

2/19/2009

Good Afternoon, Ladies and Gentlemen

We are here at the request of the 4 legislative members of the Forecast Council, who asked that I provide the legislature with early guidance to the March official forecast.

Before I begin the presentation, I would like to publicly acknowledge and thank my staff, who worked late, on weekends, and through the President's Day holiday to help me put this together in time.

Today's forecast does not replace the official March forecast, which will be presented to the Council, as scheduled, a month from today. Also, today's unofficial forecast is issued with a number of important caveats. [\[Slide\]](#)

Economic conditions are in a state of flux, and can change rapidly. The March forecast can, therefore, be significantly different from the numbers I present today. Moreover, these numbers have not been subjected to the oversight and critique that we normally receive from the Governor's Council of Economic Advisors or our own internal inter-Agency forecast workgroup. [\[Slide\]](#)

Today's forecast should be viewed as a preliminary update to our November forecast. That forecast was considered pessimistic by many, but in the light of economic developments since then, it has become clear to me that we were not pessimistic enough.

Before presenting our early revenue guidance, I want to emphasize the difficulty we face in trying to make predictions. Like Yogi Berra said, "It is difficult to make predictions, especially about the future."

That has never been truer than now. We are witnessing an unprecedented economic crisis, the likes of which arguably, we have not seen since the Great Depression. A perfect storm of housing and banking crises and a crisis of confidence have battered the real economy, which in turn has weakened housing and banking even further.

Our computer based forecast models can only go so far in projecting the turnaround. Policy to break this negative feedback loop is only now being put in place – and it remains incomplete, as I will discuss later. Till the policy picture clears, the timing and trajectory of an economic

recovery remains extremely uncertain. I hope you will view my remarks today through this prism of uncertainty. [\[Slide\]](#)

Washington's economy, which had been outperforming the nation, "hit the wall" late in the year. The decline in economic activity was sharper than we had anticipated in November. Credit markets by and large remain frozen, so already weak auto and home sales weakened further. And the weakness spread to other sectors of the state economy, which had previously been unaffected. The layoff announcements by Boeing, Microsoft, and Starbucks added to the increasingly negative economic picture. The federal fiscal stimulus did turn out to be larger than we had anticipated in November, but the hole we now have to climb out of is deeper too. One more positive surprise, although it has nothing to do with our forecast, is that Ken Griffey Jr. is returning to the Mariners. Just goes to show that sometimes things turn out alright even when all seems lost. [\[Slide\]](#)

OK, back to the business at hand. In the three months since November, for which we have actual revenue collection data – and this includes taxable activities through January 10th – we are 197 million dollars below target. We estimate that 34% of the miss is due to weaker than anticipated retail sales and use tax collections. Part of the reason was auto sales and construction activity, and part of the reason was the bad weather right at the peak holiday shopping period. There is anecdotal evidence that sales picked up after the holidays, but we won't have the revenue collection numbers for January taxable activity until March 10th.

Another 44% of the forecast variance was attributable to a larger than expected decline in the estimated B&O tax receipts. This possibly points to the fact that overall economic activity in the state weakened sharply at the end of the year.

Another 19% can be explained by a shortfall in the real estate excise tax collection. Both home prices and the number of sales slowed sharply at the end of the year. [\[Slide\]](#)

Before I lay out where I think the state economy is headed, it is important to recognize the nature of the economic environment that surrounds us. The U.S. economy has now been in recession for 14 months, just short of the longest downturn since the Great Depression. Financial markets remain gummed up for the most part – and credit to consumers and businesses remain tight. WA lagged the national economy into recession, and I still believe will get out of it

sooner – but that does not mean we can be sanguine about the prospects for recovery in state revenues. This is a consumer led recession, and until confidence returns, and spending returns, our revenues will continue to suffer. [\[Slide\]](#)

The state is not alone. The world is in recession. Of the top 15 economies in the world, which collectively account for three-quarters of the world's output - just India and China, less than 8% of the global economy – are not in recession. All the others are in recession or on the brink of it. [\[Slide\]](#)

We are also in one of the worst bear markets since the Second World War. The Dow is down about 45% from its peak in October 2007, in half the time that it took to fall the same percentage in the 1973-74 bear market, which until now had been considered the worst post war bear market. For comparison, I also show the decline in the Dow during the Great Depression, and the fall of the NASDAQ after the dotcom bust. [\[Slide\]](#)

