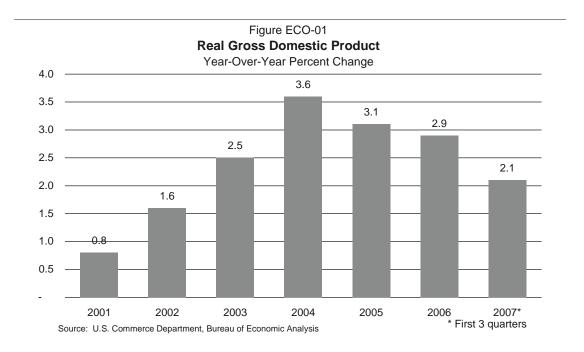
ECONOMIC OUTLOOK

The California and national economies faced considerable headwinds in 2007—a deepening housing slump, a breakdown in mortgage markets, tighter credit, more volatile financial markets, and rising energy prices. Upward resets of subprime mortgage rates made payments unaffordable for many borrowers and helped push mortgage defaults and foreclosures to record levels. Several large financial institutions reported huge losses on subprime mortgages and securities backed by these mortgages. Uncertainty about how far the problems with these mortgages would spread increased financial market volatility and prompted lenders to tighten credit standards. The Federal Reserve injected liquidity into the financial markets and eased monetary policy on a number of occasions in the second half of the year, but as year-end neared, financial markets were still not functioning normally.

The effects of the housing slump are evident in a broad range of measures of the national economy. New home sales will likely be down between 35 and 40 percent in 2007 from their peak level in 2005 and new single-family home building, about 25 percent from the peak level in 2006. Total job growth will be the smallest since 2004, and unless future revisions change the historical numbers significantly, real GDP growth will be the lowest since 2002 (Figure ECO-01).

In California, where the housing slump has been deeper than the vast majority of other states, single-family housing permits in the third quarter of 2007 were only about one-third of their level in the third quarter of 2005 and existing home sales, about half



of their level two years ago. Personal income has held up well, but taxable sales have slowed considerably.

The outlook for the national economy is for slower growth in 2008 and improved growth in 2009 and 2010:

- Real GDP is projected to grow 1.9 percent in 2008, and 2.9 percent in 2009 and 2010, as compared to 2.1 percent in 2007.
- Nonfarm payroll employment is forecast to increase 0.8 percent in 2008, 1.2 percent in 2009 and 1.3 percent in 2010, as compared to 1.3 percent in 2007.

The outlook for the California economy is also for slower growth in 2008 followed by improved growth in 2009 and 2010:

- Personal income is projected to grow 4.8 percent in 2008, 5.2 percent in 2009, and 5.4 percent in 2010, as compared to 5.6 percent in 2007.
- Nonfarm payroll employment is forecast to increase 0.7 percent in 2008, 1.0 percent in 2009 and 1.6 percent in 2010, as compared to 0.8 percent in 2007.

THE NATION—SLOWING GROWTH

The struggling housing sector continued to slow the national economy in the first 11 months of 2007. Home building, home sales, and related retail sales all declined. The slowdown in home building alone reduced national output growth by almost one percentage point, on average, in the first three quarters of the year. As 2007 closed, there was little evidence that the housing downturn is abating. The problems with subprime mortgages have raised financial market volatility and have spurred a credit tightening that not only could delay a housing recovery, but hurt parts of the economy outside the housing sector as well.

The contraction in residential construction and mortgage finance and a slide in housing-related retailing have cooled labor markets in the nation. Through November, job gains averaged 118,000 per month, a sharp drop from a year ago when the average monthly gain was 185,000. In addition, the nation's unemployment rate trended up from 4.5 percent in June 2007 to 4.7 percent in September, October, and November.

Fortunately, American consumers continue to spend freely, and foreigners are enjoying how much more American goods and services a Euro, a British pound, or a Canadian dollar will buy. American consumers increased their spending by 3.6 percent in 2004, 3.2 percent in 2005, 3.1 percent in 2006 and 3 percent, on a year-over-year basis, in the first three quarters of 2007. The growth in U.S. exports was even more impressive: 9.7 percent in 2004, 6.9 percent in 2005, 8.4 percent in 2006, and 8 percent, on a year-over-year basis, in the first three quarters of 2007. Without the contribution of exports, output growth would be sluggish.

Energy prices increased in the first 11 months of 2007, with the average price for regular-grade gasoline about 8 percent higher than a year ago. Prices of light, sweet crude oil almost reached \$100 per barrel in November before sliding back. The average price in the first 11 months was about 9 percent higher than a year earlier. These increases boosted measures of overall inflation in the economy, but measures of inflation that exclude energy prices remained relatively stable.

California—Slowing Growth As Well

Total personal income has held up surprisingly well in California during the housing slump. This broad measure of the economy was 5.8 percent higher than a year earlier in the first half of 2007, which is not much lower than the 6.5 percent growth in both 2005 and 2006.

