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President's Corner

The year 2009 will be one of the most unsettled our region's economy has ever seen. Unemployment is likely to reach levels not seen since the early 1980s. Residential construction, an important part of this region's economy since World War II, will remain at deeply depressed levels. Private funding for research and development will be extremely scarce as the depressed equity markets force venture capitalists and angels search for a new model where by they can recoup their investments. With consumer confidence at record low levels, retail sales will continue to contract, putting pressure on commercial real estate.

That is the forecast that National University System Institute for Policy Research's Economist and Senior Fellow Kelly Cunningham is making in this issue of the economic ledger. While we are forecasting a modest rebound during the second half of 2009, we believe that unemployment will continue to increase throughout the year and that even 2010 could be a year of sluggish and tepid growth.

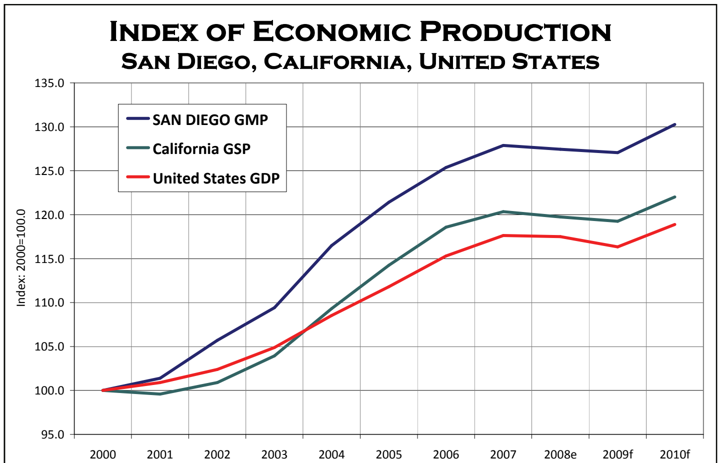
All of this will put a significant strain on local municipal finances. Those cities that are heavily reliant on sales tax and/or new residential development to fund general public services are going to be facing serious strains and fiscal challenges. This could be a long term issue, particularly if we are entering a period of fundamental restructuring with American consumers increasing saving levels and decreasing discretionary spending combined with a long term slump in housing values and construction levels.

More then ever we believe it is important for San Diegans to get unbiased and information about new public policy ideas and the economic conditions impacting San Diego. That is why we are so

(Continued on page 6)

San Diego's 2009 Economic Outlook

"Leading In and Out of Recession"



Source: National University System Institute for Policy Research.

Executive Summary

San Diego's economic performance during 2008, as measured by the region's gross metropolitan product (GMP), is estimated to have risen only 0.3 percent, the lowest increase in fifteen years. The outlook for 2009 is much more pessimistic with the local economy projected to decline 2.4 percent before turning positive again in 2010.

The region's unemployment rate is projected to rise to an annual average of 9.2 percent in 2009. Businesses are projected to shed a net 35,000 jobs. The retail and construction sectors will continue to be weak where job losses are most prominent. The few bright spots are likely to be defense industry related and health care based. Stimulus spending by the federal government for infrastructure, "green" technologies, and other projects could start to kick in towards the end of year, but job gains will probably not be noticeable until 2010.

New housing projects will fall to historic lows, with only 3,200 permits projected to be pulled during the entire year, the lowest number for any year locally since the Great Depression. If there is one bright spot, the cost of living change will continue to be low, as sluggish economic conditions serve to keep inflation at an anemic 1.5 percent.

At the beginning of 2008 it was thought, or at least hoped, that the impact of the housing market slump and credit crunch in San Diego would largely remain within those sectors of the economy. It had become clear that the housing market was out of balance to the region's supply of income and jobs. The median price of a home in San Diego rose to nearly eight times median area household income, according to *National Association of Home Builders* reporting. In comparison, the ratio hovered between 3.0 and 4.0 from 1991 to 2000. A correction of housing prices was obviously necessary to bring the market back into some semblance of balance. Outside of construction, real estate or finance, other industries were expected to carry on expanding sales and increasing investments. While there would be some slowing, it was thought the recession would largely be confined to those real estate related areas.

It was wrong to presume this was a normal market correction, however, that would quickly correct past imbalances. The assumption that this was a garden-variety cyclical downturn and would rebound to normal growth proved to be far off the mark. What is clear now is that this is not a normal bear market or business-as-usual economic downturn. Instead, what is described as an "epic" bear market and the worst financial crisis since the Great Depression rippled throughout the nation and across the world.

National outlook: Impact of collapsing credit markets

The pin that popped the bubble and set loose the financial crisis was the collapse of inflated housing prices. Those high prices led people to take out mortgages they could not afford from banks that should have known the money would not be repaid. With home mortgage refinancing having all but disappeared, households severely cut back spending as evidenced by retail sales plummeting. This was particularly bad on the economy as consumer spending accounted for 70 percent of the nation's gross domestic product (GDP).

