Dr. Anita Chaudhry: Hi, everyone. Most of you know me, I think. Yes? My name is Anita Chaudhry. I'm an Assistant Professor in the Economics Department, and we are very proud to welcome Bill Watkins from California Lutheran University (CLU) of California. So let me introduce the speaker. So Bill has been the Executive Director of California Lutheran University's Center for Economic Research and Forecasting. He's also an Associate Professor of Economics at that university. They have a new graduate program at the university and we are happy to have him here to speak with our -- some of our motivated undergraduate majors -- about that graduate program. Now prior to CLU, Bill used to be at the University of California, Santa Barbara Project for Economic Forecasting. And he's had a wealth of experience looking at understanding California's economic issues, workforce issues, equity issues, economic development issues. And I think -- I have a feeling you're going to learn a lot from Bill. And here is something I've learned about Bill since he's been here in Chico. He was born in Chico. And he even attended at least a semester at Chico State.

Dr. Bill Watkins: One year.

Dr. Chaudhry: One year?

Dr. Watkins: They didn't invite me back. [Laughter]
Dr. Chaudhry: And he doesn't remember much of what happened that year [Laughter]. So I'll let him expound on that if he wants. Okay, so let's welcome Bill. That's what we'll do.

Dr. Watkins: Okay, great. Good afternoon. Thank you for having me back. It was kind of funny. I -- at that time there was the Vietnam War. This is 1969 - 1970, and if you partied too much you -- you didn't get invited back to university and the military sent you an invitation. And so it turned out to be a bad, bad lifetime decision, but eventually I was able to compensate for it. And one good thing that happened is I met my wife there in the military service.

So in 1297, Marco Polo went to China. And when he got there, he found the most advanced society on Earth. They had by far the largest vessels. They had deep water mining. They had water-driven [inaudible] pieces. They had the logistical capability to deliver hundreds of ships, thousands of men, hundreds of miles in order to engage in warfare and stuff like that. So you fast forward a few hundred years, Gringos show up in China again and China no longer led the world. Not only did they not lead the world, they had regressed. They no longer built ships as large as they had built. They had no idea what to do with deep-water mining – deep-rock mining. They were amazed at the western timepieces, things like that. So something happened there in between. And we're going to talk about that at the very end.
As we start this -- I want to talk first about the topic of sequester. So the Republicans are saying the sequester is nothing, don't worry about it. The Democrats are saying it's the end of the world. And it turns out they're both lying to us. The way to -- one way to think about the spending is between discretionary spending and between mandatory spending, spending that's written into law and which the government has no choice to cover. The sequester only fits in on the discretionary, because it doesn't change any law. And so, while it has a small impact -- this chart shows the difference -- it has a small impact, it's on top of what's happening to discretionary spending. So discretionary spending is things that you think the government should do. Fundamental research, defense, education. All those things. And the mandatory spending is wealth transfers, basically from your generation to mine. And what's happening is as the discretionary spending become a larger and larger component of the federal budget, it is squeezing out all those things that government -- you think government should do, what we really-- most of us really value in government. And so, yes, the impact in terms of total spending is not that big, which the Republicans were right about. But the Democrats also have a point in that it's affecting things that we value. The problem is nobody has the political courage to deal with the politics of fixing the transfer problem -- the inter-generational transfer, the Social Security -- because people in my generation show up to vote at higher rates than you guys do. Plus we have more money to spend on political support. So that's part of that.
Okay, one of the things I'd like to talk about is why it doesn't feel like a recovery. And I get this question all the time. People just go, you know, we're not in a recovery. I don't have a job, or my income's down.
And the reason it doesn't feel like one, people are -- fewer people are working. Even after years of recovery here, we have, after today's report, somewhere close to three million fewer people working than were working at the beginning of the recession. So few of us are working.
And while Gross Product -- you guys remember the definition of a recovery is when GDP is growing, right? But that includes a population component. Once you adjust for the population, our income still isn't back to where it was. Per capita, GDP spending is lower than it was before the recession, even though it's been growing nicely for quite a while.
And then there's – we're poorer. The red line is adjusted for inflation. The yellow line is nominal. And we had the housing flop, and while the stock market is mostly recovered, most people -- well, they don't feel the investment they have. So most middle class Americans that have an investment in the stock market is through some sort of pension plan, something like that. But their house they see, and their house has lost a lot of value and it's still down. And it's starting to come back, but it's still down.
And then this is -- two things to say about this. One, this is the -- well, first I'll describe what it is. This is the percentage of people that are in the labor force, that are looking for work or have jobs. And it's gone way down. Now it's really gone down for two things. One is the economy is slowed, and that's been it. And that's all people talk about. But the fact is, the decline was predicted. It was predicted because the baby boomers are getting older and some of us are going out of work. It's been delayed a little bit by the recession for a lot of them, but the fact is, we expected some of this decline. So this is not all due to the recession, which is what it's typically chalked up to.
Then we have, you know, sort of this persistent budget problem. It's really gotten better over the past few years. I remember, what was it two years ago, 2010, the budget deficit was 10% of Gross Product. And that's the way to measure it. When people talk about trillions or billions, don't even think about that because that makes no sense. The best way to think about the budget is either on a real per capita basis, how much you're spending in real terms on a person, or as a percentage of Gross Product. The two best ways to think about it. And it was 10% of Gross Product. It has been brought down to 5%, about 5% of Gross Product right now. And that's a huge improvement, because 10% is actually bigger than the sum of what we spend on Defense and Social Security. So we spend about 4.5% of Gross Product on Defense and about 5.5% of Gross Product on Social Security. So that was looking like a real big problem. The fact is we've worked it down. So again, we have this problem in Washington where, you know, Democrats are saying -- they're bringing it down, and that's absolutely right. It is coming down. Republicans are saying the nominal is going up. Well, it is, too. Sure. Both of them happen.
But once we normalize -- and normalization is a key part of my job is to help people see the right way to do it. So now it's out there and we already talked about that.
This is a big problem. It's this squeezing out that the Social Security and Medicare -- increasingly it's Medicare -- what it's doing to all the other things is something that's going to take a while. And the R&D crash is because when the government is cutting back all these things, because they want to keep sending checks to old people. So they're doing that.
Okay, so how do you fix the budget? One; you absolutely have to deal with the Social Security - Medicare issues somehow. And -- but the easy case is right now, what happens is the Republicans want to go out and cut spending, and the Democrats want to raise taxes and neither one is going to do any good for us I don't think. What happens when you cut spending? Have you guys seen what's going on in Europe? What went on in Wisconsin a few years ago? Everywhere that democracies try to cut spending, it's like a prescription for social chaos. People protest. They riot. They get mad. And it's just too hard to cut spending, so I wouldn't even try that. At the same time, I personally believe that government as a percentage of Gross Product probably too high. And so I'm not anxious to increase taxes because -- we'll be talking about crowding out a little bit later. And so, the way to do it, I think. is to cap it on a real per capita basis, so there are no losers the first state. Just cap it - - real per capita basis. And then roll the economy. Institute a bunch of plans-- policies that would allow the economy to grow faster than the rate of inflation plus population growth. That make sense? Yeah? All right, fix the budget.
Another thing that's just phenomenal about this recovery is the difference between Wall Street and Main Street. Wall Street is doing pretty good. We're hitting records on a daily basis right now in terms of stock valuation. Big businesses are doing well. And there's a few reasons that small businesses aren't. And what you need to -- there's a standard sort of inherited wisdom in economics that small business creates most jobs. And that's slightly wrong. What it is, is new businesses create most jobs. And there's a high correlation between being new and small, but at the same time, recognize there is a difference. So a new business has started off and they're small, and so why isn't small business?

