
Research Report

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A Strong California Economy Spurs Real Estate Activity

The California economic expansion has continued into 1998, leading to a thriving real estate market. The expansion is spread through many sectors of the economy, with diverse employment growth in both manufacturing and services sectors. Strength is evident in many of the largest metropolitan regions of the state, in both southern and northern California. The diversity of growth is apparent in real estate activity of many different product types, in many locations throughout the state. However, to this bright picture must be added the caution that international conditions may already be leading to a slowing of growth in the state, with potentially important implications for the state's real estate markets.

Official Statistics Show Expanding Economic Growth

In the first half of 1998, California has continued to outpace the national average in employment growth, according to official estimates by the California Employment Development Department and the US Bureau of Labor Statistics. California's total nonfarm employment expanded at an annual rate of 3.5% in the first half of 1998, compared to a rate of 3.3% for California in 1997, and a US 1998 rate of 2.7%.

Real estate has played a significant role in growth in the past year. California construction employment is expanding at a rate of 9.4%. At over 580,000, jobs in construction exceed the pre-recession peak.

California manufacturing employment is growing at a slower pace, at 2.6%, but has added almost as many jobs as the construction sector, and is expanding significantly faster than manufacturing nationwide (which grew at 1.2%). Most of the manufacturing growth has come in durable goods manufacturing, especially industrial machinery, electronic equipment, and fabricated metals. Lumber and wood products (growing at 2.9%) and furniture and fixtures (5.6% growth), two sectors closely related to real estate activity, have also shown strong growth. Transportation equipment and instruments, two sectors that were badly hit by defense cuts in the first half of the decade, both increased employment, adding, in combination, over 7,000 jobs in the past year. Nondurable goods grew more slowly than durable goods. Employment losses in food products were balanced out by growth in apparel manufacturing.

The services sector expanded at an annual rate of 4.9% in the first

half of 1998, adding 196,000 jobs from the previous year. Almost half of the sector's new jobs are in business services, with significant growth also in tourism and recreation related sectors (hotels, amusement and recreation services), in health services, and in engineering and management services. In contrast to this expansion, motion picture production, one of the fastest growing sectors in California in 1996 and 1997 (and over 10% of services jobs in Los Angeles County), showed little growth in the first half of 1998.

Employment growth is strong in office-related sectors. In addition to business services and engineering and management services, employment in the finance, insurance and real estate sector (FIRE) is growing for the first time this decade. These activities added over 25,000 jobs in the past year, an increase of 3.4%. Half of the new FIRE jobs are in financial firms, despite the absence of employment growth in depository institutions.

Trade as a whole (wholesale and retail) is expanding more slowly than total employment statewide, but trade sectors related to manufacturing and to building activity show greater strength. Durable wholesale employment

rose by 3.9% in the past year, and employment in retail sales of building materials increased by 7.9%.

Expansion Strongest in the Bay Area and Southern California

Many different parts of the state are enjoying the benefits of expanding employment. Of the six metropolitan areas that exceed the statewide rate of growth, three are in the San Francisco Bay Area, two are in Southern California, and one is in the Central Valley. (See Figure 1.) The Vallejo-Napa-Fairfield MSA, which encompasses Solano and Napa counties, was the fastest growing metropolitan area in the state in the first half of 1998, despite continuing adjustments to defense cutbacks. San Jose, although now in third place, is still expanding strongly, adding almost 40,000 new jobs in the past year. Although the Oakland and San Francisco MSAs grew more slowly than the state average, the Oakland MSA has added almost 30,000 new jobs and the San

Francisco MSA over 20,000 new jobs.

The Riverside-San Bernardino MSA, east of Los Angeles, was second only to the northern Bay Area in the rate of employment growth over the past year, growing at a rate of 4.6% and adding as many jobs as the San Jose MSA. Orange County, growing at 4.3%, showed significant recovery in defense related manufacturing sectors as well as expanding employment in construction. San Diego, growing slightly slower than the state average, nevertheless added jobs at a rate of 3.3% in the first half of the year. Unlike in Orange County, defense related manufacturing sectors in San Diego County do not show signs of recovery, but other durable manufacturing sectors, especially high-tech related, increased employment rapidly in the first half of the year.