Inventories of unsold homes, while down slightly, are still high. Until this inventory clears, and prices stabilize, residential housing will remain a major drag on consumer spending.

From tumbling retail sales to soaring unemployment claims, the latest statistics show the economy growing increasingly grimmer. The market for goods and services plunges as consumers, battered by tightening credit, falling wealth and rising unemployment, drastically reduce spending. According to the London-based *Economist* magazine, "Americans' collective and sudden rediscovery of thrift is pushing the economy into its worst recession since at least

(Continued on page 2)

2009 Economic Outlook

(Continued from page 1)

1982 and unlike the early 1980s, there is little prospect of a quick turnaround.”[1] Spending by consumers, widely recognized as having driven recoveries from previous business downturns, is not going to revitalize the economy this time.

The collapse of real estate expanded into falling asset values for stocks, commodities, corporate loans, commercial paper and the derivatives based upon them, largely because the foundation of the assets were based upon a mountain of leverage. As leveraged borrowing unwound, creditors demanded more collateral for loans and borrowers rushed to sell before asset prices further fell with creditors demanding even more collateral. This fear, compounded by uncertainty about what anything purchased with borrowed money is really worth, drove financial institutions such as *Bear Stearns*, *Lehman Brothers* and *Washington Mutual* over the edge to insolvency. This created the credit crunch as even lenders with money started to hoard cash reserves rather than make loans that might not be repaid.

“The bottom line is that deleveraging is like an epic flood,” says Satyajit Das, a banking expert in Sydney, Australia. “Governments can't hold it back; they can only channel it. The public expects them to actually save the day just as they did after the 1987 equity crash, the 1991 real-estate crash and the 1994 junk-bond crash, yet none of those blowups involved an equity, credit, commodity and currency crash all rolled up in one.”[2]

Troubled banks receiving bailout funding from the Federal government are reluctant to lend, opting instead to shore up their reserves in case more loans go bad as the economy continues to deteriorate. Prospects for the economy recovering remain bleak so long as capital markets are not circulating and banks are not lending. This tightening financing scenario could linger over the economy for several years.

Industries across the board are seeing sales fall, bad debts soar and cash flows deteriorate

SAN DIEGO GROSS METROPOLITAN PRODUCT

	San Diego Gross Product			Annual Percent Change					
	GMP	Percentage of:		Current Dollars			Constant Dollars*		
Year	(Billions)	Calif.	U.S.	S.D.	Cal.	U.S.	S.D.	Cal.	U.S.
2001	$112.435	8.64%	1.12%	2.9%	1.1%	3.2%	1.4%	-0.4%	0.8%
2002	$120.165	8.96%	1.16%	6.9%	3.0%	3.4%	4.3%	1.3%	1.6%
2003	$126.838	9.02%	1.17%	5.6%	4.9%	4.7%	3.5%	3.0%	2.5%
2004	$138.630	9.12%	1.19%	9.3%	8.0%	6.6%	6.5%	5.2%	3.6%
2005	$148.390	9.09%	1.20%	7.0%	7.5%	6.4%	4.2%	4.5%	2.9%
2006	$157.509	9.04%	1.20%	6.1%	6.7%	6.3%	3.3%	3.8%	2.8%
2007	$163.293	9.01%	1.19%	3.7%	4.1%	4.7%	1.1%	1.5%	2.0%
2008e	$170.062	9.04%	1.20%	4.1%	3.8%	3.3%	0.3%	0.0%	1.1%
2009f	$176.233	9.06%	1.26%	3.6%	3.4%	-1.2%	-2.4%	-2.6%	-3.2%
2010f	$184.833	9.10%	1.26%	4.9%	4.4%	4.4%	2.8%	2.3%	2.7%

*Adjusted by GDP/GSP/GMP implicit price deflator. e: estimate f: forecast

Source: Bureau of Economic Analysis, U.S.Department of Commerce; National University System Institute for Policy Research.

sharply. Concerns about a deflationary spiral may result in a persistent decrease of the price of goods as demand for goods and services declines. Due to lowered business activity, companies laying workers off or reducing wages cause further reductions in the economy. An ever-growing spiral of decreasing economic activity and falling prices becomes a perpetuating cycle. In order to combat this, the *Federal Reserve* lowered interest rates to near zero percent, while Congress and the Treasury enacted the Troubled Asset Relief Program (TARP) to prop up failing banks and their toxic assets, expanded other banking fund guarantees, and enacted vast stimulus programs and spending.

Consequently, the federal budget deficit has more than doubled from $162 billion in 2007 to $410 billion in 2008. The Congressional Budget Office now predicts a deficit of $1.2 trillion in 2009, about 8 percent of GDP, which would be the highest share of the economy since 1945. This does not include the $825 billion rescue plan already proposed by the Obama administration. Although deflation is an immediate concern, these massive deficits raise the specter for accelerating inflation in months and years to come once the economy starts to recover.

