

EXECUTIVE SUMMARY

March 2010

Oregon Economic Forecast

The fourth quarter of 2009 posted the seventh consecutive quarter of job losses. Job growth has been relatively sluggish since the second quarter of 2007. The preliminary estimate of fourth quarter job loss in Oregon is negative 3.7 percent at an annualized rate. On a year-over-year (Y/Y) basis, jobs decreased by 4.9 percent in the fourth quarter. This is the first quarterly growth of Y/Y to not further decline since the third quarter of 2006.

Although a majority of the employment sectors declined in the fourth quarter, a few more sectors joined in to show job growth. Food processors, transportation, warehousing and utilities, financial activities, health services, and state government added job. Relatively large job losses occurred in construction, wood products, transportation equipment, nondurable goods (includes paper and allied products), private and local government educational services, and other services.

Except for a small monthly job increase in July 2009 and increases in July 2009, the preliminary seasonally adjusted job numbers for December are the first monthly job increases since November of 2007. Average monthly job losses for the last six months of 2009 were 2,300 compared to the first six months of 2009 with average monthly losses of 9,800. This does not necessarily mean Oregon's job growth has returned, but at least the news is an encouraging sign for the end of the year.

Attention now centers on the economic recovery. Analysts argue as to the path the economy will follow to bring the U.S. economy out the Great Recession. IHS Global Insight does not project a V-shaped recovery, but sees a "jobless" recovery where the labor market is sluggish to add jobs as production of goods and services start to rise. Their view is for a "lazy W" whereby the strong impacts from federal stimulus packages and an inventory cycle lose their strength in the middle of 2010.

The "lazy W" is not the only view and analysts warn that we are not yet out of the woods. IHS Global Insight lists a number of "...reasons to be worried."

Aftershocks from the Financial Crisis. Bad financial news has not ended. Troubles in Dubai and Eurozone countries remind us that financial problems are still popping up. Banking problems may continue to proliferate at small- and medium-sized banks as real estate, both residential and commercial, defaults continue to come to light.

A Double Dip in Housing. The good news on stabilizing housing prices and sales may be more tied to the federal homebuyer incentive than first thought. As this incentive goes away, we may see a return to lower prices and sales.

Higher Oil Prices. Given the slow economic activity throughout the world, it is somewhat surprising to see oil and other commodities still rising. Any supply disruption could stall the economic recovery.

Premature Policy Tightening. With all the stimulus following from fiscal and monetary policy, the fear of inflation may cause a tightening of policy happen sooner than is desirable, chocking off an already weak recovery.

Not all is so cautionary on the horizon. IHS Global Insight also sees "...reasons to be cautiously optimistic."

A V-Shaped Recovery in Other Parts of the World. There are a number of regions, notable Asia, that were not so burdened by the bad debt seen in the U.S. and Europe. Their economies could spring back much faster and provide a boost to U.S. exports.

A Quicker and Stronger Release of Pent-up Demand. Spending on many items are well below historical norms such as for housing sales and starts and car sales. Businesses are internally building up their cash balances. Some signs of releasing pent-up demand were relieved through spending jumps related to the cash-for-clunkers and first-time home buyer programs. This pent-up demand could come forward to reach more normal levels faster than anticipated.

Stronger Growth in Total Factor Productivity. Through the cost cutting period of the recession, businesses also found ways to make the existing work force more productive. Further technology and innovation could boost the bottom line while helping to keep inflation and interest rates low. This backdrop would boost business optimism and keep hiring on a possible faster track.

Oregon faces these same uncertainties as it moves through the early stages of recovery. The forecast has a "jobless" recovery where employment rises slowly starting in the second quarter of 2010, going through a soft growth period into 2011.

Another uncertainty facing the Oregon economy is the impacts from the two tax measures which were passed on January 26. Studies on both sides of the issue from respectable sources derived very different conclusions. Given the uncertain nature of the impact of these two tax measures, we will not incorporate possible impacts into the Oregon economic forecast. We will be monitoring closely to see if any changes are warranted in future forecasts.

OEA (Office of Economic Analysis) forecasts a decline of 0.5 percent in total employment in the first quarter of 2010. The second quarter of 2010 will turn positive with growth of 1.9 percent followed by slower positive growth for the second half of the year. Stronger sustained job growth does not start until 2011.

The year average for 2010 is an employment decline of 1.0 percent. Job growth improves in 2011 with a yearly average growth of 2.0 percent. Job growth is projected to continue in 2012 at 2.8 percent.

The wood products sector is projected to lose jobs in 2010 at an annual rate of 7.0 percent before positive growth of 3.0 percent in 2011 and 5.1 percent in 2012. Even forecasted increases through 2015, employment levels will still be well below job levels in 2008.