The Los Angeles-Long Beach MSA, with an employment growth rate of 2.8%, continues to recover

ground but has not yet fully replaced the jobs lost in the 1991-93 recession. Manufacturing employment plays a significant role in the area's recovery, adding over 20,000 new jobs. Employment in defense-manufacturing industries is increasing slowly. High tech employment plays little role in the MSA's manufacturing growth, which stems more from construction related activities and the region's strong apparel sector. The services sector has added over 40,000 jobs to the MSA in the past year, many in business services.

With the exception of the Modesto MSA, Central Valley places have grown more slowly than California's major coastal areas. The Sacramento MSA, with a rate of growth at the national average, has shown strength in a wide variety of manufacturing sectors, as well as in construction, FIRE, and state and local education.

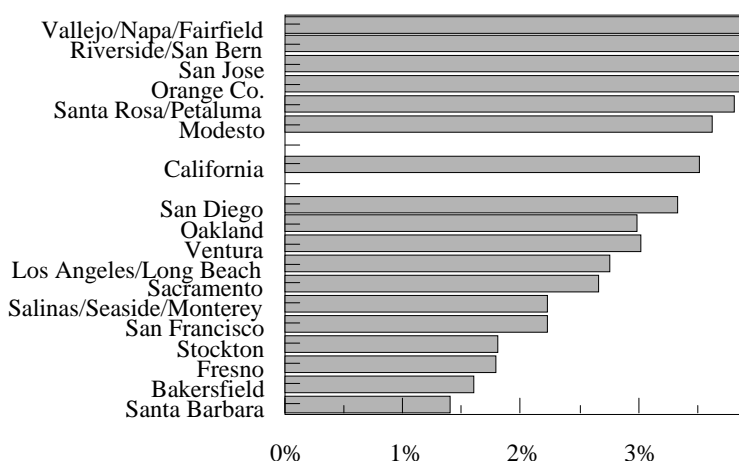
Despite Strong Growth, Unemployment Remains Higher than the Nation

Statewide, unemployment was 5.7% in June 1998, significantly below the rate of 6.3% for 1997, but well above the US rate of 4.5%. Nevertheless, many of the state's largest and fastest growing MSAs have extremely tight labor markets. In the Bay Area, unemployment rates range from a low of 3% in the San Jose and San Francisco MSAs to a high of 5.1% in the Vallejo-Napa-Fairfield MSA. Southern California MSAs of Orange, San Diego and Santa Barbara all have unemployment rates below 4%.

Unemployment remains above

Figure 1

Percent Change in Employment, California: 1997-1998 (Annual Rate through June 1998)



Source: FCREUE from unpublished BLS data.

average, but is significantly improved in the Los Angeles (6.3%) and Riverside/San Bernardino (6.1%) metropolitan areas, compared to recession levels close to 10%. Unemployment remains highest, as is common, in the portions of the state more heavily dependent on agriculture. With the exception of Sacramento (with only 5% unemployed), all of the major Central Valley metropolitan areas had June unemployment rates above 10%.

A Few Signs of Slowing

While current economic conditions are very strong in the state, there are some signs that a peak has been reached and that the rate of employment growth has already begun to slow. The year-to-year rate of change is slowing in the most recent months. According to July data, for example, (as opposed to data averaged over the first half of the year), the annual rate of employment change has dropped to 3.0%, with manufacturing growing at less than 1%. The drop appears greatest in the Bay Area, where the annual growth rate for July was 2.4% in San Jose and 1.5% in San Francisco. Southern California counties have slowed much less, with Los Angeles the slowest of the major Southern California MSAs, at a 2.6% growth rate in July.

A second “interim” series of employment estimates produced by the California Employment Development Department suggests that employment growth in California for the first half of 1998 has, in fact, been slower than in 1997. (This alternate series takes into account changes observed in smaller and newer businesses as

well as the larger, more established firms reporting as part of the official series.) Interim series statistics show employment growth slowing in the first half of 1998 to 2.6% yearly, with manufacturing employment growing at 2.0% and services at 3.8%. (The recovery of the FIRE sectors, however, is confirmed by the interim employment series.)

