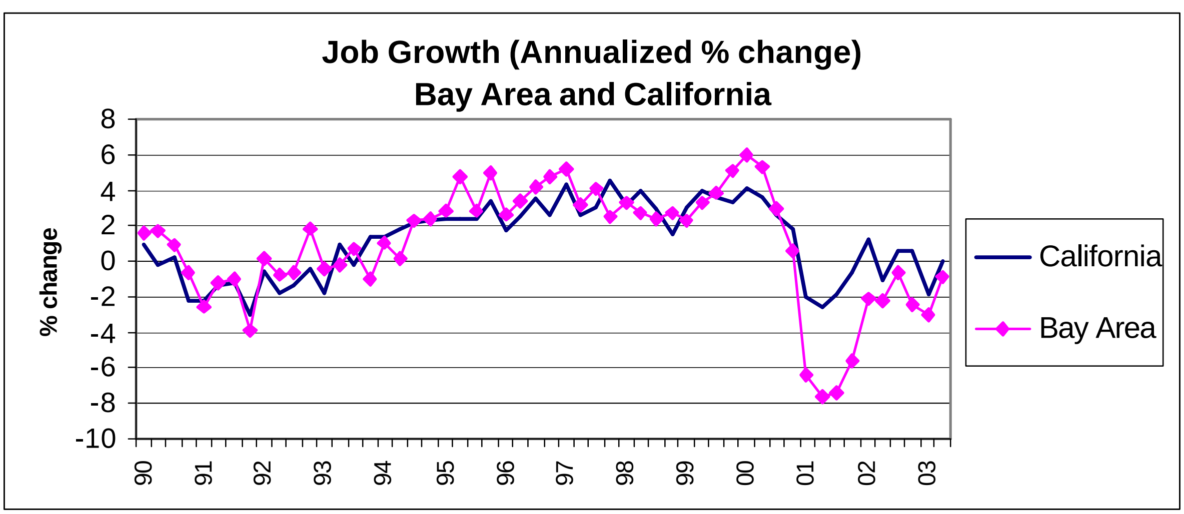
The recession that started in 2001 has been called "the dot com meltdown" due to the plunge in high-tech stocks, the disappearance of so many startups, and the large job losses in associated industries. The Bay Area[1], home to Silicon Valley, has really felt that "meltdown". Within the Bay Area, the nearer one is to the "Valley," the worse the damage and Santa Clara County, (including San Jose) has really suffered. The Valley's northern neighbors such as San Francisco have been hit almost as bad. Across the Bay, Oakland has experienced a moderate downturn, and the northern part of the Bay Area has seen a slowdown, not a real downturn. Activities that need strong business and employment growth to hold up well, such as commercial real estate, have turned down and will have to wait to rebound. Housing, which hasn't yet fallen, will adjust. There are some other boosts coming, but overall, it will be years, not months, before the Bay Area's economy regains its luster.

Looking Back

The contrast between the Bay Area's experience in the 2001 recession and the 1990-1993 recession is remarkable. In the long and deep recession of the early 1990s, the Bay Area's payroll employment

Chart 1



fell 1.9%, while California as a whole saw a 3.6% job drop. As can be seen in the quarterly growth pattern of the chart, the Bay Area's payroll jobs performed better than the state's in all years except 1994 and 1998. Particularly in 1992 and 1993, the Bay Area slowly lost jobs at about a 1% annual rate. Another measure of the hit the economy took was unemployment. That chart shows that the Bay Area's jobless rate jumped from about 3% to nearly 7% from early 1990 to 1993. On the other hand, the state's unemployment rate surged from 5% to nearly 10%. The spread widened a whole percentage point. Overall, this difficult three-year period was nothing at all like the past two and a half years in the Bay Area.

The Big Hit

The Bay Area's economy has been the center of this recession. Revisiting the job growth chart, the collapse in employment is remarkable. Within one year the Bay Area's economy shifted from nearly 6% annualized payroll employment gains, to a nearly 8% rate of shrinkage. In contrast, the state's employment growth rate dropped from plus 4% to a minus 2% over the same period. The region's unemployment rate climbed so rapidly that within four quarters, it roughly equaled the whole state's rate of just over 6%. The Bay Area's jobless rate, and California's rate have been very close since the end of 2001. Translated into numbers, the job losses for the Bay Area were 337,000 from the first quarter of 2001 to the third quarter of 2003. The state as a whole lost 286,000 jobs over the same period. Those figures make it plain as possible that the recession was a Bay Area event.