One, it turns out that small business people own a lot more real estate than the rest of us. So I'm going to show you a chart a little later that shows about 65% of Americans own the home they live in. For business people, it's over 90%. And more than half of them own a second piece of property. They own a lot of real estate. So if you think of before the recession, their balance sheet was the right way they wanted it. So they had assets and liabilities, whatever they were. And some sort of liability to equity ratio that they were happy with. When the value of all their assets went down, and at the time of the recession, real estate prices went down, as did the stock market at that time. And a lot of securities-- the value of other non-stock type securities went down. Dead instruments. And so these people all of a sudden were over-leveraged. So if they were property-leveraged, they became over-leveraged. And given how slow it's taken for real estate to recover, they're still over-leveraged.
Another thing that happened was the continuing consolidation of banking. So I was a banker for 20 years before I went back to grad school, and during that time I sort of lamented. During my time, I think we went from over 14,000 banks to less than -- fewer than 10,000, and it's still continuing. I think we're down to fewer than 6,000 now. The problem is, small banks loan to small businesses. If you're a small business and you want a loan, you don't go to Bank of America or Wells Fargo, okay? They're just not going to help you. You go to your local -- there used to be a very good bank here locally, Tri-Counties. I don't know if they're still any good -- they're still in existence. Good local bank in the days I was in banking. So that's happening. Another thing that's happened is sort of the changing in culture.

So when I started out in the banking business back in the Ice Ages, only men owned businesses, and when the man came to borrow for his business, we would suggest the possibility of using their house as collateral, and they would explain what their wives would do to them if they did that. And so we gave that up. And so we did a type of lending called "asset-based lending." We used receivables, inventory, and other assets to loan on.
Over time, that's changed. So now, somebody goes into a bank, odds are better than half, 50% chance it's a woman that goes into a bank, and she's perfectly willing to use her house as collateral, and the husband's going to do exactly as he's told. Well, if there's no real estate equity, that model doesn't work anymore, right? We need to go back to the asset-based type lending, and in fact we're seeing it. You'll occasionally hear advertisements for some sort of lender -- non-bank lender making loans on receivables and stuff like that for big business. I think that needs to accelerate if we're going to get them back into it.

The final thing that's really effecting it is the regulatory environment has changed a lot over than past 20 years. And I sort of mark -- business people have been complaining about regulation for as long as there has been at least one regulation for business people. I remember my grandfather who had a business here locally back in the '60s complaining that if the regulation -- regulatory environment was as bad as it was then when he started his business, he'd have never done it. You hear people say that every day. The fact is it is becoming increasing onerous, and particularly Sarbanes-Oxley. And again, this is a-- both parties claim to be against regulation. Both parties claim to be against debt and all this stuff, but when they're in power, they do.
So Sarbanes-Oxley was passed during the Bush administration in response to the Exxon crisis. You guys remember the -- were you alive when they had the Exxon crisis? No, I don't think so. What was that in 2000 -- 1990 - 2000 -- somewhere around there. In any event, the point on that crisis was that everybody who did something wrong went to jail except for one guy who died before we could put him in jail, and that really irritated a lot of people. And the point is, the law was in affect already that you need. But Congress felt they needed to do something and so they passed this Sarbanes Oxley which increases the cost of small, publicly-traded businesses quite a bit. And made the process of becoming public more difficult. And then -- since then we've had Dodd-Frank.