Interim estimates are not reported for the individual metropolitan areas, but show slower growth for electronics and apparel sectors. This could lead major metropolitan areas such as San Jose and Los Angeles to grow more slowly this year than has been estimated from the January through June statistics for 1998. Even at this more moderate rate of growth, MSAs with very low unemployment rates may see little easing of their tight labor markets.

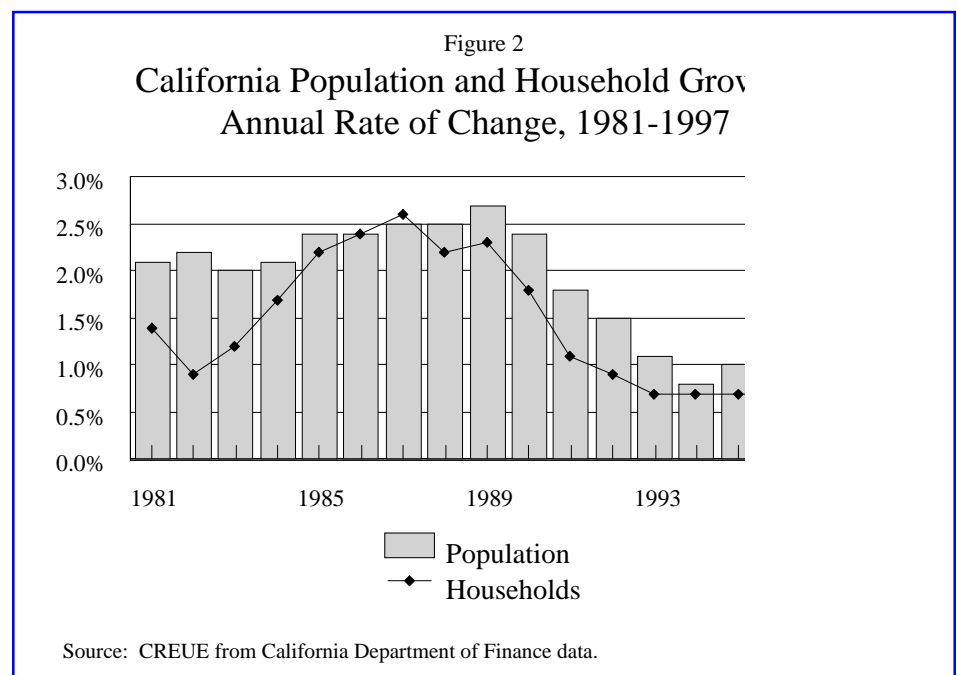
Population Growth Revives

The rate of population growth has begun to increase in response to strong economic conditions,

although it has not yet reached the pace of the late 1980s. The state’s population grew by 2.0% in 1997, compared to an average of only 1% annually from 1993 through 1996, and a rate of 2.4% in 1990.

The faster growth rate can be attributed to a shift in migration patterns. For the first time since 1990, more people moved into the state from other parts of the US than left for other parts of the country. The net gain through domestic migration for 1997 was just over 20,000 — far less than the peak of 188,000 in 1989, but a reversal from the net loss of 370,000 experienced in 1994. (With natural increase and foreign immigration as well, the state grew by 574,000 people in 1997.)

The rate of household growth has been slower than the rate of population growth. The annual rate of household growth peaked in 1987 at over 2.5%, but had dropped to only 0.7% in 1994 and remained below 1% in 1997, as shown in Figure 2. Lagging



household formation in a period of expanding employment and population has affected the rate of recovery of the housing market. Statistics on household formation are not yet available for 1998, but changes in California's residential real estate markets, as described below, indicate a rising pace of household formation.

A Steady Increase in Residential Building

The slow rate of household formation through 1997 contributed to lagging construction activity. However, residential building activity increased in the second half of 1997 and the first half of this year. Residential building permits for 1997 reached 111,000, as shown in Figure 3. This was the first year since 1991 that residential permits exceeded 100,000. Single family permits accounted for more than three-fourths of new permits, as has been the case since 1992. Residential building activity expanded further in the first half of 1998, at

an annual rate of 125,000 units.