The computer and electronic product sector is projected to lose jobs at a rate of 1.2 percent in 2010. Job growth will be positive in the second half of 2010 leading to an annual growth rate of 0.1 percent in 2011 and 1.6 percent in 2012.

The outlook for the transportation equipment sector is further jobs losses of 1.2 percent in 2010. The job outlook improves with gains of 3.2 percent in 2011 and 7.5 percent in 2012.

For the year 2010 compared to 2009, metals and machinery employment will decline 5.7 percent before turning to job gain of 3.5 percent in 2011 and 4.4 percent in 2012.

Other nondurables, which includes paper and allied products, is projected to have job declines of 5.5 percent in 2010 before adding jobs in 2011 at 2.0 percent and at 1.3 percent in 2012.

With non-residential building lagging during the recession, construction jobs are expected to decline by 7.3 percent in 2010, and then slowly grow by 0.5 percent in 2011. Job growth will improve to 4.3 percent in 2012.

Trade, transportation, and utilities sector lost jobs in 2009 at a rate of 6.3. This sector is projected to lose a further 0.5 percent in 2010, and then add jobs at a rate of 1.4 percent in 2011 and 3.1 percent in 2012. Retail employment declined in 2009 at 5.7 percent and will mildly decrease in 2010 at a 0.5 percent rate before rebounding in 2011 with positive 1.4 percent growth and 2.1 percent in 2012. Wholesale trade jobs were down in 2009, and are expected to fall a further 0.2 percent in 2010, followed by 1.0 percent in 2011. Growth of 4.7 percent is projected for 2012.

The information sector, which includes traditional publishers such as newspapers and publishers of software, lost jobs at a rate of 3.1 percent in 2009. This sector is expected to report positive job growth in 2010 at 0.8 percent. Job growth should continue at 2.9 percent in 2011 and 1.3 percent in 2012.

The financial activities sector is expected to lose jobs for the third consecutive year with losses of 2.4 percent in 2010. This sector is projected to add jobs in 2011 at 1.8 percent and in 2012 at 3.4 percent.

Professional and business services lost employment by 7.1 percent in 2009. This sector is expected to be mildly rebound in 2010 with a projected gain of 0.8 percent. Beginning in

2011, the industry will show stronger job growth with 4.8 percent followed by 4.5 percent growth in 2012.

Education and health services are surviving the downturn better than any other sector. Job growth was 2.7 percent in 2009 and is expected to be 1.8 percent in 2010, 3.0 percent in 2011, and 2.8 percent in 2012.

Leisure and hospitality felt the decrease in household discretionary spending with a job loss of 4.7 percent in 2009. The lingering affects of the recession will continue into 2010 with job losses of 1.8 percent. Job growth should pick up with the economy and grow 1.7 percent in 2011 and 2.0 percent in 2012.

The government sector employment increased by 0.5 percent in 2009. Government employment typically lags during recessionary times and is expected to lose jobs at a rate of 0.9 percent in 2010. Job growth will be mild at 0.4 percent in 2011, increasing to 1.4 percent in 2012.

Population growth in the state is forecasted to increase 0.9 percent in 2010, and grow at a slightly faster rate in 2011 at 1.1 percent and 1.2 percent in 2012.

Forecast Risks

Discussions on the US economy have turned to recovery. More economists and financial analysts have turned their attention to how this recovery will play out. IHS Global Insight now (January) views the risks around their baseline forecast to be equally balanced. Basically, the upside risk is that the economy will take off quickly once the recovery begins. The downside risk is that the economy will bounce on the bottom for awhile before growth begins. To these are extremes of “taking off like a rocket” or having a lost decade of no growth once we hit bottom.

As with the US, the risks for the Oregon economy appear to be balanced on the up- and down-side. Job losses in the last few months are at lower rates than during the free fall period of late 2008 and the first half of 2009. Inventory of Oregon homes on the market is starting to fall and prices are not falling as fast. The bulk of Oregon’s share of the stimulus package is being implemented with about half yet to go. Stabilization signs are more numerous with the hope that job growth, though mild, will commence with the second quarter of 2010.

We will continue to monitor and recognize the potential impacts of 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.* Credit markets are easing, but consumers and businesses still have difficulty getting loans. To the extent that credit markets take longer to come back to some sort of state of normalcy, the

current recovery could be slower than projected or thrown off track. Oregon will suffer the consequences along with the rest of the nation.