Not a run of the mill recession

In economic terms, a recession is defined by “a period of reduced economic activity” or a business cycle contraction. An often cited but not necessarily defining technical concept for a recession is reduction in the nation's GDP over at least two consecutive quarters. The *National Bureau of Economic Research* (NBER) defines economic recession as “a significant decline of economic activity spread across the economy, lasting more than a few months, normally visible in real GDP growth, real personal income, employment (non-farm payrolls), industrial production, and wholesale-retail sales.”

Evidence suggests recessions are longer when accompanied by a financial crisis, especially if the crisis was associated with cheap capital and high amounts of leverage. Especially troubling is the extent to which the downturn was so rapid and pronounced. It has been said that there has never been as much destruction of wealth in such a short period of time as investors largely lost confidence in financial markets. A *Newsweek* analyst puts it this way, “We're now living history, suffering one of the greatest financial panics of all time. It compares with the big ones—1907, 1929—and we cannot yet know its full consequences for the financial system, the economy or society as a whole.”[3]

Over the past 50 years, the nation has endured recessions (or recession-like economic downturns) in 1969-70, 1973-75, 1980-82, 1990-91 and 2001. Some of these have been relatively mild: the 2001 recession saw only 0.7 percent negative growth over three quarters. Some have been more painful: the economy contracted 7.8, 4.9, and 6.4 percent in the second quarter of 1980 and first and second quarters of 1982, respectively. Some downturns are extremely brief: The recessions of 1990-91 and 2001 lasted only three quarters nationally. Some go on and on: The downturn that began in the second quarter of 1980 did not fully release its grip on the U.S. economy until the fourth quarter of 1982, ten quarters later.

“We've come through a half-century of history where recessions have been sort of mild,” notes Richard Sylla, a professor at *New York University*'s Stern School of Business. “But never have problems in the financial sector been as great as they are now.”[4]

A “depression” is characterized by abnormal increases in unemployment, restriction of credit, shrinking output and investment, numerous bankruptcies, reduced amounts of trade and commerce, as well as highly volatile relative currency value fluctuations, mostly devaluations. Price deflation or hyperinflation are also common elements of a depression. These conditions are widely evident in the current downturn, although the decline of real GDP, unemployment levels of 25 percent, and length of the downturn have not nearly reached those depths, at least so far as of the end of 2008. The current downturn is thought to be more like the early 80s recession, although that may be a “best case” prognosis.

Negative outlook for some time

Consensus for the national economy is this is not going to be a normal recession and will last longer than usual. Traditional measures of interest-rate cuts and increased government spending may be largely ineffective. *MSN*'s Jon Markman says “The global battle to fight the scourges of deleveraging, disinflation and defeatism will be long and hard, and will suffer many setbacks.”[6]

There will also not be anything like a usual and hoped-for V-shaped recovery, in which the economy zooms out of the bottom, showing growth of 5 percent or more. The economy is more likely to come out of the recession below optimal growth levels of 2.5 percent.

While a final assessment for the nation's 2008 economy has not been released at this time, the fourth quarter is expected to reveal a much greater decline than the third quarter, which had a 0.5 percent contraction. The troubles of the financial market were just beginning to unwind at the end of the third quarter, so the fourth quarter will undoubtedly be much deeper with estimates ranging to a 6.2 percent annual drop. Combined with growth over the first half of the year, the annual change is anticipated to show only a 1.1 percent increase for the entire year.

The outlook for the national economy, according to the *Wall Street Journal*'s poll of prominent economists across the nation during January 2009, was for the national economy to contract by 3.2 percent in 2009.

Opportunities in a downturn

Today's tough economic environment may provide unexpected opportunities. Business people who are financially positioned to act quickly when lending markets reopen or loosen up will be the ones most likely to succeed.

A downturn can actually be a good time to start a business. There will certainly be more people forced to work for themselves as they lose jobs and are unable to find other employment. Established firms tend to cut back too much on growth investments during downturns, focusing more on defending their core established activities.

The *Economist* maintains, "As in every downturn, who succeeds and who fails is likely to be determined not by what costs are cut, but how they are cut and above all which ones are not cut. There is a hint of blind panic about some redundancies…firms that get a reputation for too readily offloading people whom they described only recently as 'our most important assets' will suffer eventually in the labour market. One reason why downturns tend to be good times to launch new businesses is because established companies abandon promising growth opportunities too fast."[5]

There is an impressive array of companies that have been founded during economic downturns, including *Disney*, *Microsoft*, *Hewlett-Packard*, *Oracle* and *Cisco*. Some of the talented people, now unable to find work among existing firms, will direct their energies toward creating a new generation of start-up businesses.