Residential building activity varies throughout the state and within the state's subregions. Single family building activity has slowed in the San Francisco Bay Area in 1998, with permit levels dropping throughout the largest MSAs and increasing only in the Vallejo-Napa-Fairfield area. Single family permits are also down in the Los Angeles and Orange County areas, but San Diego and the Riverside/San Bernardino areas show significant increases in single family building activity, and single family permits are up 13% in Southern California as a whole. The Central Valley has emerged from a period of very slow building activity. Single family permits are up by 26% in the largest five Central Valley MSAs, with Sacramento showing a rise of 21%.

Multifamily permits statewide are up 30% from a year ago. The increase comes primarily from the San Francisco Bay Area and the

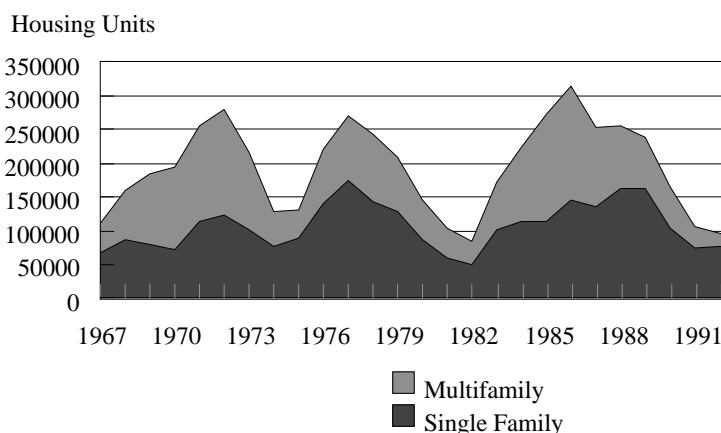
Central Valley. Multifamily permit activity has doubled in the San Francisco MSA and tripled in the Sacramento MSA. Southern California as a whole has shown little change in permit activity, although both San Diego and Los Angeles have greater multifamily building activity in 1998 than a year ago.

Housing Demand Increases

A strong economy, the reversal of outmigration flows, and a slow recovery in building set the stage for expanding home sales, strong home price increases, rising rents, and dropping apartment vacancy rates. California home sales increased by 10% in 1997 and by an additional 13% in the first quarter of 1998, reaching an annual rate of close to 600,000, according to data from the California Association of Realtors. Home sales gains have been spread widely throughout California in the past two years, with increases of 15-20% or higher in many of the large coastal MSAs this spring.

Home prices, which had remained low despite an expanding economy, showed solid recovery in 1997 and even stronger growth in the winter and spring of 1998. Statewide, the median sales price reported by the California Association of Realtors rose by 5% in 1997, matching the US price increase for the first time in the 1990s. In the first quarter of 1998, the median price of a California home was up 10% from a year earlier, compared to a 5.5% gain for the US as a whole. With these gains, California's 1998 median price has matched its previous 1990 peak of over \$200,000.

Figure 3
California Residential Permits
1967-1997



Source: FCREUE from CIRB data

Prices have recovered most quickly in the San Francisco Bay Area. The price index published by the Real Estate Research Council of Northern California shows Bay Area home prices up 10% between April 1997 and April 1998. The region's homeowners have regained the value lost earlier in the 1990s, and prices are now 3% above their previous peak in 1990. The greatest gains have been in Santa Clara County, which had already regained its previous peak by April 1997, and where prices rose by 18% between April 1997 and April 1998.

In contrast, in both Southern California and the Central Valley, home prices remain below their 1990 levels, despite recent price increases. Home prices in Los Angeles and Riverside counties are 30% below their 1990 values, according to the home price index published by the Real Estate Research Council of Southern California. Nevertheless, prices have been rising in small increments in these areas. In Los Angeles, home prices began rising in 1997 and by spring 1998 were up 5.3% over the previous year. Greater gains have occurred in Orange County, with prices up 9% over a year ago. In Southern California, coastal areas have seen the greatest price recovery. While overall indices are also rising in the inland markets, significant numbers of homes in inland areas still experience negative annual price changes.

In Sacramento, home prices remain 20% below their 1991 peak, and rose by only 1.8% in the last year. Some suburban and foothill areas outside of Sacra-

mento, such as Placer County, have seen greater gains in the past year.