And right now the administration is issuing a large number of proposed regulations for comments and stuff like that. And that uncertainty slows everybody down a little bit. But what it really does is, you think about the cost of the regulatory compliance. A big business can allocate it over a larger sales base, or a larger asset base, whatever it is, whereas a small business, it's much harder. So the effect of increasing regulation is to tilt the playing field slightly toward big business, and I think that's yet another reason we've seen business come in slowly.
Okay, here's the question I finally figured out. I've been asking this question -- why are you guys borrowing? We are shoving a huge amount of debt on you on a daily basis, okay? Your generation is just watching debt stack up. So then you go out and you borrow -- well, not you necessarily, but young people are borrowing an awful lot of money for education loans. The return on that is really high and it's probably worthwhile, but it has all sorts of effects. And I think I've figured it out. Your entire life, everybody that's over-indebted themselves has been bailed out by somebody so you think somehow somebody's going to bail you out. Okay? And I don't know about that one. That's a tough bet.
Okay, so the minimum wage increase that's being proposed right now to increase the minimum wage. You guys have all seen the economic chart, right, where, what it does. A few weeks ago, maybe a week ago, two weeks ago. A couple -- when it was first proposed - - a couple of other California forecasters, Jim Thornberry [assumed spelling] at Beacon and Steve Levee [assumed spelling] who works down in the Bay Area, were asked about the minimum wage law. And they said, "Well, the impact's going to be pretty small." And they're right. But I think that's the wrong question. And in fact, I think I've got a piece out in the Orange County Register today saying that's the wrong question, because who loses when you increase the minimum wage? Who's the loser? Yes, sir?

Audience member: [Inaudible response].

Dr. Watkins: Not exactly. Who loses their job?

Audience member: [Inaudible response].