Local economic outlook

Standing at the forefront of the crisis, San Diego was one of the first areas in California, and among the first in the nation, to see the housing price meltdown, financial destruction, and loss of jobs. The rate of San Diego's regional economic production growth, which generally exceeds both the nation and the rest of California, matched the national slowdown in 2007 with 2.0 percent "real" growth. California revealed greater slowing in 2007 as indicated by the *U.S. Department of Commerce*'s Bureau of Economic Analysis (BEA) estimate for growth of only 1.5 percent in 2007.

Both San Diego and California are estimated to have absorbed more slowing in 2008, with annual economic gains of only 0.3 percent and no gain, respectively. ***Our forecast for 2009 shows a decease as the first half of the year is expected to continue declining before modest growth in the second half softens the full year's contraction.***

There are reasons to believe San Diego will come out of the recession earlier and in a somewhat stronger position than the rest of the nation, once the turnaround starts to occur. Unlike neighboring regions, San Diego was not previously overbuilt or overwhelmed by too much development.

One of the first sectors of the economy to see a revitalization of growth will be in business investment, as companies that are now slowing production and shedding jobs, will need to gear up to meet returning and undermet market demand by both businesses and consumers. Investment toward research and development and for new technologies will be the first areas to see increasing activity.

Industries directly dependent upon consumer spending are being most impacted by the financial turmoil. One of the first regions to enter the recession, San Diego should also be one of the first to lead out due to the region's mix of technology sectors, scientifically skilled workers, and highly entrepreneurial spirit. San Diego is one of the nation's more prominent regions for business investment with well-diversified technology base of telecommunications, biotechnology, computers, electronics and other scientific endeavors. Technology employment was actually still growing in San Diego through the end of 2008. While these areas will also see some drawdown during the first half of 2009 due to investment cutbacks, it will not be to the extent seen in industries more directly dependent upon consumer spending.

Defense contracting work is expected to bolster San Diego's economy in 2009 with continued spending coming from the federal government for homeland defense. In addition, bringing soldiers home from foreign duty, as the Obama administration has vowed to do, is always an economic benefit to San Diego's extensive military base operations. The region also seems fairly well positioned to compete and win at least our "fair share" of the expected Federal stimulus package from government spending for infrastructure and other projects that should start to kick in during the second half of the year.

Population growth increases

Somewhat surprisingly, San Diego population growth accelerated in 2007, according to estimates by the *California Department of Finance*. Population gains over the past few years steadily rose from 26,000 in 2004 to more than 46,000 during 2007.

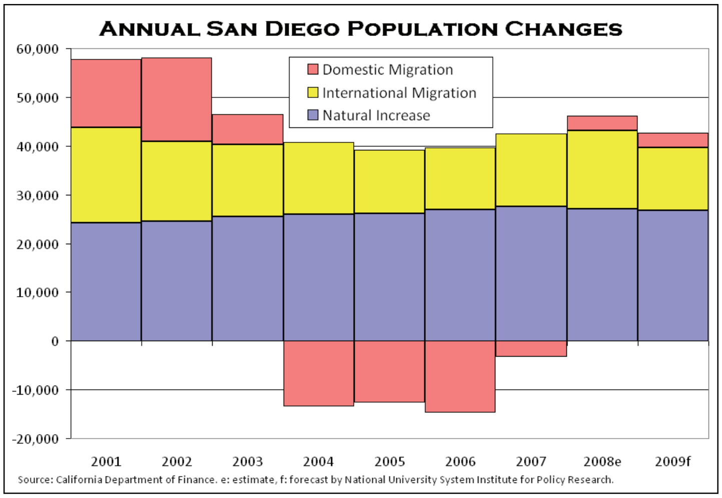
Natural increase, the number of births over deaths of residents, remains fairly consistent