Apartment markets also show rising demand. In the Bay Area, vacancies average 3.3% according to data from RealFacts published by the Real Estate Research Council of Northern California. Five of the nine counties (Marin, Napa, San Francisco, San Mateo and Santa Clara) have vacancy rates below 3%, and only Solano County (at 7.5%) has a vacancy rate above 4%. Bay Area rents are up 6.9% over a year ago, with increases of close to 10% in San Mateo and Santa Clara Counties and 13.5% in San Francisco.

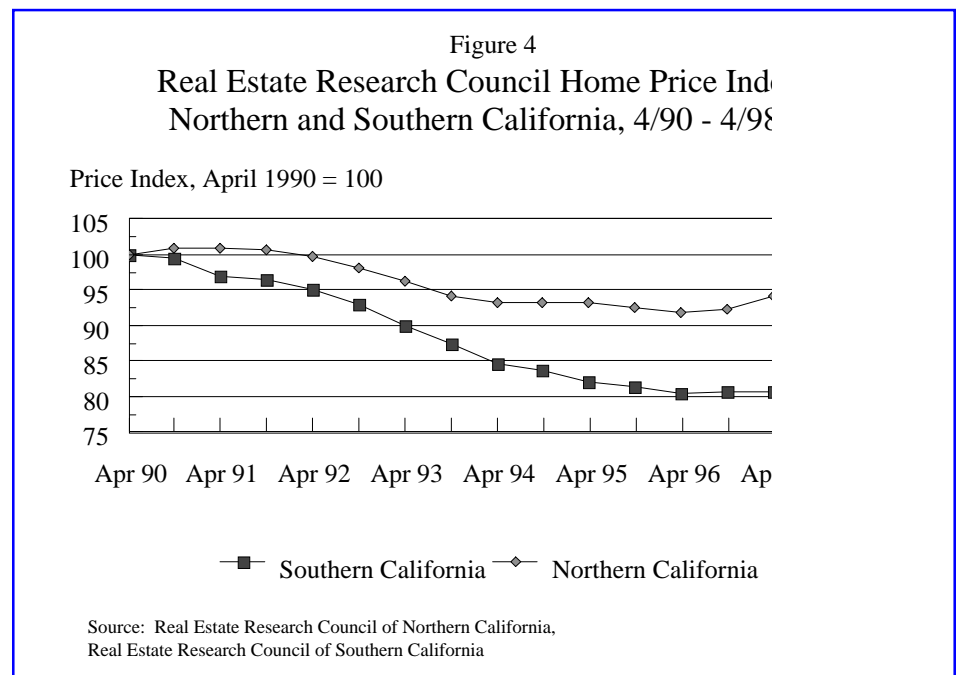
Southern California vacancy rates average 4.6%, ranging from a low of 3% in Ventura and Santa Barbara counties to over 6% in San Bernardino and Riverside counties. Southern California rents are almost 25% below Bay Area rents, but are rising nearly as rapidly, up by 6.1% in the past year. Rents rose by over 8% in

Orange and San Diego Counties, by 3.2% in Los Angeles County, and by less than 2% in San Bernardino County between first quarter 1997 and first quarter 1998.

A slowing of the rate of employment growth in California will not necessarily slow the gains in housing demand this year, as long as employment growth remains at least 2.5% and interest rates remain low. The recent surge in home sales and prices reflects several years of pent-up demand combined with relatively low levels of construction activity.

Nonresidential Markets Continue to Show Strength

The nonresidential recovery preceded the recovery of the residential market. Building activity has been expanding, vacancies dropping, and rents rising since 1994 or 1995 in many California markets. The value of nonresidential building permits increased by 27% in 1997 (in current dollars; by 24% adjusting



for inflation). Office permits more than doubled in 1997 from the previous year, industrial permits increased by 39%, and retail permits by 16%. (See Figure 5.) Building activity is up again in the first half of 1998, although the rate of increase has slowed. Total nonresidential permits are up by 20% for the first half of the year, but retail permits are up only 9% and office permits have dropped slightly (by less than 1%). Industrial permit activity continues a four-year growth pattern, up by 63% in the first half of 1998.