Dr. Watkins: Somebody earning the minimum wage. And the odds are they are young and minority. Okay, the unemployment rate for young black men is well over 30% right now. Maybe pushing 50%. My point is -- and so what happens? These are at-risk populations, right? And if -- and the best single social program is a job.
And if you -- they don't have a job, you're pushing them back on the street and you increase the probability that they're going to be involved in drugs, end up in crime, perhaps prison, you name it. And my point is, why would you do that to somebody? Keep the minimum wage. They're willing to work for that wage. We can backfill. And that's the second thing. Well, you know, we'll get to that again. We will be discussing minimum wage again a little bit later.
Okay, so let's talk about the forecast for the United States. And did -- is everybody aware of the data -- that job data came out today? I know you're not because students aren't. You are, so we got a great jobs data report today. 236,000 jobs came out or were created last month. This is on a seasonally-adjusted basis -- some economists are arguing about the seasonally-adjusted process. This great report, and 60,000 more than our forecast was, which is -- over the past four years, our forecast on jobs has been remarkably accurate. We missed this one big time, and we're still trying to figure out why.
So our forecast is slow growth, up to 3%. So the long-term average U.S. GDP growth is somewhere around three, three and a quarter. We look to get that eventually. The jobs data that came out today may make this slightly more attractive.
Our jobs forecast after today's data point is low, so it'd be nice to see a little bit of gain. But the problem is, even at 239, I don't think anybody expects it to stay at over 200,000 over the next couple of months or through the rest of the year. That's not enough to drive down the unemployment rate by itself. So we need about 250,000. And even today's data that came out -- 300,000 people left the workforce. So while we created 236,000, another 300,000 left the workforce. Now some of those are retirees. That's fine. But also some number of them are discouraged workers. And one of the things that's really worrisome about this recovery is that discouraged worker cohort, because businesses when they're advertising now for jobs, are already saying, if you don't have a job, don't bother [chuckle] to call us. And so these people are going to have a hard time. And some of its structural, and we'll talk about that a little bit later.
Unemployment rate declining slowly. We don't show it getting down the fed's target rate. So the fed has a target rate, right, of 6.5%, and they're saying they're going to keep doing extraordinary measures until we get to that. We don't see that in our two-year forecast horizon.
And then talk about some of the data and the technologies. So, Jimmy over there, my son, is playing on a tablet. And one day I needed a new drum machine because I play guitar and it occurred to me, maybe there's an app for that. And I went online and I bought a drum machine for $2.99, okay? [Laughter]. Now, if I go to Guitar Center, it's going to cost me $300 for that. So there was -- as far as the GDP, though, it just measures the transaction value, right? I'm as happy with the $2.99 one because I'd been willing to pay the 300. I saved some money. I get this. And so GDP doesn't show the same pop. So -- and then I got really excited, so I downloaded a metronome and a tuner and got each of those for free and neither comes with an app. And there's no impact on GDP as we measure it that way, right? And so in some sense, I'm pretty sure GDP's being measured low in terms of the improvement. We're getting more than it says.
Then the other thing, there's a book out -- oh, Brynjolfsson -- I can't even pronounce his name. Brynjolfsson. I think he's from Sweden, but he's at MIT these days, and he's got a co-author, and it's "Race Against the Machine." And they're worried about structural unemployment because of the machine taking away people's jobs, okay? People have been worried about this for centuries, and so far it's never occurred, right? There's a possibility though. So who lost the Industrial Revolution? Who was -- well, not who, what was the big loser in the Industrial Revolution? Horses. Before the Industrial Revolution, there were about 11 people for a horse in Europe. And for every horse, 11 people. And horses did all the agricultural work. They did a lot of the transportation. They drove whatever manufacturing was happening, that sort of thing. And now it's over 100 people in the United States for a horse, right? And the horse is a very expensive pet for people who have lots of money to deal with them. So it's possible that we could have some structural unemployment because maybe -- because up until now at least, even the least skilled human could do something machines couldn't do, and they were valuable without uses for them. Now it's possible with Artificial Intelligence increasing, they might put some of these people out of work. We're worried about that. But the demographics, what this means is if the machines are -- they're going to help you guys pay my Social Security, okay? This helps you. And so, while these guys worry about it, I'm looking at this technology as an ability to generate huge productivity increases. That is, output growth per worker. So I hope to see that.
Horses and the minimum wage. This is one to talk about. Okay, if a machine puts somebody out of work that tells us one thing that's valuable, there's still some marginal -- positive marginal productivity out of the human being, right? So -- or else they wouldn't be put out of work by a machine. So there's some value. And if you also notice that across the world, societies that have everything provided for them are really strange societies. Huge amounts of drug abuse, crime is high, relationships tend to be very short, very temporary. Out-of-wedlock births are very high, health is bad. There's all sorts of negative things because it turns out that jobs do something for people that we have a hard time measuring. And so, you know, when your utility functions in class, they put leisure, and consumption, right? Well, people that have unlimited leisure and a certain amount of consumption provided for them still don't have something. There's something that a job gives you. And so there's something wrong with that utility function. But that's another problem.
So my proposal is, instead of doing -- increasing the minimum wage, we drop it to zero and back fill it with something like the Earned Income Tax Credit, so that the person is willing to go to work at say $2 an hour. They have a job. They have a reason to get up every morning, someplace to go, the pride to have it, and you're going to take care of them either way. If they don't have a job, the government's going to support them, and probably they're going to be more expensive because they have too much time on their hands. You're better to let go with the market wage and then through some sort of negative tax, Earned Income Credit, something like that, get them up to an income level that we're willing to observe. So that's my proposal there. It's going nowhere [Laughter].
Okay, how to grow the economy. First, regardless of what your political opinions are, I'm going to say at least something that you're not going to like here, okay? Because nobody likes my program.
Okay, the first thing is an increase in immigration. Big increase in immigration. Now when I first started saying this, I got nasty emails. People are starting to understand, though. Okay, so a couple of things. If the problem is that we have too few workers per retiree. So right now-- I think when Social Security was started, it was something like 16 workers per retiree. It's been steadily declining. I think maybe to six or 7% now and projected to go down to 3%. You don't want to pay that as a worker. Why not bring in some more workers? Just bring them in? And so, one, is bring them in.

And second, note that immigrants are different, okay? It's not like somebody closes their eyes, reaches into France, and grabs out a crazy Frenchman, okay? What happens is, these people self-select, right? People choose to go. And so there's a difference between that Frenchman that left the 500 family home in the village where his family has lived for the last several hundred years, learn a new language, a new culture and do something like that. So immigrants are a big addition, and-- to the economy in that way. Another thing is they start businesses at a far higher rate. And so -- at a higher rate than people who were born here. So, usually a little bit of trivia for you to take home to your family. What nationality starts jobs at the highest rate in the United States? Anybody have any clue? I'm sure you do.