SELECTED SAN DIEGO COUNTY ECONOMIC INDICATORS

	Actual	Actual	Actual	Actual	Estimate	Forecast	Annual Change				
Indicator	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**'05/'04**	**'06/'05**	**'07/'06**	**'08/'07e**	**'09/'08f**
Gross Metropolitan Product											
(billions)	$138.630	$148.390	$157.509	$163.293	$170.062	$176.233	7.0%	6.1%	3.7%	4.1%	3.6%
"Real" Change+							4.2%	3.3%	1.1%	0.3%	-2.4%
Population*	3,038,074	3,065,077	3,100,132	3,131,552	3,173,407	3,216,000	0.9%	1.1%	1.0%	1.3%	1.3%
Change	26,304	27,003	35,055	31,420	41,855	42,600	2.7%	29.8%	-10.4%	33.2%	1.8%
Net Migration	271	829	8,058	3,875	14,734	15,900	206%	872%	-51.9%	280.3%	7.9%
Natural Increase	26,034	26,174	26,998	27,546	27,121	26,700	0.5%	3.1%	2.0%	-1.5%	-1.6%
Employment											
Unemployment Rate	4.7%	4.3%	4.0%	4.6%	6.0%	9.2%	-0.4%	-0.4%	0.6%	1.4%	3.2%
Industry Payroll Employment	1,271,500	1,292,800	1,312,500	1,319,700	1,310,000	1,275,000	1.7%	1.5%	0.5%	-0.7%	-2.7%
Change	20,200	21,000	18,200	11,000	-9,700	-35,000					
Construction											
Housing Units	15,587	14,306	9,191	7,435	5,132	3,200	-8.2%	-35.8%	-19.1%	-31.0%	-37.6%
Retail Taxable Sales (billions)	$32.35	$33.78	$34.62	$34.04	$31.45	$30.44	4.4%	2.5%	-1.7%	-7.6%	-3.2%
Inflation Adjusted Change							0.6%	-0.4%	-2.1%	-10.3%	-2.7%
Per Capita	$10,647	$11,022	$11,167	$10,870	$9,910	$9,465	3.5%	1.3%	-2.7%	-8.8%	-4.5%
Inflation Adjusted Change							-0.3%	-1.6%	-3.1%	-11.5%	-4.0%
Inflation Rate											
San Diego Consumer Price Index (CPI-U: 1982-84 = 100)	212.8	220.6	228.2	233.2	242.3	245.9	3.7%	3.4%	2.2%	3.9%	1.5%

+Adjusted for inflation by Implicit Price Deflator for California. #Adjusted by "Commodities less food" component of San Diego CPI-U. *Population as of the end of the year.

Sources: U.S. Department of Commerce, Bureau of Economic Analysis; California Department of Finance; California Employment Development Department; U.S. Census Bureau; California Board of Equalization; U.S. Department of Labor, Bureau of Labor Statistics. Estimates and forecasts by National Univiersity System Institute for Policy Research.



between 26,000 and 27,000 per year. Net migration patterns, on the other hand, show the greatest deviation with barely 271 residents added in 2004 and climbing to 18,600 by 2007.

Domestic and international migration make up net migration totals. International migration is fairly consistent through the years, while domestic migration widely varies. Domestic migration was actually negative in San Diego from 2004 to 2007 as 43,000 more residents moved away than to the County. Seeming to correspond with the collapse of housing prices the past few years, migration turned positive again in 2007 to San Diego. This may be due to housing becoming much more affordable and as the economic downturn spread across the nation there was little advantage to moving elsewhere. This pattern of shifting migration appears to have continued in 2008.

International migration to San Diego primarily comes from Mexico, and recently diminished with fewer opportunities for work available in the weakened economy. As construction and retail activity in particular turned downward, work opportunities for immigrants significantly eroded. According to analysis of the nation's foreign-born population, numbers have already stopped growing after many years of rapid expansion. As the recession worsens, foreign-born residents are expected to actually decline.

Although population overall is still growing, San Diego's migration gains are projected to slow in 2009. Natural increases will slightly diminish as foreign migrants also tend to have more children.

Weakening employment outlook

San Diego's unemployment rate, which is generally lower than the rest of California and the U.S., climbed above the national average by mid-2007. San Diego's latest rate of unemployment reported for December 2008 was at a 14-year high of 7.5 percent. This remains well below California's 9.3 percent, but still slightly above the national rate of 7.1 percent.

A dubious record for unemployment was set in the final months of 2008 with 117,700 San Diego residents reported to not be employed, the highest actual number ever recorded in the County. With 1,473,300 still working, however, the 7.4 percent unemployment rate is not yet near the peaks recorded in previous eras.

Unfortunately, the worst is still to come and San Diego could exceed the unemployment peak of 8.6 percent unemployment reached in 1993. Unemployment is still rising throughout California and the nation as well.

With additional corporate bankruptcies and restructurings looming on the horizon, more job layoffs are in store for San Diego. ***We project San Diego's unemployment rate to reach 9.2 percent in 2009 and California will see unemployment rise to 11.0 percent.***

We project this difference between the state's fortunes and San Diego on several factors. Chief among them is, while San Diego was one of the first regions to see slowing job growth in southern California, neighboring counties are now absorbing much greater job cuts. Los Angeles, Orange County, and Riverside-San Bernardino are seeing double the number of job losses as San Diego. Up until the final months of 2008 northern California reported slowing yet still positive job growth, but as of November San Francisco and San Jose started showing year-over-year job losses as well.

While the annual loss of San Diego payroll jobs shows a net loss of 9,700 for 2008, this is the annual average over the entire year. Job losses reached 30,100 by the end of the year, with another 45,000 jobs anticipated to be cut by mid-2009. Some job growth is anticipated by the second half resulting in the average loss for the entire year at 35,000.