With falling equity portfolios, diminished retirement savings, and declining home values, household net worth fell close to a fifth of its value in the last year. This is in sharp contrast to the 2001 recession when household net worth remained relatively stable, despite the bursting of the hi-tech bubble. [\[Slide\]](#)

This chart shows the Ted spread – or the difference between the 3-month London Interbank Offer Rate, or LIBOR, and the yield on the 3-month Treasury bill. LIBOR is what banks pay to borrow from each other. The T-bill is considered risk free. So the difference, or spread, between these two is the premium banks have to pay to borrow from each other.

After the collapse of Lehman Brothers in September, the Ted Spread spiked – indicating that banks wanted a much higher premium to lend to one another. Or, inter-bank lending froze, freezing credit markets down the line. Now, it appears that the Ted Spread has declined back to near normal levels – so interbank lending has eased... [\[Slide\]](#)

But lending to businesses and consumers remains tight. This chart shows the results of a survey of senior loan officers at banks, conducted quarterly by the Federal Reserve Bank. The number reported in the net percent of banks who say they are tightening lending standards minus the net percent that say they are easing lending standards. Under normal credit conditions, net tightening

minus easing is somewhere in the 8% - 15% range, depending on the type of loan. It is shown by the horizontal bar. If the number is above this range, it means credit conditions are tight. If the number is below this range, it means credit conditions are easy.

The vertical line marks results from the October survey that we had in November – indicating extremely tight credit conditions. Since then we have the January survey results. So we have had some easing since October, but conditions are still pretty tight. [\[Slide\]](#)

With declining net worth, uncertainty about their jobs, and little access to credit, October consumer sentiment was at a record low. Since our November forecast, the October record has been beaten twice, as the index declined again in December and then in January. So right now we are at a new record low for consumer sentiment.

This is important because consumer sentiment is a good predictor for consumer spending, especially for big ticket items like cars and houses, on which we depend for our state revenue. [\[Slide\]](#)

The decline in car sales in the state appears to be accelerating. The bars show national car and light truck sales, and the line shows Washington new car registrations. Car sales in our state have fallen sharply, just as they have in the nation.

January car sales in Washington were 40% below what they were a year ago. In the last quarter of 2008, Washington car sales were 16% below third quarter sales, twice the rate of decline in the third quarter. [\[Slide\]](#)

State housing permits, a leading indicator of state housing starts, lagged the nation into the housing bust – but are now declining at a faster pace than the nation. In the last year, housing permits issued in the state fell to half of what they were at the start of the year. [\[Slide\]](#)

Existing home sales and other real estate activity is doing no better. Both the number of transactions and the value per transaction evident in our Real Estate Excise Tax collection data show declines of 26% and 28% respectively over the last year.

Total taxable value declined 45% over 2008 – 15% in the first three quarters and 30% in the last quarter. It is quite clear with the benefit of hindsight to see that conditions in real estate weakened very sharply at the end of the year. [\[Slide\]](#)

In November, we had identified all of the decline in retail sales tax as being automotive or construction related. That is still mostly true, but now other categories have also turned negative. Our forecast for future retail sales tax growth is also shown here – we don't expect a return to robust growth until the middle of 2010 – and remember we'll be growing off a much smaller number. [Slide]

The annual export growth numbers look healthy, but our export picture darkened pretty dramatically in the fourth quarter of last year. After having grown 25% in the first half of the year, exports flattened in the third quarter, and plummeted in the fourth, shrinking by 33% from year ago levels. Of course most of this decline can be explained by the planes that were not exported because of the strike at Boeing – but notice how sharply exports excluding transportation equipment are falling. With the global economy in recession, we cannot expect to export our way out of trouble. [Slide]

In November, we had anticipated a peak to trough decline of 33,000 jobs in the state. In just the fourth quarter, preliminary data indicate that we lost around 50,000 jobs. Our new forecast now has the state losing 90,000 jobs peak to trough. We expect job losses to stabilize by mid-year, and some anemic job growth in the second half of this year. Robust job growth is not expected until 2010 when the federal fiscal stimulus begins to kick in. [Slide]