**Audience member:** [Inaudible response].
Dr. Watkins: Starts businesses. Starts their own business, entrepreneurship. Turns out to be Greeks. And my answer to that is that the Greek regulatory environment may be the worst in the world, and after Greece, even California is easy, okay? And so they come and they start businesses. Now I've got “legal” up there, and that's mostly to cut down the number of emails I get. As far as I'm concerned, anybody that wants to come, they gain, we gain. The research shows that even the lowest-skilled workers on that tend to be a small positive to the economy. So the worst case is they're all good, and so I'm a big supporter of immigration.
Oh, one more last thing. What happens when they get here? So say that French person flies into New York. What are they going to do first thing? Get a hotel, right? Got to have a hotel. They're going to start looking for a house, and our problem has been housing, right, and the low demand. So, nice help there. Better -- excuse me -- get rid of some of this bad regulation we've been doing.
And then crowding out. So in your class, I'm sure you've heard stories about crowding out and the economics of government crowding out. Usually it's given as a full employment phenomenon. And I think -- I'm not positive -- and if any of the professors here want to talk about it afterwards, I'm happy to. I think we've actually seen a natural experiment in it. So, think of your International Trade class. If you're -- if a country's going to run a trade surplus with another country, what do they have to do? They have to buy something. They have to make some sort of an investment, right? And what the Chinese have been doing, because we've been very cooperative, is they've been buying low-risk treasury securities because we've been creating them by the trillions, literally. And -- but what happens -- what would happen if that government debt wouldn't have existed? And the Chinese -- the Chinese, for a lot of reasons they have to have a trade surplus. They have a population that's very young, that's going under this mass migration that every industrialized country has gone from rural to urban. And they've got the added problem is that they've got a huge imbalance between men and women. Way too many men. And an unemployed young man without a girlfriend is just bad news for politicians, okay? And so they've deliberately chosen to keep their currency low to generate a trade surplus. Basically, they've been having us employ Chinese. And to do that, they -- like I say, they have to buy something. If the treasuries weren't there to buy, they would have had to buy houses, stocks, debts of company, something else that would have been productive. So I think we've actually seen a natural experiment in crowding out here there.
Develop domestic energy. So right now, we're -- so we'll step back. September of 2008. I think it was the day Lehman Brothers collapsed, I had to give a forecast, and I knew it was junk because Lehman Brothers had collapsed, and the way I interpreted that was a regime shift. We had gone from a good equilibrium to a bad equilibrium, and we don't know how to predict those or change them again. And we'll go through that a little slower. Okay, think of the bank. A bank is just great. Everybody goes in and makes their deposits, their withdrawals, get their loans. It -- does business. But if there's a rumor that the bank is going to fail, you generate a run. There doesn't have to be anything real. Nothing real has to change. And nobody wants to be the last person in line. Even when there's deposit insurance. A few years ago in late 2008, early 2009, I can't remember the name of the bank -- bank failed, people were still lining up. The FDIC had already gave assurances they were going to cover all the deposits. But still people were lining up. Well, that's what happened to sort of the world's financial situation. There was a run. We switched to a bad equilibrium. I knew that. And so I had to go on TV and say we have a bad forecast and make the best of a bad day.

But today, we're starting. We've been talking now for a couple of weeks, three weeks, about it might be time for us to change our models again. So as a result of that, we changed our models to try to build in what the impact of the new world, particularly we looked at home ownership rates. And so now we're thinking about it. You know, our forecast was for relatively slow growth, right?
We've seen two big things happen in the past few months -- very, very recent. Well, one in the past few months. One has been developing for years. The energy's been developing. It's the amount and quantities of recoverable oil, carbon-based, is huge in the United States. And huge in California. So the people are suddenly aware of the vulcan shield.

It's the shale oil probably in North Dakota. And so Minot, North Dakota. Anybody know where Minot, North Dakota is? Yeah? You can see Canada from there. When I was in the Air Force, it was the second worst place you could be sent in the world. And by far the worst place in the world where they didn't shoot at you. And it's cold. It's -- there's just no reason to ever want to go to Minot. Apologies if you like it [Laughter]. I hear the pheasant hunting's pretty good up there though. Minot, North Dakota is a town of about 40,000 people. Right now, it has, last I heard, 15-17,000 job openings. It's booming because of the vulcan shield. And North Dakota has an unemployment rate very close to 3%.
But California's Monterrey Shield, they think has about four times the reserves. The government -- federal government estimates four times the reserves. So there's a lot of that floating around. The other thing that's happened more recently is the real estate market has clearly turned around. And that is building up people's wealth. We're seeing increasing demand and an awful lot of those small businesses that aren't participating in the recovery are in the construction business one way or another. So, if we were to have an oil boom and a real recovery in real estate, then we could generate, you know, four and a half some quarters, perhaps even higher GDP.
So taxes, I don't care what the tax rate is. If you've got the rest of the stuff right, the tax rate, within the range that we typically discuss in the United States, I don't care. So you know, we argue about very small changes, but I think that the regulatory environment and the loss of wealth is probably affecting us more than the tax rate, so I don't worry about the arguments in D.C. about tax rates.
So, what could go wrong?

[ Laughter ]

So, the Euro. Now, the Eurozone, in my estimation, is destined to fall apart, because, and some of you may have had an International class where you discussed some of the things, the ideas that what makes an optimal currency zone, and you would have talked about how country's economies are fairly similar, pretty diversified, have similar fiscal policies, stuff like that. They're pretty similar.

But the fact is that there's a big difference between Norway and Greece. And it's getting bigger by the day. And so if there's a break up or if there's a major default -- step back, one thing. Greek -- not Greek banks. All banks in Europe are regulated in one way that's pertinent to this discussion, is that they don't have to have reserves for loans to governments. So if they make a governmental loan, that's considered risk-free. So they've got a big exposure into that, and it doesn't matter whether it's Germany, France, or Greece. Whoever you make the loan to, no reserves. And so that's a big exposure.
If a country defaults, that's going to be coming out of bank equity and that could cause bank failures. And more likely what's going to happen is the European Central Bank is going to bail them out. So there's that. But -- or the currency falls apart. Either way, you're probably generate a financial crisis. And two years ago, when we did some simulations, if they had a financial crisis about the same as ours was in 2008, we expect that impact of the United States to be about a third as bad as what we saw in 2008. So that's probably gone down. I know that mutual funds, banks, all financial institutions are doing their best to reduce their exposure to the Eurozone, so that's going on at the same time.