ECONOMIC OUTLOOK

Personal Income

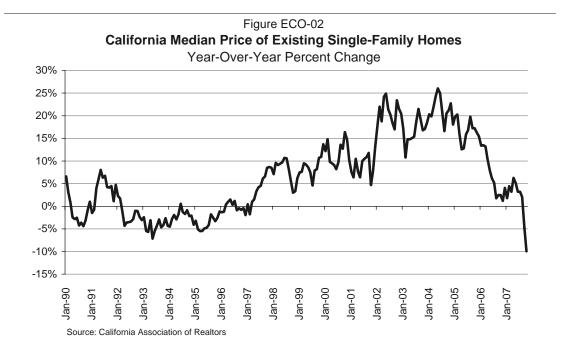
- California personal income, as defined by the U.S. Bureau of Economic Analysis, is the total of all Californians' earnings, including wages and salaries, supplements to wages and salaries, proprietors' income, rental income, dividends, interest income, and personal current transfer receipts (e.g., retirement and disability insurance benefits, medical payments, unemployment insurance benefits, veterans benefits), less contributions for government social insurance. Capital gains are not included.
- California personal income grew by
 6.5 percent in 2006 to \$1.43 trillion.
- Personal income and payroll employment are the most important broad and timely measures of state economies.

However, the housing slump and higher energy prices have taken a significant toll on taxable sales, another broad measure of the economic performance. After growing by 7.4 percent in 2005, taxable sales increased by only 4 percent in 2006 and 0.8 percent in the first three quarters of 2007. While industry detail on taxable sales is not available yet, weaker vehicle sales and sales at home improvement outlets likely played a significant role in the deceleration of taxable sales. New vehicle registrations fell 2.3 percent in 2006 and 7.3 percent from a year ago in the first nine months of 2007. And, no doubt, some of the declines in sales of national home improvement chains were in California.

California home building and residential real estate markets continued to slow in 2007. Single-family residential permits were down 36 percent from a year ago in the first ten months of 2007, and existing single-family home sales, 25 percent. In October, the number of unsold homes on the market amounted to 16.3 months of sales at the October sales rate. A year earlier, inventories amounted to 7.2 months of sales. The median price of existing single-family homes sold in October, \$497,000, was 9.9 percent lower than the median price a year earlier (Figure ECO-02).

Growing private-sector nonresidential building offset some of the drag of residential construction on the California economy in 2007. The value of private-sector nonresidential building permits issued in the first ten months of 2007 was 4.2 percent higher than the year-ago value. But the value of public works construction was down 3.9 percent.

Monthly job gains slowed considerably in the state in the first ten months of 2007, averaging just 5,800. Gains averaged 20,900 in the first ten months of 2006. The state's unemployment rate increased from 4.8 percent in March 2007 to 5.6 percent in September and October 2007.



THE FORECAST

The state and national economies will continue to face the same headwinds—a struggling housing sector, problems in mortgage markets, tighter credit, more volatile financial markets, and high energy prices—in 2008 and, to a lesser extent, in 2009, but economic growth should start to pick up in late 2008 (Figure ECO-03).

Figure ECO-03
Selected Economic Data for 2007, 2008, and 2009

United States	2007 (Est.)	2008 (Projected)	2009 (Projected)
Real gross domestic product (2000 CW* \$, percent change)	2.1	1.9	2.9
Personal consumption expenditures	2.9	2.0	2.7
Gross private domestic investment	(5.0)	(3.9)	4.5
Government purchases of goods and services	2.1	2.1	0.6
GDP deflator (2000=100, percent change)	2.6	1.6	1.7
GDP (current dollar, percent change)	4.7	3.6	4.6
Federal funds rate (percent)	5.04	4.27	4.57
Personal income (percent change)	6.5	4.9	5.0
Corporate profits before taxes (percent change)	4.8	(2.1)	3.3
Nonfarm wage and salary employment (millions)	138.0	139.2	140.9
(percent change)	1.3	8.0	1.2
Unemployment rate (percent)	4.6	5.0	5.0
Housing starts (millions)	1.35	1.02	1.29
(percent change)	(25.7)	(24.1)	26.9
New car sales (millions)	7.5	7.4	7.5
(percent change)	(3.6)	(1.8)	1.3
Consumer price index (1982-84=100)	207.1	211.7	215.8
(percent change)	2.8	2.2	2.0
California			
Civilian labor force (thousands)	18,187.2	18,454.3	18,709.0
(percent change)	1.6	1.5	1.4
Civilian employment (thousands)	17,227.1	17,402.8	17,659.9
(percent change)	1.2	1.0	1.5
Unemployment (thousands)	960.1	1,051.4	1,049.1
(percent change)	10.0	9.5	(0.2)
Unemployment rate (percent)	5.3	5.7	5.6
Nonfarm wage and salary employment (thousands)	15,177.4	15,283.4	15,443.7
(percent change)	0.8	0.7	1.0
Personal income (billions)	1,515.8	1,588.5	1,670.3
(percent change)	5.6	4.8	5.2
Housing units authorized (thousands)	117.0	95.0	104.0
(percent change)	(28.4)	(19.1)	10.1
Corporate profits before taxes (billions)	187.7	188.6	196.2
(percent change)	5.6	0.5	4.0
New auto registrations (thousands)	1,742.0	1,750.5	1,758.0
(percent change)	0.2	0.5	0.4
Total taxable sales (billions)	563.1	582.5	609.1
(percent change)	0.9	3.4	4.6
Consumer price index (1982-84=100)	217.3	223.0	229.0
(percent change)	3.3	2.6	2.7

^{*} CW: Chain Weighted

Note: Percentage changes calculated from unrounded data.