San Diego Institute for Policy Research

San Diego
Economic Ledger

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Chairman's Corner

One of the commitments that we made when SDI launched the Economic Ledger was to call attention to economic warning signs. While overall the San Diego economy remains strong, a weakening housing market, a decrease in the region's labor force, a decline in the number of new business license applications

Steven Francis, Founder & Chairman of the San Diego Institute for Policy Research

and a negative shift in local consumer confidence are all signs that point to a slowing local economy.

In particular, San Diego's housing market looms as a bigger danger than ever. Prices have increased to such stratospheric levels that most San Diegans cannot afford their own home. Yet a significant and rapid downturn in prices could dramatically hurt employment in the real estate and financial services industry and so negatively impact consumer confidence, which has fallen since January, as to take the region into a recession. The quandary for policy makers is how to manage a "soft-landing" so that housing

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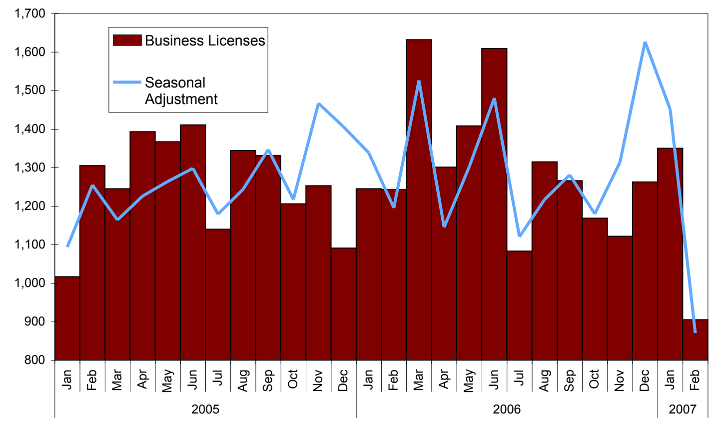
Dashboard Observations

by Kelly Cunningham, Economist, Sr. Fellow

NEW BUSINESS LICENSES ISSUED
CITY OF SAN DIEGO



Indicator	Feb 2007	Change (Sea. Adj.)	Annual Change
Unemployment Rate[1] San Diego County	4.2%	0.1% ▲	0.0% ▶
Residential Building[2] Units Authorized for Construction San Diego County	539	-26.5% ▼	-14.0% ▼
New Business Licenses[3] Issued by City of San Diego	905	-40.0% ▼	-27.2% ▼
San Diego Stock Index[4] San Diego based public cos. 2nd Thursday of month	138.8	5.9% ▲	-1.1% ▼
Economic Consumer Confidence Index[5]	113.2	-9.2% ▼	

[1]California Employment Development Department
[2]Construction Industry Research Board
[3]Business Tax Program, City of San Diego
[4]Bloomberg News, San Diego Daily Transcript
[5]Survey by Competitive Edge Research and Communications, conducted the first week of January and March 2007.
For detail of data, see website: *www.sandiegoinstitute.com*

Among the five indicators of San Diego's economic activity in February 2007, four showed a decline from January, and only one equaled the previous year number from February 2006.

While San Diego's unemployment rate had been higher in both December 2006 and January 2007 compared with the same month of the previous year, the February 2007 rate at 4.2 percent is the same as February 2006. Although this relatively low rate remains a fairly healthy level of unemployment, there are indications of slowing employment activity in San Diego.

Looking beyond the unemployment rate reveals some worrisome signs. Over the past 17 years, employment increased in San Diego County between January and February by an average of some 7,000 workers. But not in 2007. Instead, the total civilian labor force decreased between January and February by 5,300. The region has not seen a decrease of its labor force since 1993, the low point of one of the region's severest recessions. There are a number of possible reasons for this decline, including workers continuing to move to Riverside and Imperial County, workers dropping out of the labor force, and continued deployment of reserve and guard units to active duty.

Residential construction also continues to show significant slowing from the previous year. While January 2007 recorded a strong gain, February was down again, and over the year shows a 14.0 percent decline. The annual average shows a two-year slump of activity.

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New San Diego Consumer Confidence Index Shows Local Economic Outlook Sliding

In this issue of the **SDI Economic Ledger**, we are introducing a new measure of San Diego's consumer confidence. As part of the ongoing Opinion Barometer by SDI and Competitive Edge Research & Communication (CERC), the survey includes a measurement of San Diegan's attitudes towards the local economy and towards their own personal financial situation.

