



## [What's Next LA: The Road to Economic Recovery \(A Preview\)](#)

### **Video interview with David Smith, PhD, Associate Professor of Economics and Christopher Thornberg, Founding Principal of Beacon Economics**

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**Dr. David Smith:** Hello. I'm Dave Smith, associate dean of academic affairs and associate professor of economics at Pepperdine University's Graziadio School of Business and Management.

**Christopher Thornberg:** I'm Chris Thornberg, cofounder of Beacon Economics.

**Dr. David Smith:** Pepperdine University's Graziadio School of Business and Management, Beacon Economics, and the Los Angeles area Chamber of Commerce have joined forces to launch What's Next LA, the Road to Economic Recovery, a new Los Angeles economic forecast conference on July 28 at the Los Angeles Airport Marriott. I'm really pleased here- to be here today with Chris Thornberg from Beacon Economics to talk about top-line thoughts about where the economy's headed. Chris, first why don't you tell us at a top-line level in broad strokes the lay of the land in California economy?

**Christopher Thornberg:** Of course, as we know things are pretty rough out there. You're looking of course at an enormous wave of problems in the housing market. We have seen continued acceleration of defaults on mortgages. Unemployment in this state is up over ten percent. Right now here in Los Angeles County it's above 12%. Clearly, things are very rough and we have yet to really see any signs of substantive recovery.

**Dr. David Smith:** Chris, why is California different than the rest of the nation when it comes to this recession?

**Christopher Thornberg:** Well, there's really two issues that we're facing, and the first of course is the fact that like Arizona and Nevada, Florida this state has really suffered worse from the housing downturn than many other places. When it came to the subprime mortgage market about a third of all of that subprime cash ended up right here in the state of California, and so we're suffering that effect much worse than other places. The other side of things of course is that California is also a very trade-dependent nation. We have an enormous import and export sector both in terms of manufacturing, not to mention transportation, and of course those sectors have been hit very hard in this downturn as well so it's a confluence of A and B that have sort of come together here in California and make us one of the hardest-hit states in the U.S. right now.

**Dr. David Smith:** Thank you. Where do you see inflation and interest rates headed over the short term, over the next year let's say?

**Christopher Thornberg:** That's a huge question. As you know, of course the bond markets are very worried about inflation right now. We've seen a big expansion of sort of that base money supply. Of course, what we know from the historical precedent is that the base money supply increases that we've seen usually typically don't have any kind of inflationary pressures for somewhere on the order of two to two and a half years. What this means of course is the fed does have some room to maneuver hopefully to get that in- those- that inflation rate down before things really start to kick in. However, you got to keep in mind that whether inflation kicks in or whether they start pulling back hard to get rid of inflation in either case you can expect interest rates are going to be rising as soon as the economy starts to recover.

**Dr. David Smith:** What about the banking sector? What do you see happening in both the short and long term with the banking sector?

**Christopher Thornberg:** Well, there's been some changes in the FDIC rules that have allowed banks to really pretend that a lot of those bad assets really aren't nearly as bad, well, as they actually are. In other words, in many ways most of the policies simply allowed the banks to push their problems down the road six months, nine months, 12 months. At some point in time the piper's going to have to be paid and these losses are going to have to be registered, and when that point in time comes I can only think that the federal reserve and the treasury are hoping that the economy's recovered enough that we'll be able to withstand those problems. In the meantime, it's kind of a wait and see game. Things are definitely not fixed by any stretch of the imagination. Of course, in the longer run the big question is what is all this regulation going to look like by the time it gets- passes through Congress. Of course, that's a big issue that the financial industry is really worried about and frankly we all should be worried about.



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**Dr. David Smith:** Yeah. Good point. Let's talk a little bit about residential real estate market. We see home sales on the rise but also mortgage delinquencies seem to be still rising. What do you-- What's important to you in a recovery? What metrics should we be looking at- for when we see signs of recovery?

**Christopher Thornberg:** Well, home sales are obviously a critically important determinant of a housing market that is starting to come to a bottom if nothing else. What it means is the prices have gotten to the point that people are finding affordable again. With prices down you're seeing people moving to the market to snap up those bargains, yet as you point out we have come nowhere close to the end of the problems with the mortgages. In fact, according to the last Mortgage Bankers Association numbers, something on the order of 7-1/2% of all mortgages in California are 60 or more days behind on payment. You can guess that most of those people are eventually going to be foreclosed on so what does this mean? Well, home sales increasing means we're getting close to bottom but all those foreclosures mean we're not going to come off that bottom any time in the near future. I think prices are probably going to stop falling close to the end of this year, but you can bet your bottom dollar that they're going to stay at the bottom probably for two or three years until we really clear out this excess inventory of homes.

**Dr. David Smith:** What about the commercial real estate market? Is that an issue that's potentially lagging where the residential real estate market is right now?

**Christopher Thornberg:** Yeah, that's very traditional. It's funny because residential, commercial, two sides of the same coin and yet they come at completely different parts of the business cycle, residential leads and commercial lags. The problems you saw in residential reflected in commercial. That is to say too much leverage align, too much speculation causing the prices of these commercial buildings to go to levels that didn't make any sense. Now we're seeing the back end of that. There are a lot of investors who are under water. They're in big trouble. Again this is a slow-moving process. The banks have very little incentive to push on the issue very substantially. However, rising vacancies, falling rents means the issue is going to come to a head over the course of the next couple years and it's not pretty.

