Economic Update

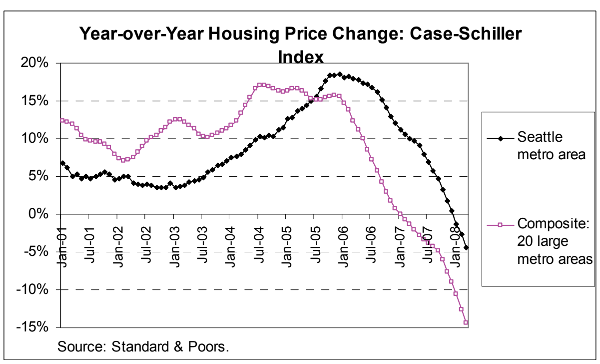
Update on economic issues affecting Seattle's tax revenue performance

The newsletter of the City of Seattle's Economics Team/June 2008

U.S. Economy

The economy, as measured by GDP, has continued to slow; suffering from turmoil in financial and housing markets. In response, the Federal Reserve has opened the credit flood gates, providing liquidity to a wide array of financial institutions that became reluctant to lend to each other as securities tied to mortgages plummeted in value. Financial markets are still dysfunctional however, as evidenced by the number of banks still lining up for emergency funding from the Fed. Recession is very much a possibility, and a number of leading forecasters consider it to already be reality.

The threat to the economy is two-pronged as credit markets remain jittery and housing continues to sag. The housing boom this decade fueled widespread economic gains. Cheap financing enticed many into homeownership. Abundant credit and new demand caused house prices to rise very fast. Homeowners used increased equity to borrow extensively for home improvements, college educations, vacations, etc. fueling growth in GDP.



Boom turned to bust when too many debtors couldn't afford their mortgages, banks tightened credit and house prices popped. The first quarter numbers for the Standard & Poor's/Case-Shiller home price index show that national home prices declined 14.1% from a year earlier. Home prices are now down 17% from their peak in 2006. The consensus among analysts and economists is that there is at least another 10% decline to come as a result of more stringent loan standards and an increase in the number of homes on the market due to foreclosures.

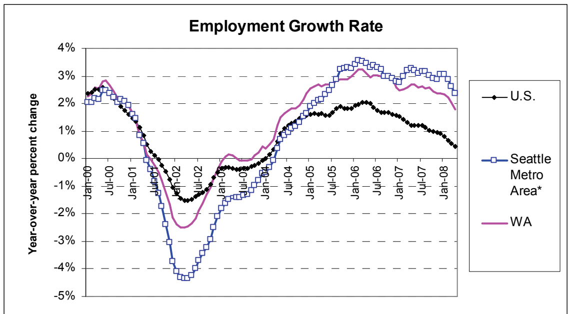
Stress on the economy isn't just coming from financial and housing market disorder. The specter of inflation has arrived by way of increased energy and food prices. Crude oil has recently peaked above $139 a barrel and the average price of a gallon of gas is now $4. Food prices have surged as supplies of corn, wheat, rice, and other staples are outstripped by global demand. Global Insight, an economics firm, has forecast the consumer price index to reach 3.8% in 2008 with risk on the upside.

Currently prices are rising faster for producers than for consumers. The decline in household consumption from the housing bust is dampening pressure on domestic producers and retailers to increase prices, but if energy remains expensive that pressure will become impossible to ignore. There is some positive news however. The dollar has fallen significantly against a broad range of currencies; down some 40% against the Euro from its 2002 highs. This has led to a modest boom in exports which rose 8.1% in 2007 and are expected to do likewise in 2008, propping up GDP.

The threat of a recession caused the Federal Government to quickly put in place a stimulus package worth around $152 billion. The bulk of this, $107 billion, is going out to households in the form of tax rebates and represents over 4% of quarterly consumer spending. The rebates started to go out to taxpayers in late April and will continue into July. Global Insight believes that some 50% of the consumer stimulus will be spent within a year providing a significant boost to spending in the third quarter of this year. They believe that the boost provided by the stimulus in 2008 comes at the expense of growth in 2009 and therefore they expect to see another dip in GDP growth next year.