Then of course there's the Middle East. By most people's models, if you shut off the supply of oil from the Middle East, you generate a recession pretty much that day, and so we worry about that. So too big things that could go wrong. So that's it. Back to the forecast.
So, California's forecast.
First this is a Taylor Coldwell quote: “If they can't do it in California, it can't be done anywhere.” And when I was your age, that still was the case.
But since then, an example I've been giving is this. This is the Miramar Hotel, which is Montecito, California. It shut down for a nine-month remodel in -- no, an 18-month remodel in September 2000 -- 2000. It's -- recently, this is what it looked like a few weeks ago. It's [inaudible], not that one, upper right. It's been bulldozed. But the problem is that has been a battle. In California, everything -- in fact, in Southern California, the newspapers routinely describe projects as a “controversial project.” Well, in Southern California, controversial project is redundant. Just drop the controversial. So things take a lot longer than they do.
California's become a smaller player in the U.S. economy, so we've got about 12% of the U.S. population in 1990. Over 11% of the jobs. We suffered big time with the defense industry downsizing. California paid the peace dividend and -- but, you know, the defense industry's rebounded in several places. Not California. Climbed up with the .com boom, but even then the housing boom didn't gain much on net, if anything. And then we suffered in the recession again. So California's a challenge.
We've also almost achieved zero population growth; which again, when I was your age, was impossible to imagine.
These are net migration figures including international. So domestic migration -- the migration between other states and California has been negative according to the Census Bureau for 20 consecutive years. Again, that's a first. It started 20 years ago and it never happened before that. International immigration has gone way down over recent years, and a couple of reasons for that. One, in Mexico, the unemployment rate is about 5% as opposed to almost 10% here in California. The cost of going across the border has become much higher. Just a few years ago, it was $3,000. It is now $6,000, plus it's controlled by drug gangs. You have to carry drugs across if you want a coyote to bring you across. So the cost has gone up and the risk has gone way up. And in fact, the harvesters in my neighborhood, they -- strawberries is the big crop there -- at the end of the season last year, they asked them if they'd come back and lots of them said they weren't. And that's one reason that explains the fact that there's now strawberry picking machines built in Spain. It's been demonstrated here in the Watsonville area, and you can get a video, I think it's on the web page, or on YouTube someplace. It was sent to me. But you know, declining.
And our birth rate's gone way down. California -- you know, kids -- Californians just aren't having that many babies anymore.
And so there's zero population growth. What about it? One, unless there is a huge increase in productivity, if you go from a transformation from a growing economy, growing population to a declining population, one generation has to suffer a lower standard of living. It's just the math. And that's going to be the first time in the United States that's ever happened. You know, every generation has had higher consumption than the generation before, so that's one concern. The other concern is that, you know --people are valuable whether you like them or not. And yeah, you know, its people that come up with the great ideas of doing great things for the future. And finally, we'll get to it a little bit later, so those are the two things. I think zero population growth is something to be very concerned about.
So what's California look like in the long run? So the domestic migration is negative, but you've got to think about who's leaving. You guys are leaving. It's the reason I go to New York to see my grandkids. I got to Oregon to see my daughter. Young people, as they form families, are the people who are leaving California. And they're going to places like Texas or Oklahoma and stuff like that. And so that creates something that I think is kind of weird.
One is there's the state itself. In general, coastal California from -- oh, just north of the Bay area down to San Diego is a region of relative prosperity. And in fact, a few weeks ago, there was an investment advisor had a column out said that -- he described space. He said, if you have a home in a -- in what he called a failed state, and the two leading examples are Illinois and California, then you want to sell it because it's a bad investment. The price will decline. You know, that's true in Detroit, but it's not true in Monterrey. You don't have to have any jobs in Monterrey. House prices are going to be high because there's a certain amount of wealth in the world. It's a national or it's a global market rather than a market that's dependent on the local economy. So that -- inland though, is a separate area. We have -- inland, you guys have seen the valley from here to Bakersfield except for a little bit of prosperity around Bakersfield because of oil. You know, the Central Valley is suffering. San Bernardino is not only bankrupt, but according to the New York Times, you can buy a house there for $50,000 and who'd have thought in California. Imperial County typically has the highest unemployment rate in the United States. Part of that is that the unreal unemployment rate is not near as high as it is there. It turns out doing illegal things are working in Mexicali. There's big business there. So those jobs are not reported.
And then bi-modal distribution. So who's buying those homes in Monterrey. It's not me. It's not you. It's rich people from almost anywhere, right? And so a bunch of rich people and then if there's no real jobs being created, who's -- what other jobs are there. Take care of rich people, right? I know a person who gets paid $100 an hour to take rich people in Santa Barbara for a walk, okay? He has to walk slow, gets paid $100 an hour for doing that. In Santa Barbara, if you take your dog to the doggie daycare center, they will have an online camera. You can watch your happy dog and they'll give you a report at the end of the day telling you how well your dog plays with the other dogs. I mean, you know, taking care of rich people is big business in coastal California.
And then the older rich -- the richer old -- whatever -- older, and sort of the young poor. And so this is a society that to me looks very, very strange, right? And a society that I really don't think we want to see.
And then Dan Walters, who I highly recommend you read him. He's got a daily column -- I think, weekly column. A weekly column, but a daily blog at Sacramento Bee. Are you guys aware of the fight over education right now that's going on? So what's happening is they want to take money away from rich schools and give it to poorer school so that when you got done, the poorer schools would have about 50% more spending per student than the rich schools. The big gainer on this is the LA Unified School District. And Dan Walters says "This is the first of the bout rounds of a series of class warfare sort of political fight that we can expect to see going forward." So that.
And then there's venture capital. So, the one area and one sector in California that's been doing really well, month after month, quarter after quarter, has been tech in the San Jose area. A couple of counties in the Bay Area have been doing really, really well. And until very recently, I was convinced that that was a persistent infrastructure for California that would give us a persistent boost. And the reason is that venture capitalists, particularly the first stage, want to be within 15 minutes of their investment. And so I got a chance to talk -- a guy was setting up with a venture capital, a branch off of one of the big ones in Santa Barbara because of UC there. And I said, well, what about Cal Poly? “Too far away.” San Luis Obispo was I don't know, an hour and a half drive. Needs to be close.