What Got Hit?

Not surprisingly the big job losses were centered on a few industries, though the effects spread as the economy turned down. As noted in Table 1, the large buildup of the information industry in the 1990s – up 74% in the five years 1996 to 2001 – shifted to a huge 27% crash in just two and a half years.

Chart 2

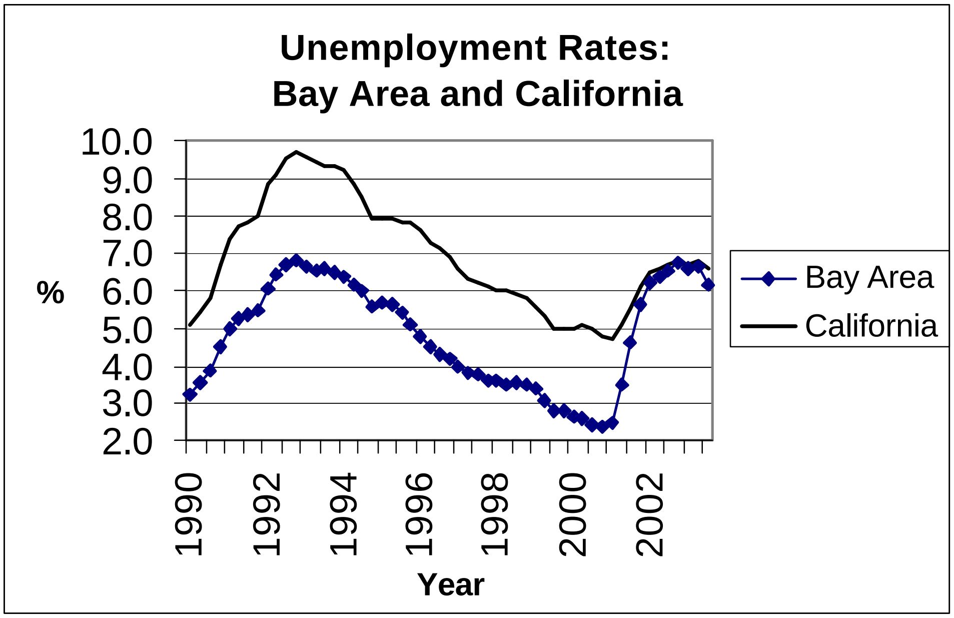


Table 1

The Bay Area				
Bay Area Ups and Downs:	**Key Industry Employment Changes**			
	% ch 96:Q1 to 2001:Q1	Level change (1,000)	**% ch** 2001:Q1 to 2003:Q3	Level change (1,000)
Total Payroll	18.7%	563.6	-9.4%	-336.5
Manufacturing	11.3%	49.7	-23.9%	-117.0
Construction	61.1%	75.5	-9.3%	-18.5
Education and Health	11.6%	35.1	9.9%	33.2
Finance	11.2%	21.3	-1.0%	-2.2
Information	74.0%	68.5	-26.7%	-42.9
Leisure & Hospitality	15.2%	40.6	-2.3%	-7.1
Professional Bus Svs	33.7%	168.4	-21.3%	-142.4
Retail Trade	14.3%	44.2	-4.9%	-17.3
Wholesale Trade	13.8%	17.2	-11.0%	-15.5
Other Service Industries	11.3%	11.6	-0.6%	-0.7
Government	5.8%	25.2	2.3%	10.7

Manufacturing, and much of that is durable goods manufacturing associated with high-tech, saw a decline that was more than twice the size of the pre-recession gain. Those jobs don’t look like they will come back. Professional business services, a large classification that includes the management and those jobs that run and manage businesses of all types, surged in the 90s but fell more than 20% and accounted for more than 40% of the total area job losses. Construction, which of course includes residential and nonresidential, surged in the 1990s, as the office buildings for the dot.coms got built. The drop off since then as been large by other industry standards, but given conditions in the office market, could go down further. It is important to note that some areas have not declined at all. Education and health should be a source for strength in the next few years. The other, the government sector is likely to turn the other way. The biggest part (nearly 90% of all government jobs are at the state and local level), and the strongest part over the past few years has been state and local government. Budget problems at all levels of California will end that job growth and even start some declines.