Puget Sound Region Economy

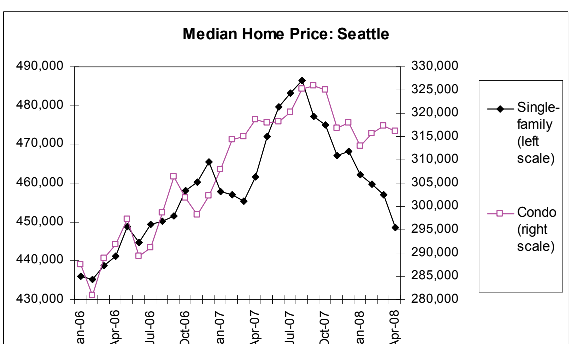
The Puget Sound region remains somewhat insulated from the national upheaval. Job growth remains positive but the rate of growth is slowing. The *Puget Sound Economic Forecaster* (PSEF), published by Dick Conway and Doug Pederson, predicts non-farm employment growth will be 1.6% and 0.6% in 2008 and 2009 respectively, down from 2.8% in 2007. Boeing and Microsoft have provided a lot of this growth, but the growth in their payrolls is slowing. Boeing's employment in the State of Washington now stands around 75,000. The Puget Sound's role as a global shipping center is continuing to benefit from increased U.S. exports. The Seattle area unemployment rate for non-farm payrolls was 3.5% in April, down from 3.7% a month earlier.



*King & Snohomish Co. Data are 3 month moving average of seasonally adjusted non agricultural wage & salary employment. Data adjusted for Sep-05 Boeing strike.

Puget Sound retail sales growth was a strong 7.5% in 2007 led by auto and gasoline sales. PSEF expects that growth to slow to 3.9% this year and settle around 5% by 2010. Taxable retail sales are expected to follow a similar pattern, but with only 2.2% growth in 2008. Personal income growth has been flying high in recent years, 9% and 8% in 2006 and 2007 respectively. PSEF is forecasting some moderation in income growth to 5.7% and 4.7% in the next two years, but still above inflation.

The Puget Sound region and the Northwest are still staying above water in the housing market compared to the national scene. Global Insight however sees the Pacific Northwest as one of the last areas of home price overvaluation and expects a correction of some form to come. Seattle median home prices have come off their summer 2007 highs, both in single-family and condominium homes. Sales have also seen year-over-year declines and Seattle inventories have grown by 60% in April 2008 over April 2007. PSEF has forecast a 33% reduction in the number of Puget Sound housing permits issued in 2008.



Source: NW Multiple Listing Service. Data are 3-month moving average, seasonally

Seattle revenues from excise taxes on real estate transactions reached an all time high in 2007, $71.8 million, a 36% increase over 2006. Commercial sales comprised 48% of those revenues. Construction activity in both commercial and residential markets has been high in recent years. The commercial office market, particularly in downtown Seattle, has been very active and has a healthy vacancy rate of 9%. As a result, office space construction has been busy, especially in the fast developing South Lake Union neighborhood. It is difficult to believe though that the reduction in credit availability and stricter lending terms will not make an impact in the region's construction and real estate activity. Without cheap financing we do expect commercial and residential construction to moderate.

Special Topics: Recession

Seattle tax performance during recessions*

Revenue	Jan '80 - Jul '80	Jul '81 - Nov '82	Jul '90 - Mar '91	Mar '01 - Nov '01
Property	-13.5%	-0.7%	0.4%	3.2%
Sales	-6.5%	-8.0%	-5.0%	-6.3%
B&O	-8.5%	23.7%	-1.0%	-3.0%
REET	N/A	N/A	-13.3%	-18.7%
Utilities	-2.8%	10.2%	-6.8%	14.9%
Total	-6.8%	5.9%	0.0%	1.2%

*yr/yr tax growth rates; first year of recession
Adjusted for inflation

Recession is a word being mentioned more and more these days as the housing market collapses and the credit crunch continues. Some economists now claim the economy is in one. If we are in a period of recession, natural questions are what does this mean for the economy and how does it affect Seattle.

The National Bureau of Economic Research (NBER) collects monthly data on a wide array of statistics including employment, personal income, industrial output, and so on. They use these data to determine the state of the national economy; whether it is in expansion or in recession. When NBER's analysis shows that economic activity has peaked and is diminishing, the economy is considered to be in recession. Because this is determined on a broad range of economic factors, periods of recession have real consequences on Seattle's financial health.

The most recent recession, in 2001, was particularly bruising to Seattle as the busted technology asset bubble closed a number of local businesses and Boeing let go some 30,000 workers peak to trough. Seattle area employment suffered severely and just regained its pre-2001 level. Sales, B&O, and REET taxes are particularly sensitive to recessions (see table) as they are good representations of economic activity. Inflation adjusted sales tax receipts declined on average 6.5% in the first year of the last four recessions. B&O receipts suffered similar fates. If we are in recession the NBER likely won't identify it until late summer. By then Seattle's tax receipts should provide some guidance as to where we are and where we're going.