In respect to specific job sector changes, retail sectors are projected to continue having the greatest job losses, led by decreases among auto dealers, furniture and building materials, clothing, and general merchandise stores. Construction, finance and real estate will also continue to shrink, although losses are already starting to ease among these sectors after the brutal losses absorbed in 2008. Administrative and support positions will be shed as businesses contract and cut expenses. Following several years of expansion, hotels in San Diego began laying workers off towards the end of 2008 and will continue to do so in 2009 as visitor travel is expected to decline. Budget problems will cause state and local governments to cut jobs over the year as well.

Professional, scientific, and technical jobs, encompassing San Diego's high-tech industries, continued to expand through the end of 2008. Unfortunately, with the onslaught of the credit crunch and wavering business investment, these sectors will see job cutbacks in 2009 as well.

Already a significant slump in venture capital investment reached San Diego, an important source of funding for local start-ups. *PricewaterhouseCoopers/National Venture Capital Association's* third quarter 2008 report of venture capital deals revealed such investments falling some 57 percent over the past year.

Durable goods manufacturing, which in San Diego is primarily composed of computer, electronics, aerospace, and shipbuilding, should continue to hold up bolstered by defense related spending. Health care and private education will also continue expanding in 2009. Despite the downturn of visitors, employment among restaurant and bars will partially be sustained by San Diegans continuing to spend this part of their budget.

Construction languishing

Unlike previous eras, San Diego is not suffering from overbuilding. The number of housing units authorized for construction in 2008 is estimated to be only 5,200. This is about one-third the average 15,200 units built per year from 1997 through 2004. According to ratios for population and household growth, approximately one housing unit is needed to accommodate every 2.5 residents. With population growth of 50,000 per year, 20,000 housing units are needed to house additional residents. Recent construction obviously falls far short of this.

What is largely limiting new construction is the glut of foreclosed homes flooding the market. Nearly 45,000 properties went into foreclosure in 2008, according to *RealtyTrac* records, more than double the 20,200 in 2007, and six times only 7,832 in 2006.[7] Former residents of the homes obviously still need a place to live, and most find a rental unit to move into or else double up with relatives or other households. The demand for homes therefore remains largely the same, whether occupied by a home owner or renter. Additional home foreclosures are forthcoming and will take some time to be absorbed into the marketplace, but there will come a time when housing vacancies tighten and little additional housing available from new construction.

The outlook for housing construction in 2009 remains very pessimistic. ***Only 3,200 housing permits are projected to be issued in 2009, the smallest number in 70 years.*** This historically low number not only bodes ill for the current downturn, but when the economy recovers, given the considerable amount of time needed to gain approval for new housing and construction to commence, it is easy to conceive of housing shortages rising and significant upward price pressures building.

Faltering retail sales

An important indication of economic and consumer wealth is reflected by retail sales. San Diego's taxable retail transactions began to falter in 2007 with a 1.7 percent decline of total annual sales. This occurred despite the County's population rising and jobs still being added at the time. This was a most telling sign that consumers, faced with weakening housing values lost confidence and purchasing power and began to cut back discretionary spending.

National studies show consumers have been spending beyond their means for some time through extended credit spending. This was possible as mortgage holders borrowed against inflated values on their homes. The cutback in consumer spending presaged the later downturn of the overall economy. Prospects are for further losses to occur in 2009 as job losses mount and the economy continues to readjust to diminished consumer spending.

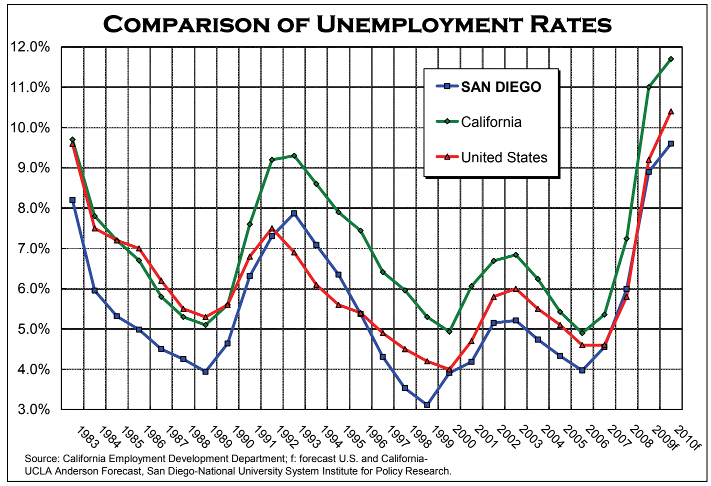
Corresponding to the spending decrease, retail store numbers began decreasing in San Diego from a peak of 42,917 outlets in 2005 to 40,011 by 2007. More closures will undoubtedly occur as consumers further cutback spending.