Who Got Hit?

San Jose was by far the hardest hit in the Bay Area.

Peak to Trough Change in Payroll Employment:

- San Jose (4th Q, 2000 to 3rd Q ‘03) = 190.5 thousand jobs: a -18.1% drop.
- San Francisco (4th Q ‘00 to 3rd Q ’03) = 126.9 thousand jobs: a -11.6% drop.
- Oakland (1st Q ’01 to 3rd Q ’03) = 26.1 thousand jobs gone: a -2.4% change.
- Santa Rosa (1st Q ’01 to 3rd Q ’03) = 6.5 thousand jobs gone: a -3.4% change
- Vacaville/Fairfield (1st Q ’01 to 3rd Q ’03) = up 5.6 thousand: a 3.1% gain.

The difference between San Jose and San Francisco versus the rest of the Bay Area is remarkable, and again reflects the concentration of the dot.com insurgence. San Jose's huge job loss was centered in information services (down 32%), professional business services (down 32%), and durable manufacturing (down 31%). San Francisco's job losses were also tied to information services (down 31%) and professional business service (down 27%). San Francisco also took a sizeable reduction in its Transportation and Public Utilities Sector (-18%). Oakland had double digit losses in only Information services (down 16%) and manufacturing (off 19%). Santa Rosa's biggest losses were in durable manufacturing (-38%). That accounted for all of Santa Rosa's net change. Last, the other North Bay regions, Vacaville/Fairfield, experienced growth over the period.

Tourism

Tourism is another activity that took a beating by the impact of the downturn and the changes in travel inflicted by 9/11. San Francisco's hotels had an occupancy rate of 82% in September 2000, and an average room rate of $170. In September 2003, the occupancy rate was down to 68% and the room charges are $137. Oakland has seen a similar decline, over the same timeframe its room rate dropped from $121 to $100 and the occupancy fell from 82% to 58%. The combination of lower use and lower charges has pulled down revenues sharply.

Another measure of tourism is airline passenger volumes. In the 12 months ending in August of 2003 the three major airports of the Bay Area (San Francisco, San Jose, and Oakland) combined have seen passenger volumes fall 17% from the comparable 12 month interval ending in August 2001. As already seen, the impact has been far worse in the San Jose area which in the same time period shows a 24% drop. San Francisco also had a 24% drop then but that was partly due to a major customer shift. Oakland saw a 15% increase over that period, partly due to its acquiring that former SFO customer. The focus of the tourism downturn is further proved by the fact that Santa Clara County lost 7% of its workforce (leisure and hospitality) that is associated with tourism, and San Francisco saw its tourism related workforce fall 4%. The rest of the Bay Area has seen little change or even increases.

Commercial Real Estate

The timing and depth of this recession has produced some very ominous conditions for the commercial real estate business. The three large urban areas' office markets have seen huge declines in occupancy and rents as is clear from Table 2.

Table 2

	Office Vacancy Rate (%)*		Office Rental Rate ($ per Sq Ft)*	
	2000	2003	2000	2003
Oakland	5.0	19.5	42.0	26.3
San Francisco	3.8	25.0	76.6	29.0
San Jose	2.6	29.6	54.2	28.4