The Consumer Confidence Index measures San Diegans' opinion of personal financial well-being, as well as the outlook of local business and economic conditions. Since the questions frame consumer outlook for both current conditions and expectations six months into the future, we are able to both forecast future economic activity and measure the correlation of expectations with actual economic outcomes.

A score of 100 in the index represents an even split in sentiment between consumers who are positive about local economic conditions and those who are negative. In March, the index stood at 113.2, indicating 13.2 percent more consumers remain positive about the local economy. However, this was a significant downward shift (9.2 percent) from the January 2007 index, when consumer confidence was at 124.7.

Much of this decline is due to pessimism over future conditions.

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In January 2007, in answer to the question, "Looking ahead over the next six months, do you expect business conditions to improve or worsen?", 50 percent of San Diego consumers expected business conditions to remain about the same, while 34.1 percent thought it would improve greatly or somewhat, and only 15.9 percent indicated it would worsen somewhat or greatly. By March, the number expecting conditions to stay the same increased to 56.4 percent, and only 27.2 percent now thought it would improve, as 16.3 percent said it would worsen.

Consumers had grown more pessimistic about prospects for their own situation as well. In January, 50.3 percent expected their situation would remain the same, 44.9 percent anticipated improvement, and only 4.9 percent expected their own situation to decline. By March, the outlook for most consumers had declined. Only 33.7 percent expected to see an improvement in their individual financial situation, and 8 percent expected a decline.

There were also declines, though less pronounced, in the opinions San Diego consumers held about present conditions.

In January 2007, a strong majority (60 percent) indicated they thought the state of the local economy was excellent or good, while only 36.9 percent said the economy was not good or poor. By the March survey there had been a slight decline to 58.2 percent having a positive view, with those saying the economy was either not good or poor increasing to 41.8 percent.

The final question asked was whether consumers felt it was a good or bad time to purchase a major household item. In January, 61.1 percent believed that it was a good to excellent time to make such a purchase. By March, the good and excellent statements had decreased to 56.7 percent, while the not good/poor responses increased to 43.3 percent.

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It should be noted that the March survey was conducted during a week of stock market turmoil (March 1-6, 2007). This was also a week with continuing national and local reports of the housing market slowing down, spikes in the cost of gasoline, and rumblings of a new grocery workers strike. SDI believes that it will be critical to closely monitor the May numbers to see if confidence rebounds or continues to slide toward negative territory.

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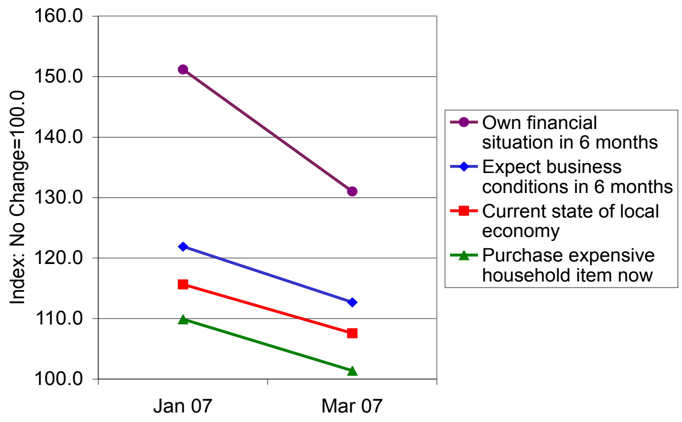
San Diego Economic Consumer Confidence Index



Index*	Jan 07	Mar 07	Change
Overall	124.7	113.2	-9.2%
Current:			
State of local economy	115.6	107.6	-7.0%
Purchase expensive household item	109.9	101.4	-7.7%
Six Months in Future:			
Expect business conditions	121.9	112.7	-7.6%
Own financial situation	151.2	131.0	-13.3%

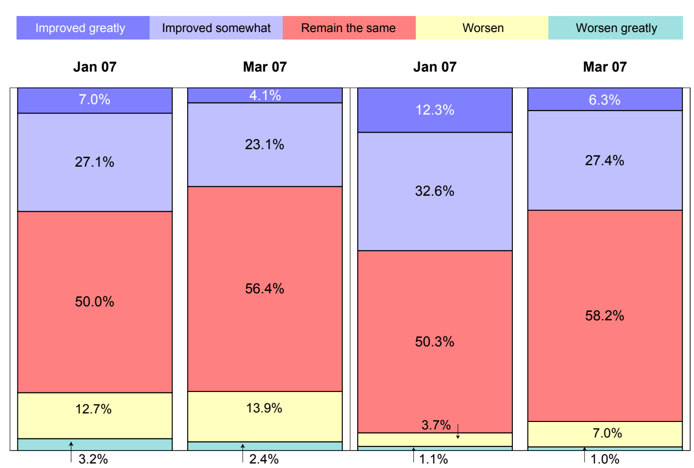
*Index: 100.0=no change.