**Dr. David Smith:** I look forward to hearing more about that at the forecast. How do you see the state and city budget shaping up over the next year or two?

**Christopher Thornberg:** Again a very rough circumstance. Not unlike the economy overall, there's two issues with the state budget situation. The first issue is that we never really got over the structural deficit that formed in the late nineties as a result of that big tech bubble. What happened of course is a little bit of borrowing, a little bit of cheating, a little bit of moving funds around allowed the state to kind of sneak through that period of time without ever coming to true grips with the extent of the problem that was formed in that late nineties period. On top of that, we're having a very nasty cyclical problem because of

the big downturn in the economy. The combination of those two things means there's an enormous budget gap that we're nowhere near fixing at this point in time. And also critical is to understand that even when revenues hit bottom, start to come back up, they're not going to come back up with the speed you would expect in a typical recovery because a lot of this downturn is due to a permanent shift down say in consumer spending due to a big decline in income that was generated off of many of these capital gains, rolling over houses, things like that. You add this all up and it's pretty clear that we have not only a short-run problem but a long-run problem and again we're just not dealing with these issues at the moment.

**Dr. David Smith:** How does the Los Angeles area fit in to the recovery for the state? What industries do you see leading us out of recovery?

**Christopher Thornberg:** Right. Well, California is getting hit very hard this time but this is not 1991. In 1991, we had enormous structural gap in the California and particularly the Los Angeles economy. Aerospace, defense spending was cut dramatically, never really returned. The aerospace industry got up and left, never really returned to the force it was in the eighties. This time around we don't have these kind of structural problems. This time around it's mainly a cyclical issue and very importantly let's think about where California's going to be when we come out of this mess. A, we're going to be a state that suddenly has affordable housing again. No one really appreciates the extent to which that was hurting our economy in 2005 to 2006. Also, over the past decade this nation's been running a very large trade deficit driven by this huge surge in consumer spending. That forced the U.S. dollar to appreciate quite substantially. At the back end of this recession we have to see that trade deficit closing. That means a weaker U.S. dollar and a weak U.S. dollar is fantastic news for California because we are so export intensive. You add those two things up. As rough as this cycle is, I think California and particularly Los Angeles are going to come out of this as a much stronger economy and we're going to see very good growth at the back end of this.

**Dr. David Smith:** So it might take a little bit longer for us to recover but once we're recovered it'll be a stronger, more robust recovery?

**Christopher Thornberg:** Absolutely, harder bottom, bigger bounce.

**Dr. David Smith:** In terms of labor markets, we're aware that unemployment tends to be a lagging indicator of the business cycle so we should continue to see the unemployment rates go up over the coming months. A couple questions here. First of all, where do you see the rates kind of topping out in California and nationwide, and then also for many of our students and- at the Graziadio School and our alumni who are early on in their careers what advice might you have for individuals who are kind of planning their career, planning their start in the work force over the next two or three years?

**Christopher Thornberg:** So what are we seeing? For the U.S. unemployment's going to get to 10-1/2, perhaps 11% although I doubt if it'll get that high, probably more like 10-1/2%. Here in California again we're harder hit. You're probably going to see that unemployment rate get up close to something on the order of 13%, a pretty bad number, no doubt about it, but again as you said that's a lagging indicator. When unemployment stops rising that's good news 'cause it means we're out of the recession and then we just have to wait for it to come down again. Now as for those students who are thinking about getting their career up and going in this kind of environment, I would tell them two things. The first thing is do not get discouraged. When you look at these bad employment numbers you have to understand that it doesn't really reflect your opportunity, the potential to get a job out there. That is to say if you think about the unemployment or employment numbers in any given month we should add about 300,000 jobs per month, but what that means is we add 3 million jobs and get rid of 2.7 million jobs. In a recession it works the other way around. We lose 3 million and we add 2.7 million jobs so there are jobs out there. You can get in. You just got to be a little hard, a little more diligent to go out there and get them. The other thing I would say is that you have to be realistic when you're looking for that job. It's just not 2005. You're going to have to maybe accept some salary cuts. You may go for sort of a lower income than you might otherwise have hoped for. Don't think about that as a downfall. Understand you have a long career. The economy's going to get better and you're going to be able to rise up that income ladder. This could be a great time to go out and do some of those really wonderful resume-enhancing activities such as the Peace Corps or AmeriCorps. Your job opportunities are not as great. That means the cost of having these life-changing experiences is that much lower and as an economist says that means this is a good time to do it.

**Dr. David Smith:** Good advice. Thank you, Chris. Well, that about does it. I'm Dave Smith from the Graziadio School of Business and Management, and it's been a pleasure today to be with Chris Thornberg from Beacon Economics.

**Christopher Thornberg:** Thank you, Dave, and again I'm Chris Thornberg, cofounder of Beacon Economics, and do join us on July 28 at the Los Angeles Airport Marriott Hotel for our first annual forecast conference covering Los Angeles, the state and the nation overall. This will be the first of our annual events that we'll be doing with Pepperdine University, the Los Angeles area Chamber of Commerce, and of course Beacon Economics. We look forward to having many of these in the future covering many of the important business issues that you and your company face every day. For more information go to our web site, [www.beaconecon.com](http://www.beaconecon.com), or go to the Graziadio Business Report. Thank you very much.

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