

EXECUTIVE SUMMARY

September 2008

Oregon Economic Forecast

The second quarter of 2008 would have been the 20th consecutive quarter of rising employment in the state. This five-year pace was cut short one quarter with a seasonally adjusted job decline of 1.7 percent. Except for the 1.6 percent job growth in the first quarter of 2008, the quarterly job gains have been below 1.0 percent since the second quarter of 2007. On a year-over-year (Y/Y) basis, jobs increased in the second quarter by 0.4 percent.

The same areas which have been pressuring the U.S. economy over the past year are also taking their toll on the Oregon economy. The combined softening impacts of housing, financial, and energy markets are causing widespread slowing in job markets. Employment sectors that lost jobs in the second quarter include construction, manufacturing, retail trade, information, financial activities, and leisure and hospitality.

Although the job losses are spread across many sectors, private education and health services had strong job gains. Three others sectors also added jobs in this second quarter: Nondurable goods, wholesale trade, and government. Professional and business services had a mild addition of jobs.

OEA forecasts a decline of 0.7 percent in total employment in the third quarter and further declines of 0.9 percent in the fourth quarter of 2008. The first quarter of 2009 will still be anemic with growth of 0.4 percent. The Oregon economy does not recover until the latter part of 2009.

The wood products sector is projected to loose jobs at a rate of 7.7 percent in 2008 and 2.1 percent in 2009. As the housing market improves into 2010, wood products jobs should grow 1.8 percent.

The computer and electronic equipment sector will see job declines of 4.7 percent in 2008 and 1.1 percent in 2009. Some improvement is projected for 2010 with job growth of 2.5 percent.

Employment in the transportation equipment industry will decline 7.9 percent in 2008 and 4.1 percent in 2009, before mild growth of 1.3 percent in 2010.

Construction employment is projected to fall by 7.3 percent in 2008 and 2.7 percent in 2009. As the housing market improves in the later part of 2009, employment in this sector should turn positive with growth of 1.5 percent in 2010.

Trade, transportation, and utilities sector is projected to mildly add jobs at a rate of 0.4 percent in 2008, a slight decline of 0.4 percent in 2009, and better growth of 1.8 percent in 2010.

The information sector, which includes traditional publishers such as newspapers and publishers of software, has slowed considerable compared to the plus 3 percent growth of the last two years.

This sector will reduce jobs by 0.9 percent in 2008, add jobs at a rate of 0.5 percent in 2009, and grow 1.6 percent in 2010.

The financial sector continues to be battered by the downturn in the housing market. This sector will lose 1.7 percent of jobs in 2008; lose 0.1 percent in 2009, before recovering 2.3 percent employment in 2010.

Professional and business services will increase jobs by 1.1 percent in 2008, continuing a slowing trend that started in 2007. Job growth will continue to weaken with 0.8 percent growth in 2009 and rebound to 4.6 percent growth in 2010.

Education and health services are surviving the downturn better than any other sector. Job growth will be 4.0 percent in 2008, 3.6 percent in 2009, and 2.2 percent in 2010. Health services are especially strong through these years.

Leisure and hospitality has slowed considerably from the 4.4 percent job growth of 2007. Employment will increase 1.6 percent in 2008. Jobs will slightly decrease in 2009 with positive growth of 1.3 percent in 2010.

The government sector employment will increase by 1.8 in 2008, 0.4 in 2009, and 0.7 in 2010.

Population growth will slow but still be above the U.S. growth rate with rates of 1.3 percent in 2008 and 2009 and 1.4 percent in 2010.

Forecast Risks

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

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

Inflation is rising and now stands at a 17-year high. The Fed continues to warn about a potential flare-up in inflation pressure. The expectation is that the softening economy will ease inflation pressures. However, sharply higher oil and gasoline prices coupled with a sharp rise in food prices will add inflationary pressure. A weaker dollar may contribute to price pressure through a run-up in import prices.

The housing market in Oregon and the U.S. continue to work off excesses accumulated in the past housing boom. Building permits and housing starts are sharply down. In fact, both have declined more than expected. With declining sales, home prices are coming down at the national

level. Oregon house prices have also declined but at a lesser rate compared to other higher population growth states such as California, Florida, Nevada, and Arizona. House prices will continue to soften in most regions. Negative wealth effect from lower house values and less mortgage equity withdrawal will dampen consumer spending. There is a risk that the housing market may deteriorate worse than expected.

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

Record oil prices remain a substantial risk. So far, the world economy has withstood the attack of high oil prices remarkably well. Although oil prices have declined by 20 percent from their recent peak in July, there is no question that high oil prices are a significant threat to the already soft U.S. economy.