The San Francisco Bay Area saw the largest increase in activity in 1997, with total nonresidential permits up by 37%. This gain came primarily from office permits, which tripled from 1996. The Bay Area has not continued this rate of growth in the first half of 1998, but total permits are up by 6% for the first half of the year. Office and retail permits have dropped in the Bay Area in the first half of 1998, while industrial permits continue to rise.

Southern California is leading nonresidential building permit activity in 1998. Permits for the first half of the year are up 35% from the same period a year ago. Retail permits are up 20%, office permits up 81%, and industrial permits up 66%. Orange County is seeing the greatest increase in office permit levels, while Los Angeles has captured the greatest increase in industrial building.

Central Valley nonresidential permits increased by 30% in 1997 and are up by an additional 6% in 1998. Office permit value grew by 25%, and industrial permit value grew by 24%, while retail permits dropped by 6% in the major Central Valley MSAs in the first half of 1998.

Office and Industrial Demand Brings Lower Vacancies and Rising Rents

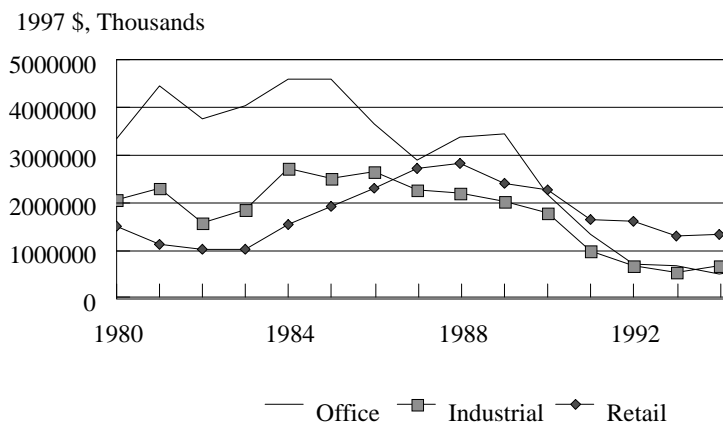
Office vacancy rates in California declined to 11% by the end of 1997, as shown in Figure 6 (based on our composite estimate that draws on broker data bases).

While vacancies are dropping throughout the state, levels vary widely. The lowest vacancies are found in the San Francisco Bay Area, which averages a 5.7% vacancy rate regionwide. Vacancies vary widely, however, from San Mateo County's 1.7% (as reported by the San Mateo County Economic Development Association (SAMCEDA)), to Alameda County's 14.3% in December 1997 (according to data compiled by Cushman and Wakefield).

Vacancy levels are higher in Southern California markets. Grubb and Ellis shows vacancies as high as 25% in the Riverside/San Bernardino area and at 16.4% in Los Angeles. San Diego and Orange Counties have lower vacancy levels (consistent with their strong economic growth). The Newport Economics Group estimates Orange County vacancies at 11.6% for year end 1997, and CB Commercial estimates San Diego vacancies at 9.7%. The Sacramento market has a vacancy rate lower than Southern California but higher than the Bay Area (9.5%, as reported by CB Commercial).

Approximately 11 million square feet were absorbed (net) in the state's major metropolitan markets in 1997. This level is unchanged from absorption levels in 1996 but is considerably higher than the average of 7.2 million square feet absorbed annually in the first half of the 1990s. Despite very strong employment growth last year, there has not been a return to the leasing levels of the 1980s, when, on average, over 25 million additional square feet of space were absorbed annually.

Figure 5
California Nonresidential Building Permit
Office, Industrial and Retail, 1980-1997



Source: FCREUE from CIRB data

Although vacancy rates are higher in Southern California than in Northern California, Southern California has shown the greatest improvement in leasing activity. Net absorption has risen in both Los Angeles and Orange Counties, according to Grubb and Ellis and Newport Economics Group figures. Both San Francisco and Santa Clara counties saw a drop in net absorption figures in 1997 (Cushman and Wakefield and Grubb and Ellis), while absorption levels have stayed steady in the Sacramento area (CB Commercial).