Fortunately, a lack of developable land and over-expansion kept San Diego from being overbuilt. Although the rate of 3.2 percent is the highest since 2004, San Diego has one of the lowest retail vacancy rates in the nation. According to *Grubb & Ellis*' 2009 forecast of commercial real estate, retail space vacancies should hold relatively steady in San Diego due to population gains and above average national income levels.[8]

Prospective deflation and inflation

San Diego's cost of living increases or inflation rate jumped to 4.6 percent during the first half of 2008, double the 2.3 percent recorded in 2007. Records were set for gas prices paid at the pump in the first half of 2008, causing costs to rise across the board. Gas prices subsequently fell in the second half of 2008, easing overall cost of living gains. However, the sharp drop of spending caused businesses to pull back on prices and offer deep discounts. This is the primary reason the annual inflation rate for all of 2008 is estimated to slow to an average of 3.9 percent over the entire year.

With more price discounting and housing prices continuing to falter, inflation is projected to fall even more in 2009. The 1.5 percent increase forecast reflects deflation in the overall cost of living, something that has not happened in San Diego for more than 50 years. The flip side is the tremendous amount of money pumped into the system by federal stimulus efforts could lead to significant inflationary pressures. Readers should continue to be vigilant on this matter, paying close attention to the monthly core CPI changes as reported by the *U.S. Bureau of Labor Statistics*.



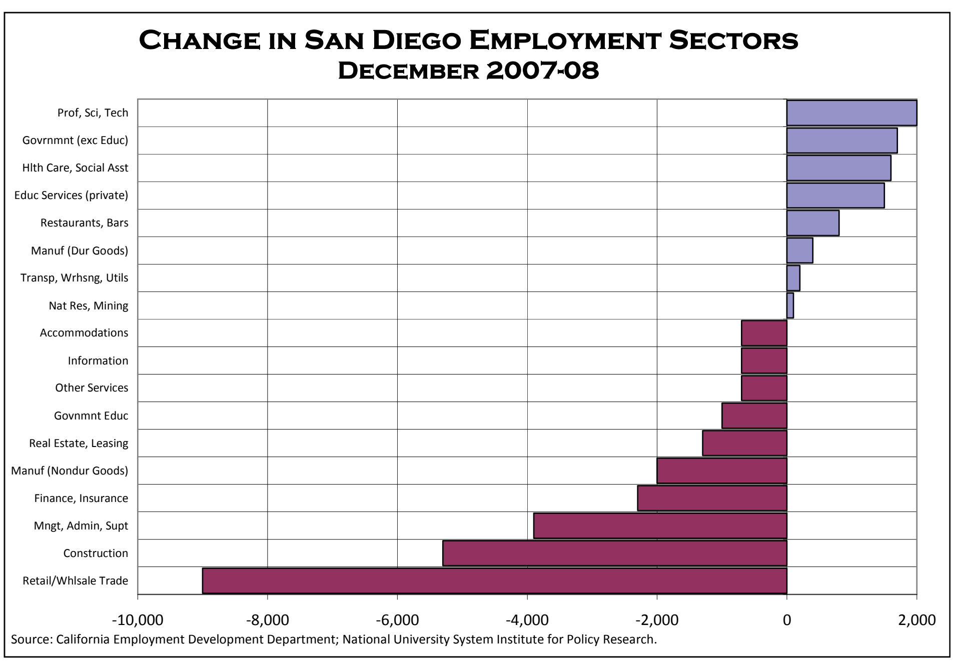
Conclusions

The economic outlook for 2009 promises to be a very challenging year. The region has not seen this kind of recession since the 1930s, fueled by fundamental weakness in the world's financial system and the devastating impact of the credit crunch, housing price collapse and deleveraging on such a massive scale. Add to this the fundamental restructuring of the nation's economy occurring as consumption declines. Any one of these factors would create difficulties for the nation's economy. In concert they bode ill for any short term recovery.

San Diego retains multiple economic advantages that position the region to do a bit better than the rest of the nation. The region's well-diversified economic base, focused on new and developing technologies, and far less dependence upon consumer-driven production where setbacks are most prominent, is a significant position of strength for San Diego in these troubled times.

Despite San Diego's long-term potential, prospects for an immediate regional economic rebound are poor. The national credit crunch, diminishing investment flows, mounting job losses, and cutback of consumer spending severely limits any prospects for improvement in the near term. San Diego cannot avoid the financial market imbalances or will be able to accomplish much alone until liquidity returns to the business marketplace.

We believe the second half of 2009 will see some signs of recovery. The stimulus spending should kick in by the summer and in six months time it is unlikely we will continue to see the kind of turmoil in the banking system stifling the flow of credit for even sound credit worthy borrowers. That said, to borrow a phrase from Bette Davis, we are in for a bumpy (and extremely unsettling) ride.



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[1]"No time to waste", *The Economist*, November 20, 2008.

[2]Jon Markman, "A credit crater too big to fill?", *moneycentral.msn.com*, November 5, 2008.

[3]Fareed Zakaria, "There Is a Silver Lining", *Newsweek*, October 11, 2008.

[4]"Desperately seeking a cash cure", The Economist, November 20, 2008.