* Data from Cushman & Wakefield RCG

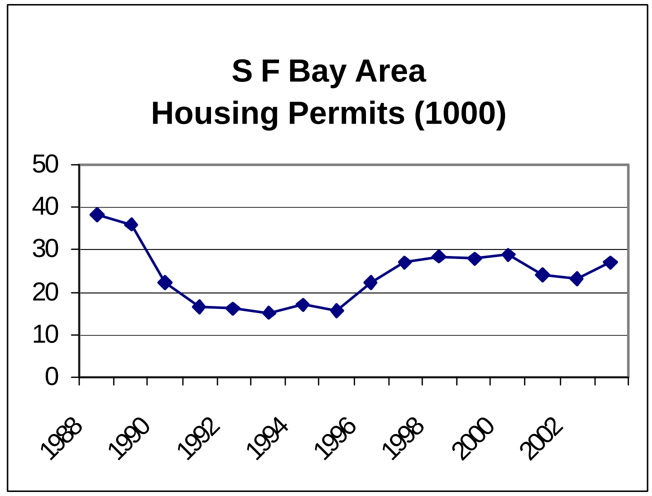
San Jose's central business district's rents have fallen from the $54.2 per square foot level of 2000 to mid-2003 rates of $28.4. Over the same period San Francisco's rental rates have plunged from $76.6 to $29.0. Oakland has seen rates drop from $42 to $26.3 a rise in vacancies from 5% to 19.5%. The huge vacancies in commercial markets insure that new projects won't be funded. Indeed, the long lag times between the market signaling the need for new space and the builder being able to secure funding, the building permit, and then constructing the building means that after the few remaining under-construction projects are completed none of these areas are likely to see any new building for four or five years.

Housing

Given the length and depth of the recession, the strength of the Bay Area's housing market is very remarkable. In Chart 3, it can be seen that the number of housing permits issued in the Bay Area has been between 20,000 and 30,000 since 1996. There is no sharp downturn seen in recent quarters despite the huge drop in employment. The 1990-1993 recession had dropped housing permits sharply, and in Southern California, where the recession was centered, home prices ended up falling about 25% from mid 1991 to late 1996. In the current downturn, the Bay Area's home prices, have continued to rise, through the third quarter, though not at the double digit rates seen in the 1998-2000 period.

The reason for the resilience in Bay Area home prices is that the region has had a housing shortage for years. The shortage can be highlighted by looking at potential household growth, not just population growth. The Bay Area's average household size is about 3 people. The growth in population,when converted to household growth, has grown faster than the housing stock. Unless there is a large excess capacity at the beginning, that trend leads to market

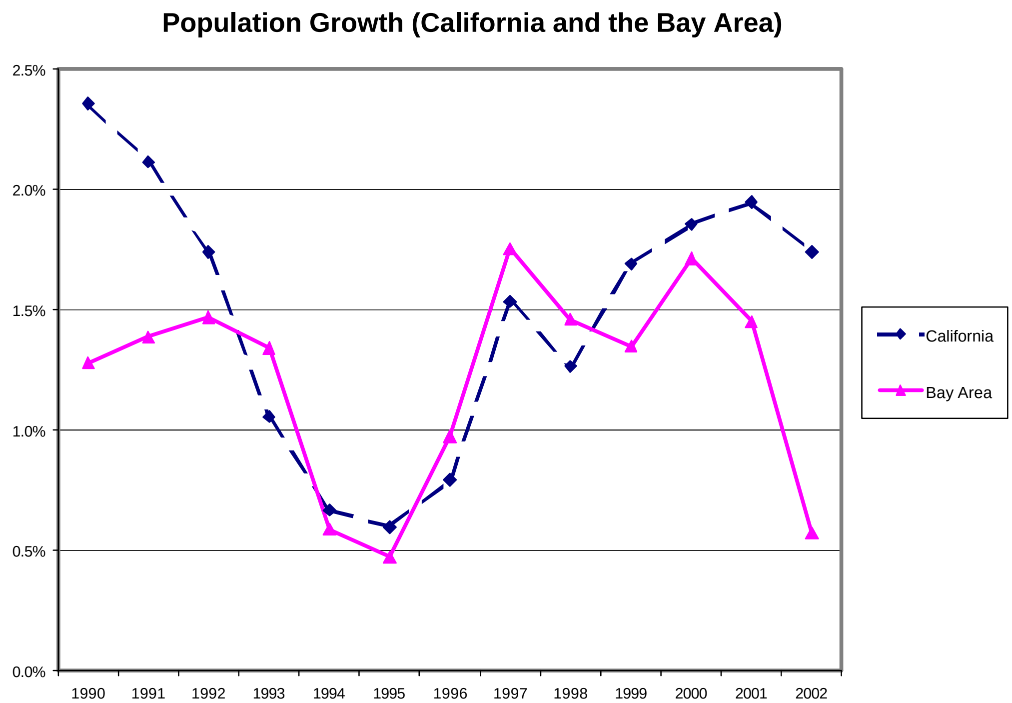
Chart 3



tightness, rising prices, and buyers being forced into long commutes. Those reactions were all widely noted in the late 1990s. Furthermore, as the "stock option wealth" chased other assets in the late 1990s, home prices really zoomed.