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

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

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

- *Contagion of the credit crunch and financial market instability.* The current instability in the financial market is weighing on business confidence, which may lead businesses to change their capital spending plans. The central banks are ready to inject more money to alleviate short-term credit problems, and their measures have been successful so far. At the same time, the Fed has lowered interest rates to stimulate the economy.
- *A further worsening in the housing market.* Low interest rates and easy lending standards have aided a boom in home purchases and mortgage refinancing. With the subprime mortgage problem spreading and tighter lending standards in place, the mortgage market is not as conducive to residential real estate activity as in the past. Troubles at Fannie Mae and Freddie Mac could exasperate the situation. Any drop in house price appreciation coupled with a large drop in mortgage equity withdrawal will slow down consumer spending. The Oregon housing market could be adversely impacted by a major housing correction in California and the rest of the nation. Continued gains in employment and personal income will be needed to keep consumer spending from falling. The federal fiscal stimulus package will temporarily help alleviate the slower consumer spending.

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

forecasted may force the Federal Reserve to raise interest rates more quickly and to higher levels. This action could further slow the U.S. economy and in turn slow the Oregon economy as higher interest rates hurt consumers and businesses.

- *Rising regional energy prices.* More businesses may slow production and lay off workers. A geopolitical incident could dramatically disrupt gasoline and natural gas prices. Regionally, electricity generation is subject to weather patterns and natural gas prices. As demand surpasses the available capacity of hydro generation, electric generation may move towards natural gas-powered turbine engines. Higher electricity prices could result because they are pegged to natural gas prices.
- *Initiatives, referendums, and referrals.* Generally, the ballot box brings a number of unknowns that could have sweeping impacts on the Oregon economy.

Demographic Forecast

Oregon's estimated population on July 1, 2007 reached 3,745,455. That was an increase of 1.5 percent over the 2006 population. The recent growth since 2005 is considerably higher than the 1.1 percent annual average growth rate between 2000 and 2005. Overall, population change since 2000 is much lower than the rate of growth of well over 2.0 percent during the early 1990s. Oregon's population will continue to grow at a moderately high rate in the near future. Based on the current forecast, Oregon's population will reach 4.158 million in the year 2015 with an annual rate of growth of 1.3 percent.

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

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

However, the annual growth rate will continue to taper as the depression era small birth cohort transitions from the younger age group.

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

Revenue Forecast

The forecast for General Fund revenues for the 2007-09 biennium is \$12,897.5 million, a decrease of \$119.2 million from the June 2008 forecast. The relatively small decrease (approximately one percent) is the result of the expectation of the current economic slowdown extending well into 2009, rather than turning around earlier in the year. The projected ending balance for 2007-09 equals \$23.8 million, \$119.2 million below the June 2008 forecast.

Total General Fund revenues will increase 19.9 percent to \$15,467.8 million in 2009-11. Personal income tax growth of 24 percent, which will raise collections to 13,815.8 million, is due in part to the \$1.084 billion kicker rebate distributed in the prior biennium. In addition, the sunset of the Bush tax cuts in 2011 are expected to have a short-run positive impact on personal income taxes, particularly through capital gains realizations. Corporate income taxes will decline 7.2 percent to \$795.2 million, as the economic slowdown in 2008 and 2009 filters through to corporate income tax receipts. All other revenues will reach \$856.8 million, mildly below the prior biennium's level.

General Fund revenues will total \$17,768.0 million in 2011-13, an increase of 14.9 percent from the prior period. For the 2013-15 biennium, General Fund revenues will equal \$20,056.1 million, a 12.9 percent increase from the prior biennium.

Projected lottery earnings will total \$1,341.7 million, an increase of \$2.3 million from the prior forecast. The gain was driven entirely by increased expectations for administrative savings, which offset a slight structural decrease, as well as a downward adjustment related to smoking restrictions which go into effect January 1, 2009. Including the beginning balance and other earnings, total available resources equal \$1,419.9 million. Total projected resources have increased \$27.6 million from the Close of 2007 Session.

Based on existing research, as well as discussions with the LRO and the Lottery, OEA has incorporated a six percent decline in video lottery sales from what would otherwise be forecasted can be expected during the first quarter of 2009, with lesser declines beginning in the second quarter as retailers adjust to the new restrictions. Finally, we expect that video lottery sales will return largely to the historical trend by the second half of 2009 at a level one percent below the

expected level of sales absent the smoking restrictions. This results in a relative decrease in earnings of approximately \$9 million for the 2007-09 biennium, and \$15 million in the 2009-11 biennium.

Lottery earnings are expected to grow 0.1 percent to \$1,342.4 million for the 2009-11 biennium. In addition to the expected impact of the smoking restrictions, the weak growth is the result of an absence of administrative savings for the biennium, compared with \$74.7 million in the current biennium. Video lottery earnings will increase 7 percent, while traditional products will decline slightly. Total available resources will amount to \$1,360.8 million.