- *H1N1 flu.* The flu pandemic is still unknown, but worries that it could reignite. The disruption to the economy of Mexico has been severe, but other economies so far have not been greatly impacted. Indications to date are for mild disruption and nothing approaching the devastation of the Spanish Flu of 1918-19. Still, rather than a smaller 5 percent of the workforce impacted, it could go as high as 30 to 40 percent.
- *Prolonged housing market instability.* Signs are starting to emerge that the housing market has hit bottom, at least in terms of housing starts, but prices may have further to fall. Though Oregon has been hit hard through this downturn, Oregon's housing market is relatively better off compared to California, Nevada, Florida, and Arizona. Coupled with the recessionary state of the economy, overbuilding and heightened credit standards will keep demand for housing relatively low. Rather than the correction of the housing bubble further hurting the Oregon housing market, it has been the deepening recession that caused further home price declines and rising foreclosures. Unlike many parts of the economy, there is an upside risk here as well. If the recession is over sooner than forecasted, Oregon's housing market should revive better than the states that experienced the greater housing market bubbles.
- *The relative effectiveness of nearly-global government stimulus.* The level of government response to the current recession has never been greater. Furthermore, the coordination of central bank actions throughout the world was similarly unprecedented. Federal Reserve, US Treasury, and the federal stimulus package may lift this economy out of recession sooner than projected.
- *The return of federal timber payments to Oregon counties.* Included in the federal bailout was a provision to reinstate federal timber payments for four years. Oregon counties will receive \$254 million, down from the previous \$282 million level and will be phased out over the four year window, through 2011. While this temporary reinstatement helps cover short term budgets for Oregon counties, finding or replacing this dwindling revenue source will be imperative as any loss of public services could have adverse impacts on economic activity.
- *The extent of the global downturn.* The U.S. economy has been an important engine of growth for the global economy. The economic woes of the U.S. have been felt throughout the global supply chain and production process. Asian economies, exposed via trade to the U.S., have begun a strong rebound in recent months after slowing or contracting last year. It is expected that Asian economies will lead the world out of recession, which is good news for Oregon's exports. China is a top export market for Oregon's products and a strong Chinese expansion, along with other Pacific Rim countries will aid the Oregon recovery.
- *National and regional energy prices.* Energy prices are generally lower coming into 2010 compared to 2008. Changes in regional electric and natural gas prices are

expected to be small over the year. This comes at a welcomed time when businesses are looking for cost savings. The benefit from lower energy prices is most likely short-lived as the underlying demand drivers will return once the world economies rebound from this recession.

- *Geopolitical risks.* Uncertainty still abounds in Iraq. Tensions with Iran and heightened security risks weigh on businesses and consumers. 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.
- *Initiatives, referendums, and referrals.* Generally, the ballot box brings a number of unknowns that could have sweeping impacts on the Oregon economy. Another uncertainty facing the Oregon economy is the impacts from the two tax measures which were passed on January 26. Studies on both sides of the issue from respectable sources derived very different conclusions. Given the uncertain nature of the impact of these two tax measures, we will not incorporate possible impacts into the Oregon economic forecast. We will be monitoring closely to see if any changes are warranted in future forecasts.

Demographic Forecast

Oregon's estimated population on July 1, 2009 reached 3,823,460. That was an increase of 0.85 percent over the 2008 population. The growth has slowed down since the highs of 2005 through 2007 when it exceeded 1.5 percent on average. This is the first time in two decades that Oregon's population growth was lower than the U.S. average. Overall, population change since 2000 was much slower than the rate of growth of well over 2.0 percent during the early 1990s. As a result of recent economic downturn, Oregon's population is expected to continue a slow pace of growth for at least a couple of years. Based on the current forecast, Oregon's population will reach 4.096 million in the year 2015 with an annual rate of growth of 1.15 percent between 2009 and 2015.

Oregon's economic condition heavily influences the state's population growth. Its economy determines the ability to retain local work force as well as attract job seekers from other states and beyond. As Oregon's total fertility rate remains below the replacement level and deaths continue to rise due to ageing population, long-term growth comes from net in-migration. Working-age adults come to Oregon as long as we have good economic and employment situations. During the 1980s, that included a major recession and a net loss of population, net migration 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 economy of 1990s. This share of migration to population change declined to 57 percent in 2002 and it is down to 48 percent in 2009. As a sign of slow to modest economic gain, the net migration will account for 50 to 65

percent of the population change in the near future. Although economy and employment situation in Oregon look bleak, migration situation is not expected to replicate the early 1980s pattern. Potential Oregon out-migrants have no better place to go since other states are also in the same boat in terms of economy and employment.