[5]"All you need is cash", *The Economist,* November 20, 2008.

[6]Jon Markman, "Why Obama is the new Reagan," *moneycentral.msn.com*, November 6, 2008.

[7]Cited by Kelly Bennet, "Half of December Home Sales Were Foreclosures", *voiceofsandiego.org*, January 16, 2009.

[8]"2009 Real Estate Forecast", *Grubb & Ellis*, grubb-ellis.com/Forecast 2009/Default.htm.

Dashboard Observations—November 2008

By Kelly Cunningham, Economist, Senior Fellow

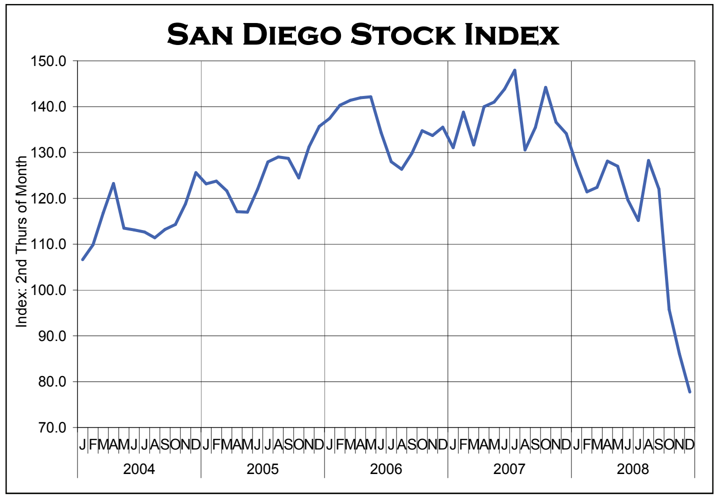
The San Diego **stock index**, a measure of the selling price of stocks among 158 publicly traded headquarter companies in San Diego, plummeted the last few months of 2008. The index shows prices trudging upward to a high in mid-2007 before trending downward and then dropping in half by the final months of 2008. This echoed national stock market indexes shaken by the nation's financial turmoil that tumbled in the final quarter of the year as well.

Since experiencing rates below 4.0 percent as recently as 2006, San Diego's **unemployment rate** steadily climbed to a high of 6.9 percent by November 2008. The rate is the highest in the County since 1995. The significant difference is the rate was trending downward at that time as the County was emerging from the severe recession of the early '90s. With the economy continuing to struggle in 2008, the trend now is for the rate to continue rising as more job layoffs loom in coming months.

The local unemployment rate remains much lower than the statewide rate, which jumped to 8.3 percent. San Diego's unemployment remains above the national rate, however which was reported to be 6.5 percent in November.

Although **residential building** shows an unexpected 43 percent gain for the month, the 232 units approved for construction during November compare with only 204 in October, which was the lowest number issued in any one month since 1992. The number also contrasts with 424 in November 2007, and 1,416 during the same month of 2004.

New **business licenses** issued by the City of San Diego in November were down only 4.6 percent from the previous month, but show a 13.4 percent gain from a year ago, and for the full year are 10.0 percent ahead of the previous year. This surprisingly positive statistic is one of the anomalies of a sputtering economy. When some workers are laid-off from their jobs and unable to find employment elsewhere, they may start their own business in an effort to find work. It could also be attributed to increased enforcement action by the City of San Diego, something that the Institute will continue to monitor in 2009.



Indicator	Nov 2008	Month Change (Sea. Adj.)	Annual Change
Unemployment Rate[1] San Diego County	6.9%	0.2% ▲	2.0% ▲
Residential Building[2] Units authorized for construction San Diego County	232	43.0% ▲	-45.3% ▼
New Business Licenses[3] Issued by City of San Diego	1,221	-4.6% ▼	13.4% ▲
San Diego Stock Index[4] San Diego based pub. companies 2nd Thursday of month	86.1	-10.1% ▼	-37.0% ▼

[1]California Employment Development Department.
[2]U.S. Bureau of the Census.
[3]Business Tax Program, City of San Diego.
[4]Second Thursday of month, Bloomberg News, San Diego Daily Transcript.

President's Message

(Continued from page 1)

excited that last month we were able to announce SDI's new affiliation with the National University System. By joining forces with California's 2nd largest not-for-profit private university and the affiliated entities that make up the National University System, SDI is positioned to expand its efforts and leverage these resources to do more economic research, investigate new policy areas, and distribute our findings more broadly throughout the entire region. We hope that in this way to make some small difference in helping the region find its way out of this economic turmoil and improve the quality of life enjoyed by our region's residents.

— W. Erik Bruvold, President
National University System Institute for Policy Research

National University System
Institute for Policy Research

11355 North Torrey Pines Road
La Jolla, CA 92037
Phone: 858-642-8008
kcunningham@nusystem.org

National University System Institute for Policy Research (NUSIPR) 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.