Source: Competitive Edge Research & Communication, Inc.; San Diego Institute for Policy Research

Table 1:

Q1. Do you expect business conditions to...

Q2. Do you expect your own financial situation to...

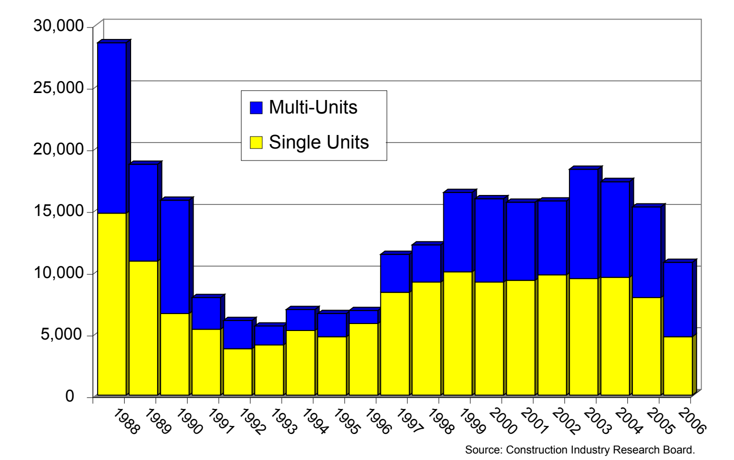


San Diego's Housing Dilemmas

Housing has always been a challenge for San Diego, but recent events may be pushing the region to the edge of financial calamity. Although San Diego's healthy economy would seem to mitigate some of the concern, residential market forces are combining to threaten the region's decade-long expansion. Housing could turn out to be the golden egg that kills the goose.

Both the construction of single and multi-unit houses faltered the past two years. The 4,727 single-units authorized for construction in 2006 represents a 40 percent plunge from 2005 to recession-era lows. The number of single-unit homes under construction in 2006 nearly match the lows of the past half century, all recorded during significant downturns in the local economy.

Figure 1: Housing Unit Construction
San Diego County



After rising to a record $3.9 billion in residential building valuation during 2004, San Diego's residential construction fell 8.1 percent in 2005, and another 30.6 percent in 2006. The value of San Diego's construction has thus dropped some $1.4 billion over the past two years.

Multi-family construction had been a bright spot. After almost disappearing in the 1990s, increased demand and tort reform helped spur a rebound for apartment and condo construction. For the first time since 1987, the number of multiple-units under construction outnumbered single units in 2006. But even here there has been a weakening, although not as great as in the single-family area. Over the past three years, the number of multiple-units under construction declined from 8,859 in 2003 to 6,040 by 2006. The outlook is for even fewer units of both single and multiple housing to be built in 2007.

The roots of San Diego's housing crisis can be traced to both rising demand, as well as limitations on the supply of new housing added to the market.

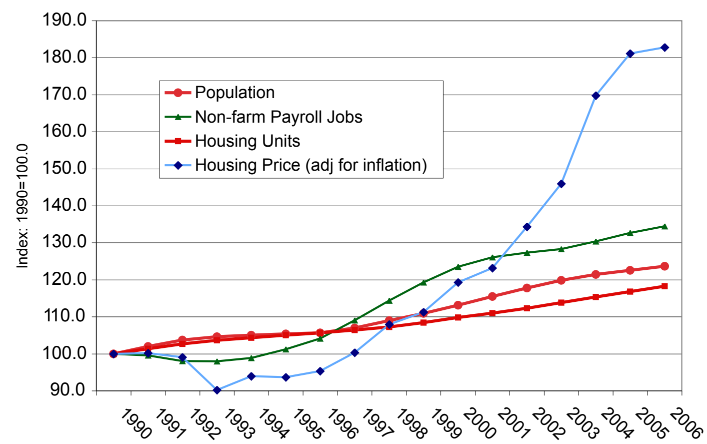
San Diego's Housing Crisis is Here...Now!

The roots of San Diego's housing crisis can be traced to both rising demand, as well as limitations on the supply of new housing added to the market. Growth restrictions, higher fees on new development, and the lack of new land available for residential development all play a role in constraining the construction of new homes and serve to fuel increased prices.