Age structure and its change affect employment, state revenue, and expenditure. Growth in many age groups will show the effects of the baby-boom and their echo generations during the period of 2009-2015. It will also reflect demographics impacted by the depression era birth cohort combined with diminished migration of the working age population and elderly retirees. After a period of slow growth in the past, the elderly population (65+) has picked up a faster pace of growth and will surge as the baby-boom generation starts to enter this age group. The average annual growth of the elderly population will be nearly 3.9 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 approaching 6 percent annual rate of growth due to the direct impact of the baby-boom generation entering retirement age. Reversing several years of shrinking population, the elderly aged 75-84 will start a positive growth as the effect of depression era birth-cohort will dissipate. 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 off 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 off to near 0 percent rate by 2012. The young adult population (aged 18-24) will remain virtually unchanged between 2009 and 2015, slowing from an averaging of 1.1 percent growth experienced between 2000 and 2009. Although the slow growth of college-age population (age 18-24) tend to ease the pressure on public spending on college education, college enrollment typically goes up during the time of high unemployment and scarcity of well paying jobs when even the older population flock back to college to better position themselves in a tough job market. The growth rate for children under the age of five will remain below the overall population growth rate. Since the change in the number of children before and after the 2009 baseline population will remain virtually unchanged, the demand for child care services and pre-Kindergarten program will be determined by the labor force participation of the parents. The K-12 population (aged 5-17) will show very slow growth which will translate into slow growth in school enrollments. This school-age population has actually decline in size. The 25-44 age group population has reversed the several year trend of decline and slow growth. 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 approach 1.2 percent annual growth by the year 2011.

Revenue Forecast

The forecast for General Fund revenues for 2009-11 is \$13,210.3 million. This represents a decrease of \$182.8 million from the December 2009 forecast. The forecast for the 2009-11 biennium is now \$365.4 below the Close of Session forecast. On net, nearly all of the decrease for the March forecast is associated with lower expectations for personal

income taxes, particularly in the remainder of the current fiscal year. In spite of increased expectations for corporate income taxes, the remainder of the changes to the forecast were offset by increases in the expectations for the amount of income tax credits to be claimed under the Business Energy Tax Credit (BETC) program. The expected ending balance is now a negative \$106.3 million. Total available resources amount to \$13,194.6 million.

There are several risks that could lead to significant deviations from this forecast, in particular are the following:

- *Increased Volatility.* With the passage of Measure 66, the state has increased the volatility of its personal income tax revenue stream. In past years, the relatively small number of taxpayers impacted by the measure – two to three percent – regularly accounted for two-thirds of the change in tax revenues from one year to the next. By increasing the dependence on this small group, relatively small changes in the economy can yield large changes in income tax collections. Essentially, the state can expect to experience greater positive revenue changes in good years and greater losses in revenue in bad years relative to the past.
- *Magnitude and Effectiveness of Federal Government Policy.* Throughout the last year, the federal government has increased their role in injecting stimulus into the economy at unprecedented levels. To the extent that impacts of these, or any new, policies deviate from expectation pose a risk to a variety of Oregon's revenue streams.
- *Taxpayer response to tax policy.* While we do not expect a sharp deviation from prior behavior related to the passage of Measure 66 and 67, there are several outstanding tax policy issues that increase risk in the forecast in both directions. For tax year 2010, the federal government has eliminated the income restriction on converting conventional Individual Retirement Accounts (IRA) to Roth IRAs. If taxpayers choose to convert these accounts, they can choose to pay taxes for tax year 2010 or spread the liability to 2011 and 2012. The extent that wealthier taxpayers take advantage of this opportunity represents an upside risk to the forecast, in particular because they could choose to pay all of the income taxes based on 2010 income in order to avoid expected marginal tax rate increases in 2011.

The popularity of Oregon's Business Energy Tax Credit has left the state with a substantial amount of credits that will serve to reduce revenues into the future. Because the credits can be redeemed, sold, or held, it is somewhat unclear when the credits will be claimed. The risk relates to the extent that the actual accumulation and redemption of credits deviates from what is expected.

Finally, the federal government may raise marginal tax rates for high income taxpayers beginning in 2011. We are expecting some increase in collections related to people taking capital gains in 2010 to avoid paying on the higher tax

rate. However, it is unclear how widespread this will be. We believe that this is generally an upside risk to the forecast for 2011.

Projected lottery earnings will total \$1,071.7 million, a decrease of \$9.5 million from the prior forecast. The typical seasonal behavior of video lottery receipts (e.g., receipts in the winter months tend to be higher than in the summer) has not been seen in the current cycle, as January receipts closely resembled those seen last July. Including the beginning balance and other earnings, total available resources equal \$1,073.8 million. After adjusting for programs that receive a strict percentage of lottery transfers, the current forecast for the ending balance in the Economic Development Fund is a negative \$33.6 million.

At the close of fiscal year 2009, the balance in the ORDF equaled \$112.5 million. The ORDF is projected to reach \$134.7 million by the end of 2009-11. Assuming no withdrawal is made to offset the negative ending balance in 2009-11, the balance would reach to \$138.4 million by the end of 2011-13. The ESF balance was completely withdrawn at the end of 2007-09 in order to fill the budget shortfall for 2007-09. Assuming no additional distributions are made during the next biennium, by the end of 2009-11, available ESF funds will total \$183.3 million.