The drop in leasing activity in the Bay Area may be due more to the tightness of the market than to a slackening in demand. Bay Area office space commands the highest rents statewide, and had the highest increases in 1997. Rents in San Francisco increased by one-third, to a weighted annual average of \$32.52/sf, according to Cushman and Wakefield data. Rents are rising by 10% and more in San Mateo County, to over \$40/sf by December 1997. In contrast, the high end of rents in West Los Angeles (the highest priced Southern California market) is \$27/sf.

With almost 2 billion square feet of space in California, the industrial market dwarfs the office market in terms of total square footage of manufacturing, warehouse, and R&D space. Bay Area vacancies average 6.3%, with the low at 2.6% for San Mateo County and the high at 14% for Contra Costa County, according to Cushman and Wakefield data. Southern California industrial vacancies range from 5.7% in San Diego (CB Commercial) to 9.8%

in the Riverside/San Bernardino area (Grubb and Ellis). Although the Bay Area's industrial vacancy rates are no lower, on average, than in Southern California, the region has the highest industrial rents in the state. The difference is highest for R&D space, where rents exceed \$15/square foot annually in Santa Clara and San Mateo Counties.

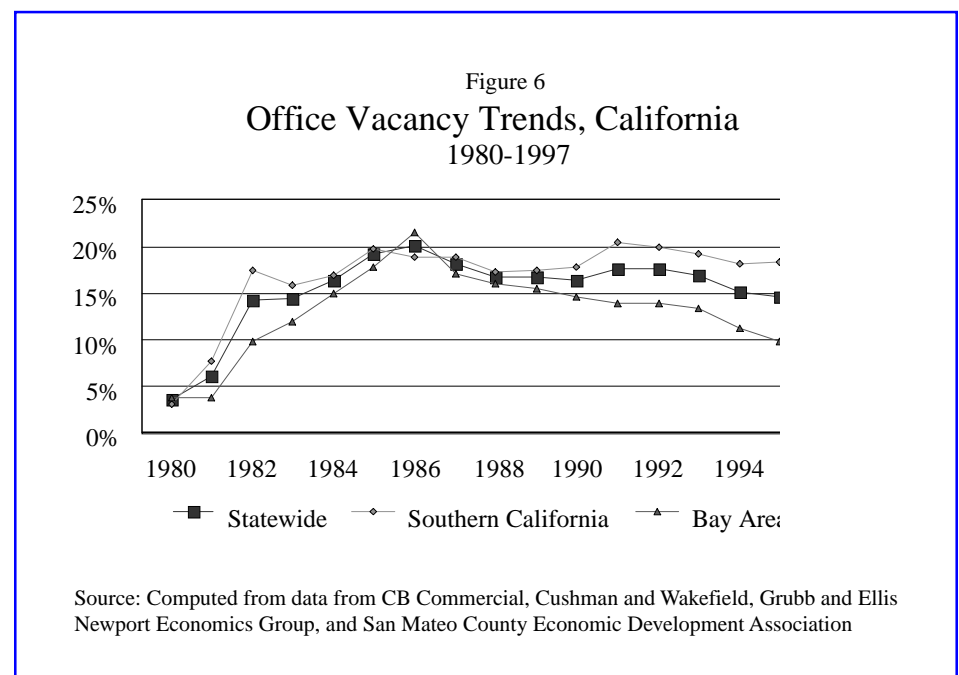
Meeting a Growing and Changing Demand

This has been a good year for most real estate products in California, and the strength should continue through the rest of 1998. Housing demand is strong in many parts of the state. With low unemployment rates, household formation is likely to expand this year, increasing the demand for both single family home ownership and rental apartments. In office and industrial markets, demand has not been fully met. If employment growth continues at the same rate as 1997, then new space under construction will be quickly

absorbed. A modest slowdown in the present employment growth rate could allow real estate markets to adjust to growing demand more gradually.

Despite this sound picture for 1998, worldwide economic conditions create an uncertain long-term outlook for California real estate. Should a more severe employment slowdown occur, real estate prices in the state could quickly peak, especially in the markets that have seen the most rapid inflation, and vacancies would begin to ease. Because of pent-up demand in many real estate markets, it could take several months to a year before the full effects of any slowdown are felt in California's residential, office and industrial markets.

Cynthia A. Kroll



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