From a high point for housing construction in the mid-'80s, the number of units built each year diminished considerably by the '90s. The six years of building from 1991 to 1996 were the lowest on record for San Diego's residential construction since the Great Depression, although San Diego's population today is nearly nine times greater than it was during the 1930s. Housing construction subsequently revitalized in the latter 90s and 2000s, but has not kept pace with demand from population and job growth.

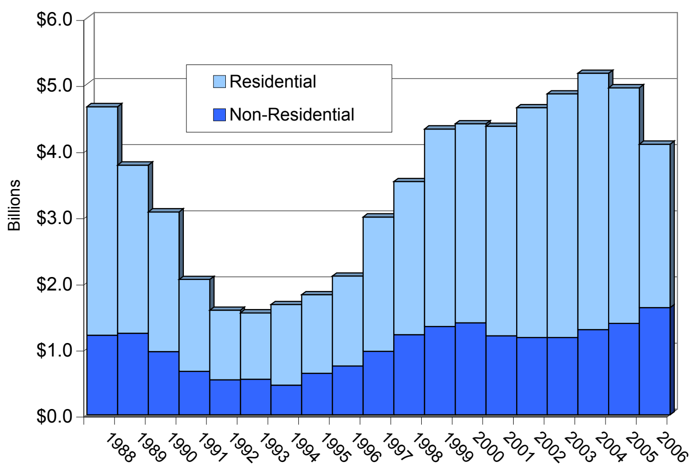
Adding fuel to the inflation of housing prices over the past decade were the lowest home mortgage interest rates in a generation, as well as creative financing schemes such as interest-only loans. Purchasing power increased, and with supply constrained, prices rapidly inflated. Of course, some residents were still unable to find the kind of home they wanted and several thousand San Diegans moved to distant lower-cost areas

Figure 2: San Diego Population, Jobs, Housing Supply and Price



Notes for Figure 2: The sources of the data used in the index of population and housing units are the California Department of Finance; non-farm payroll jobs from the U.S. Bureau of Labor Statistics; housing price is the average purchase price of homes in all loans closed during the year according to the Federal Housing Finance Board. Housing prices were adjusted for inflation by the San Diego consumer price index for all urban consumers by the U.S. Bureau of Labor Statistics.

Figure 3: Value of Building Construction
San Diego County



Source: Construction Industry Research Board.

in Riverside and Imperial Counties, and Mexico to live and commute back into San Diego to work.

Figure 2 helps illustrate both the growing imbalance in supply and its consequences. The index above assumes an equilibrium point in 1990 at which point population, jobs, housing units and prices all match (this assumption is not necessarily the case, but helps to illustrate the extent to which the situation has changed over the past two decades.) During the first half of the 90's, San Diego's population and housing stock grew at nearly equal rates. Starting in the second half, population growth began to outpace housing supply and the trend continued through 2006.

Moreover, there is also a gap in the number of jobs chasing the number of houses and this seems to be a significant determinant for housing prices. As total jobs (the green line in Figure 2) declined during the first half of the '90s, housing prices decreased. After job growth rebounded, home prices started to climb. Starting in 1996, we see a significant imbalance begin to appear between job creation and growth in housing stock. As the imbalance became more pronounced and cumulatively grew, home prices began to seriously accelerate until the unprecedented doubling of "real" or inflation adjusted home values occurred.

Adjusted for inflation, the current run-up in housing prices far exceeds previous periods of "real" price gains recorded in San Diego during the 60s, 70s and 80s. From 1966 to 1979, the average price of a San Diego home increased fourteen consecutive years by a total 115 percent (adjusted for inflation). The run up between 1985 and 1990 lasted only six years as "real" home prices increased 35 percent. The latest run-up of prices, lasting from 1996 to 2005, shows the "real" or inflation adjusted gain to be 134 percent.

Another way to consider this is the average price of a home purchased in San Diego in 1966 would be only about $160,000 in today's dollars. The comparable average price of a home in 2006 is more than $655,000. Little wonder there has been an exodus of San Diego residents from the County in recent years. (Source: Housing price data from the San Diego Regional Chamber of Commerce, Economic Research Bureau's historical housing price survey.)

The Rest of San Diego's Construction Industry

Some of the downturn in the residential market is partially offset by the rest of the construction industry. Since 2003, non-residential building has seen an increase in value of 38.6 percent to $1.6 billion, a record value for this type of construction. Commercial building, which includes new office buildings, hotels and motels, and retail stores, has led the way, with an increase of 62 percent. Industrial building, which includes manufacturing facilities, and "other" non-residential structures, such as medical, schools, churches, and other miscellaneous buildings, has also shown gains.