The other thing, but what's happening is that business is changing. Instead of designing things, people are designing apps and software programs and so the initial investment is becoming much, much smaller. Where it used to be that first stage would be a few million, it's now becoming a few hundred thousand. And you don't need all the support. So when you build a factory, you need a logistics team, a manufacturing team. You need a big team. And what you're doing now, it needs a much smaller team, much smaller investment, which means that venture capitalists can take more risk, they've got it spread out over more investments. But it also means that it can be done more and more places. So for instance, anybody know where Bend, Oregon, is? Yeah, sort of nowhere, right? Like Chico, you can't fly there. Not cheaply, anyway.
There's been a thing called "an accelerator," and there's a series of -- there's a way to take an idea from an idea into a company relative ready for first-stage venture capital. And there's one being set up there by a serial entrepreneur from the Silicon Valley. This guy has started two businesses and then ran three venture funds and is now doing -- this guy knows what he's doing, very well connected. The money for his accelerator and funding he's establishing there is all coming from the Silicon Valley. So I worry a little bit about the strength if that could be a structural change that weakens California. Okay, so we talked about that.
What's the forecast?
We’re looking at, in general, slower output growth in California than in the nation. And -- although occasionally it will be bigger, because we, you know, sometimes have some big pops in the tech sector.
Weaker job growth. And again that's concentrated mostly along the coast, from San Francisco on South.
And then inland, you know, we've seen -- even during the boom, unemployment rates were double-digit in many communities in the Central Valley and up in northern, you know, Modoc County and some of those.
So we are number one in one thing -- California has the highest percentage of its population receiving welfare of any state in the nation, which was unimaginable to me when I was your age.
So how do we change California's forecast?
One problem is that we -- so many people in Sacramento deny that there's a problem. I got a chance to visit with Craig Barrett the other day. Craig Barrett is former Chief Executive Officer for Intel. And he told me that he had four governors, both parties, say it doesn't matter what we do in California, it'll always bounce back. It'll always bounce back. And that seems to be the persistent view in Sacramento. And California does have some advantages. We're on the Pacific Rim. We have a climate that, you know, is a hell of a lot better than Minot, North Dakota's. We have a population that migrated here. Our productivity's higher. Once you adjust for capital industry composition, everything -- education, everything we can adjust for, according to the San Francisco Fed, California is about 2% more productive than the national average. So we've got out advantages. We don't have to have the same tax structure as Texas. But it's possible to price yourself so high that it becomes a problem.
Okay, so mining. I could do that. We're standing there on oil, a bunch of it.
And then there's environmental policy. So this think globally, act locally has been around a long time. In fact, I was here at Cal State Chico on the first Earth Day and we shut down First Street and it's been shut down ever since. I also got my picture on the front page of the local paper and my dad stopped sending me money [Laughter]. So, it was bad. Carbon is not a local pollutant. You put some carbon out, it drifts all over the world, okay? That's one thing. The next thing is that California is the most carbon-efficient economy in the world. To reduce carbon output in California costs a lot of money, okay? Third thing is that if you got rid of all the carbon that's emitted in California, including the critters that were here when people got here, in a year and a half, you couldn't tell it in the world data, because of the increase in China's emissions -- China's emissions. So what California's doing is trying to reduce carbon output when we're already very efficient, and killing our economy in the process when what we should do is figure out how much that's costing us, tax ourselves half of it and go fix China and fix their plants for free. You know, the reason the Kyoto agreement fell apart was because the western countries weren't willing to see the eastern countries increase their output. And the eastern countries, you know, the less developed countries have an argument. And so it seems to me an easy way to do it -- the cheap way to do it, is just go fix their factories for them. You know, wouldn't cost that much. So, but in the meantime, what we're doing here is particularly onerous.
Regulation, I talked about that.
Another problem that's happened to regulation -- am I going overtime here?

>> [Inaudible response].