However, looking down the road, there are strong forces at work to lower housing prices. The Bay Area's population growth has slowed sharply, due to the recession. San Jose, for instance lost 14 thousand people, from mid-2001 to mid-2002, who fled to other states or regions. San Francisco's MSA lost more than a thousand over the same period. The current labor force data shows a 1.1% drop for the entire Bay Area last year, and a small decline for the first three quarters of this year. The fleeing of the very expensive Bay Area will continue as long as the huge price differential exists and the job markets are tough in the area. It will take at least a year or two for these forces to ebb so one should expect weakening prices in 2004 and into 2005. That trend will be amplified if mortgage rates rise very much, since the

Chart 4



affordability of housing is highly dependent on financing costs, which have been very very low for several years. With the California Association of Realtors data showing that only 20% of families can afford the median-priced homes, in nearly all local markets, rising borrowing costs will further restrict potential buyers.

Outlook

There are a few positive developments that will help the Bay Area's economy come back. The Bay Area has been a center for biotech and medical research for some time. That is clear from the figures in the adjacent Table 3. Back in 1997, the Bay Area's biotech firms were funding 34% of research and development. In dollar terms that was \$1.588 billion. The Bay Area was spending more that any other area in the U.S. In 2003, Bay Area firms still are the biggest of the researchers, spending about \$2.3 billion or 35% of all research dollars. Thus, in a rapidly growing industry, the Bay Area has maintained its very strong position. Moreover, unless there is some completely surprising change, biotech will increase its importance in medical research. The demographics of the modern world, with a rapidly aging population will give a great incentive to treatments or cures for illnesses such as Alzheimer's, and other advanced age problems.

As the dollar declines in value, as it is likely to with many of our trading partners, trade will expand. Oakland port activity should continue to rise. Also, if the dollar does weaken, the tourism industry could be further helped.

Table 3

R&D Spending by Biotech Companies, 1997 and 2003
(by location of company)

	1997		2003	
	$ millions	%	$ millions	%
SF Bay Area	1,588	34%	2,310	35%
San Diego	518	11%	585	9%
New England	803	17%	1,238	18%
LA /Orange	522	11%	853	12%
Other	1,250	27%	1,739	26%

data source -- Ernst and Young.

Overall, the near-term outlook for the Bay Area has some road blocks that will make a rapid recovery unlikely. As noted above, housing and nonresidential construction will be weak, and that weakness could last for several years. As people leave the area, businesses lose customers. The state's budget problems promise to cause job losses in that sector and will spill over into the local government area. The flight of manufacturing to other countries won't be reversible in the near term so these job losses are essentially permanent for now. Given these obstacles to growth, 2004 should be better than 2002 and 2003, but won't look anything at all like the "recovery" years of the mid- and late-1990s.

Endnotes

[1] For the purposes of this report, the "Bay Area" is composed of the nine counties that touch the San Francisco Bay. Those counties are Alameda, Contra Costa, Marin, Napa, San Francisco, San Mateo, Santa Clara, Solano, and Sonoma.

[2] Economic data is published and collected by county and "Metropolitan Statistical Areas" (MSAs). An MSA is named for the most prominent city in a county or sometimes several counties. In the Bay Area, the San Francisco MSA includes San Francisco, San Mateo, and Marin counties. The Oakland MSA includes Alameda and Contra Costa counties. The Vacaville,/Fairfield MSA includes Napa and Solano counties. The Santa Rosa MSA is Sonoma County. The San Jose MSA is Santa Clara County. In this report, unless otherwise noted, when I refer to San Francisco", or to "San Jose" I am referring to MSAs not the actual cities.