But while non-residential building has increased and is

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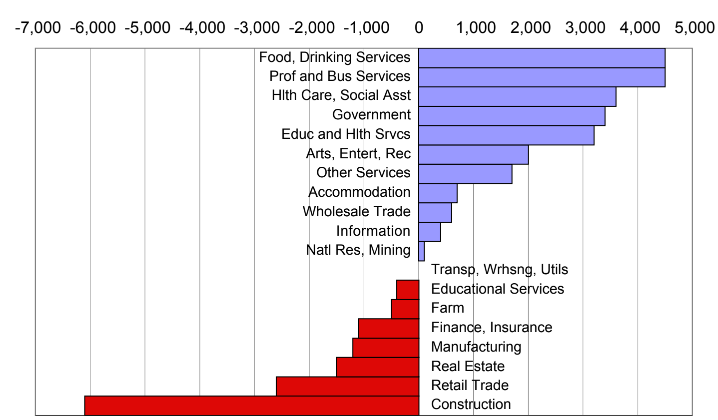
a positive sign, it has not fully compensated for the decrease in residential construction. Construction jobs are the current leading sector of job losses in San Diego. The year-over-year change in construction employment began to show declines towards the end of 2006. As of February 2007, construction jobs are down 6,100 since February 2006. This decrease of construction employment is the first year-over-year decline in San Diego since 1993, again a low point of the previous recession.

Closely connected with the construction industry demise are losses of employment in both financial and real estate sectors. Finance sector positions show a year-over-year decrease of 1,100 jobs as of February 2007, while real estate employment reports a 1,500 decline.

Another sector impacted by the slowing housing market is weakening retail spending. The latest reports for retail sales shows a significant softening of spending in San Diego County. As of the 1st quarter of 2006, San Diego had the weakest retail sales activity of California's major metropolitan areas. This is largely due to the softening real estate market. San Diegans had been able to sell real estate at a profit, or by refinancing or taking out second mortgages, and tap into the increased equity of their homes. This had freed up considerable sums of money that was abundantly spent in area stores. But now that the wave of refinancing has passed, San Diego consumers are cutting back on spending. Already employment among retail stores is declining, showing up as a loss of 2,600 jobs over the past year.

Figure 4. Annual Change of San Diego Payroll Jobs
February 2006 - February 2007



Source: California Employment Development Department.

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It remains to be seen if the recent decrease of construction and related jobs will pull San Diego into recession. Or if the critical housing situation causes San Diego's economic fortunes to falter. Both of these factors could disrupt San Diego's otherwise recent stellar economic performance.

For San Diego's economic fortunes to continue thriving, businesses need to attract and retain highly skilled, competent workers. Faced with the highly overpriced housing market, workers are hard pressed to find and obtain satisfactory housing value. It is little surprise so many hard working San Diegans moved to Riverside or Imperial Counties, or completely away from California to find a reasonable place to live.

The downturn in San Diego's residential construction and subsequent loss of construction labor, as well as softening real estate market is already constraining San Diego's economic growth. This softening trickle may become a torrent pulling under San Diego's prosperity in a much overdue correction to the housing market.

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Solutions to San Diego's Housing Crisis

First of all, subsidizing low income housing is not a solution. Although a few families benefit from the subsidized apartments, the increased burdens on residential construction, and increased competition for a finite supply of land suitable for residential construction, increases the cost of housing for the vast majority of San Diego's families who either do not qualify for low-income housing and/or which are stuck for years on wait lists. With developable land designated for housing being built out, redesignating land currently planned for other uses could help.

Higher density housing preferably along mass transit routes to facilitate mobility to work sites would be useful. While Downtown's redevelopment was expensive and for the most part has created very expensive high-rise housing units, the successfulness of this effort needs to spread into other urban centers in the County, and certainly into under utilized areas in need of redevelopment.

Otherwise, high speed rail to the north and east and/or facilitating border crossings so San Diego workers can live somewhere else may be the only alternative. Not only will workers flee San Diego, but businesses and economic activity will soon follow as well.