Job losses, a strike at Boeing, and the prospect of deflation, have caused a sharp decline in nominal personal income growth. In the first quarter of 2008, the rate of growth was over 5% from year ago. In the fourth quarter, for which we do not yet have data, we expect personal income growth will fall to close to 1%. It would be negative, if not for unemployment insurance payments. Notice also that we recover earlier and faster than the nation. We believed that in November, and we still believe that today. Boeing still has a huge backlog, and Microsoft has a robust product development program. [Slide]

But there are many uncertainties about the recovery – and I cannot stress this enough. The state economy is caught up in a downward spiral that has devastated the national economy. What started in the housing sector, spread to banking, and then to the rest of the economy – and resulted in 3.6 million jobs lost to date during this recession. That feeds back into housing, weakening it further, and the spiral continues. It has caused both business and consumer confidence, so essential to private spending, to spiral downward as well.

The Federal Fiscal Stimulus package only addresses one part of this three part problem. Spending by the federal government and tax relief provided in the package will generate demand for goods and services, and through a multiplier effect, of subsequent spending by the first round recipients, help arrest the hemorrhaging of jobs that we have seen. Most of the impact will be next year and into 2011, not this year.

The 75 billion housing foreclosure relief included in the second half of the TARP funds spending plan, will slow the supply of foreclosed homes on the market. But, housing to recover, housing prices have to reach equilibrium, and perhaps slowing the supply of excess homes will allow that to happen sooner. Finally, potential home buyers need access to credit.

So the problem ultimately rests on the third and most important leg of this three legged stool of misery – the banking sector. Toxic assets on bank balance sheets have to be dealt with. The plan unveiled by the treasury last week did not encourage financial markets because it was short on specifics – and the devil, really is in the details. The problem is complex – figuring out which banks can survive based on stress tests, figuring out a “market” price for the distressed assets, figuring out whether to buy them in collaboration with hedge funds that do this sort of thing, or to provide a federal backstop against bank losses beyond a limit.

In any case, the coming weeks and months will provide a clearer picture. But right now my magic crystal ball is cloudy! [\[Slide\]](#)

With all those caveats, and reminding you that this is just an unofficial forecast, subject to change in March, I can get to our actual forecast.

But before I do that, bear with me for one more moment. The picture I have up shows the growth in revenue minus the growth in income. The last observed data point was the third quarter when income was growing 6.5% faster than revenues. We are pretty confident of our fourth quarter estimate – we have the revenue number, it is personal income we are guessing. In the fourth quarter we expect the difference between income and revenue growth to widen to 12.5%. That is a reflection of consumer uncertainty about the future, which makes them hunker down and cut back on all but essential expenditures. That is not good news for revenues that depend on the sale of big ticket items. We don't expect revenue growth to surpass income growth, and even then barely, until late this year, or early the next. [\[Slide\]](#)

For the current biennium, we have lowered our forecast by 721 million dollars. Of this 455 million is a result of a lower forecast, 197 million is from the collection experience to date, and 69 million is due to non-economic factors. [\[Slide\]](#)

44% of the change is a lower forecast for sales and use tax collections. 37% is a lower B&O forecast, and 12% is a lower REET forecast. [\[Slide\]](#)

For the 2009-11 biennium, we have lowered our forecast 1.6 billion dollars, all of which except 61 million is due to a lower forecast. 61 million is due to non-economic changes. [\[Slide\]](#)

A little more than half of the revision is due to retail sales tax, a quarter due to B&O, and about 11% due to REET. [\[Slide\]](#)

By fiscal year, we expect a 8.3% decline in revenues in FY 09, a 3.6% growth in FY 10, and a 8.1% growth in FY 11. We don't get back to FY 08 levels until FY 11. [\[Slide\]](#)

In conclusion, if we were forecasting today, we would have reduced our forecast for the rest of this biennium and the next biennium by a combined total of 2.3 billion dollars. This is similar to our pessimistic scenario in the November forecast – everything we feared could go wrong, did.

That doesn't mean that always has to be the case – did I mention that Ken Griffey Jr. is coming back to the Mariners? [\[Slide\]](#)

We'll issue our official forecast on March 19th as scheduled. Now I'll be glad to take any questions.