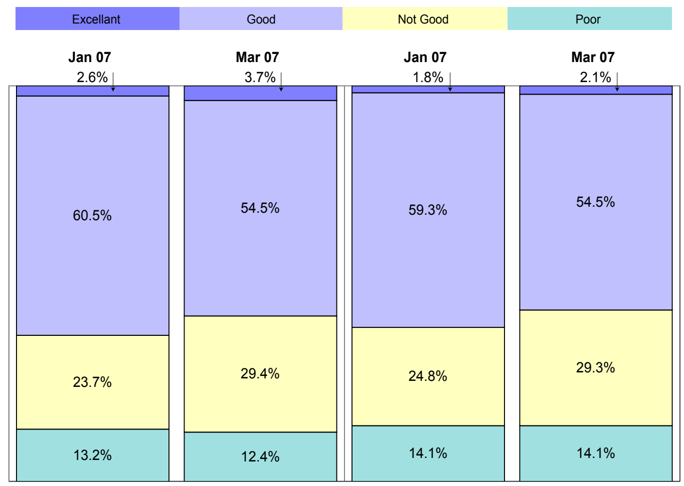
Consumer Confidence Index

continued from page 2

Table 2:

Q3. Do you think the state of the local economy is...

Q4. Do you think now is a(n)... time to purchase a major household item.



About the SDI/ Competitive Edge Opinion Barometer

The survey is conducted by Competitive Edge Research & Communication (CERC) in conjunction with the SDI. Final responsibility for all questions, the data collection and the analysis presented herein rests with CERC.

The findings are based on a random sample of 500+ City of San Diego residents. The interviewing was conducted January 3-6 and March 1-6 in English and Spanish from CERC's San Diego facility. Professional interviewers were trained for this specific project. The duration of the average interview was 16 minutes. The random digit dial sample was provided by Scientific Telephone Samples of Foothill Ranch, CA. After completing collection of the data, results were weighted on the voter registration, gender and age variables to CERC's estimates of the overall San Diego City population gathered from the US Census and the San Diego County Registrar of Voters.

Sampling Error

According to statistical theory, the confidence level associated with a sample of this type is such that, with a question where the respondents answer 50% "yes" and 50% "no," 95% of the time the results are within plus or minus ±4.4% of the true value, where true value refers to the results obtained if it were possible to interview every possible qualified respondent. The degree of error is reduced when responses have larger (e.g. 60%-40%, 70%-30%) percentage differences. Conversely, the margin of error increases when a subset of the entire 503 responses is analyzed.

In addition to error introduced by sampling variability, there are many other possible sources of bias such as how a question is worded, the question sequence, or individual interviewer techniques. Competitive Edge does everything in its power to minimize these potential sources of bias.

A survey of this type is a good measure of current attitudes that may change over time. This survey should not necessarily serve as an unqualified predictor of events, but, as an indicator to the situation in early January and March, 2007.

Chairman's Corner

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prices stabilize and adjust to a more sustainable level. Without corrective actions, it is not alarmist to say that San Diego's housing conundrum may turn out to be the golden egg that kills the goose.

As always, we welcome your feedback and input.

– Steven Francis, Founder & Chairman

Dashboard Observations

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New **business licenses** issued by the City of San Diego show the worst slump of all the indicators, with the seasonal adjustment revealing a 40.0 percent drop in number for February 2007, and 27 percent decline over the year. This measure bears paying attention to as the number of new business licenses has fallen to its lowest level since March 2002 when adjusted for monthly seasonal variations.

The **San Diego Stock Index** shows the one positive indicator for the month of February with a 5.9 percent increase from January, but the index remains 1.1 percent lower than the index in February 2006.

The new **San Diego Economic Consumer Confidence Index**, developed by SDI and Competitive Edge Research and Communication (CERC), shows a significant 9.2 percent decrease in consumer confidence from January to March. The overall index of 113.2 reveals consumers on the whole are more positive of future expectations, but there is a noticeable decline, especially as to the confidence of local consumers for future conditions. Confidence is down since the previous survey in January 2007. (See the article on Consumer Confidence on page 2.)

The San Diego Institute for Policy Research

The San Diego Institute for Policy Research, LLC, (SDI) is a non-partisan organization that formulates and promotes high quality economic, policy, and public opinion research so as to improve the efficiency and effectiveness of local governments in San Diego County.

The San Diego Institute for Policy Research, LLC (SDI) is established as a non-partisan organization whose goal is to improve the efficiency and effectiveness of the public sector throughout San Diego County. We believe that there are powerful insights that can be gained by examining how the private sector uses various tools and management techniques to succeed. We believe, as general principals, in limited government, individual freedom and responsibility. We also believe that local government governs best when it focuses on core competencies and services.

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