Dr. Watkins: Okay, I'll -- I'm wrapping up. One more slide. The way regulation is done now is that the politician who's going to be turned out anyway in two years says "I'd like these goals" and then it's designated to other people. And these people don't have any -- it's delegated to other people. And those people are there no matter who's in office, okay? They are the ones that really run Sacramento. And so I would think the politicians should take more ownership of the process rather than delegating.
And then, one last plug. I'm writing a book called “DURT.” What costs businesses is Delay, Uncertainty, Regulation, and Taxes. And taxes is the last, okay? So delay and uncertainty are something that local governments can do and they're something that really, really are costly for small businesses.
So then back to China. What happened in China? China built itself the biggest bureaucracy the world’s ever seen I think. And so young people get out in the world who want to change the world. And in China that meant you either work for the bureaucracy, you lobby the bureaucracy, or you fight the bureaucracy. And increasingly, that's becoming the way it is in the United States. My son is a very bright guy. Went to Madison for grad school as bio-chem. And he makes his living by designing the strategy to get drugs approved. And so this includes the testing strategy and the marketing strategy, to work with the people who approve the drugs. And he makes, you know, apparently pretty good money. He's got a house that's a lot bigger than mine, a bunch of land that's bigger than mine, and even buys dinner nowadays once in a while. So you know, and it's more and more. In banking industry, which is something I know quite well, the safest job in the bank the compliance officer. And the -- in fact, nowadays, it's compliance teams. And so, you know, the sucking up kind of talent. So instead of building something, my son should be doing something. Designing drugs instead of testing for them. But there he is. And it was easier than, you know, the other work. And so I think that that's one of the stories that some -- that some lessons that we can learn from China is that you get that bureaucracy and that's where all the effort is spent and that's where -- and it sucks up the bigger of the rest of the economy.
So that's that. And I can take some questions. So thank you very much.

[ Applause ]

**Audience member**: When do you think unemployment will get to 6.5% again?

**Dr. Watkins**: Well, when does unemployment get to 6.5? Given the new data, we'll probably be able to raise our forecast a little forward, but I think we were looking at 2016 and 2017. In California, in Los Angeles, we did some work for scag(?) -- and it’s 2018. In fact, there were several firms who did it and all -- everybody's forecast was somewhere around 2018 for Los Angeles to get back to the same number of jobs they had before. I mean, you know, so California’s lagging quite a bit. The new jobs data, you know, that was a big pop. Let's see if it keeps up because it was a lot higher than anybody thought. Yes, sir?

**Audience member**: [Inaudible] U.S. economy is [inaudible]?
Dr. Watkins: Okay. So what's the impact? You're worried about inflation, right? Okay, and in your class, you've been -- you've done this recently, a lot better than most of my audiences. You sat there and learned about how money is created that puts money in the bank and they take it out and they loan it and they put money in the bank and you get that multiplier, one over the reserve rate, right? It requires bank lending. And there hasn't been any.

And so the question really is, when do the banks start lending? And that's the problem. When does the Fed start having tighten up in order to do that? Now they think that they've got a handle on it. Okay? My observation is that the Fed, typically, at least since Volker, has reacted too late and too slow. And if they do that, then we can expect a batch of inflation.

You know -- their new tool is the ability to pay interest on excess reserves at the bank, that the banks keep at the Fed. So it used to be, you know, nobody kept any more than they had to because it got zero interest, but there was a minimum requirement. Now, there's over a trillion on deposit at the Fed that banks aren't lending that I think they're getting a quarter percent these days on it. And so they can slow down the acceleration of bank lending using that, and of course all their other interest rate tools and discount and what have you.

But the other thing that would affect it is the bank regulation, and there's two stories here. One is the regulators are -- have become much more difficult for the banks to deal with. Although, I have to tell you I've recently been hearing stories, and this happens.
Every cycle, after recession, banks forget the lessons they had before and they start making stupid loans. And there's some rumors out there that they may be making some stupid loans already again, which is just mind-boggling. But you know, when you give a guy an incentive to grow the portfolio and increase the interest spread and you don't worry about, you know, what happens to loans for you down the road, you might have a bad incentive system. But so the risk of it's there, but, boy, predicting the timing.

You know, we don't show it getting down to 6.5% within the next two years. That's our forecast horizon. When we took over the forecast project at UC Santa Barbara, they were forecasting five years. A five-year forecast is a dream, okay? And we just say we're not going to do that. You know, we don't do long term forecasts. So, yeah?

**Audience member:** [Inaudible].

**Dr. Watkins:** [Inaudible]. Okay, so Dan and I have a great relationship. He works and I talk, okay? And he does all the modeling. He's a fantastic modeler. We talk about it. It's like on the drive up here yesterday, we're talking about making some changes because we're starting to see some action, we need to put real estate back into it, because it's going to have some impact. We're talking about how to do that. So I have a little bit, but Dan's the guy.
Audience member: [Inaudible response].

Dr. Watkins: We created these models when we came over from UC. So we were very careful about not taking any intellectual property, and the models that we had at UC were UC's. And it was kind of perfect for us because we wanted to change them anyway after we'd been living with old models for a few years. We, you know, we saw some weaknesses. So we wrote these models in the summer of 2009 and they were specifically geared toward the recession and the recovery. So what happened there was home ownership rates reached about 69%. And it turns out in the United States -- when home ownership rates get much above 64-65%, bad things happen. And so we didn't expect -- we [inaudible] almost day one. Until the home ownership rate got down to around 65%, there couldn't be a real estate recovery. So for the last -- you know, a few times over the past three years or so, people have said, "Oh, the real estate recovery is here," and we go, "No, home ownership rate's too high." And it got down to the range last year and so we saw it [inaudible]. And so we think what' happening now, is perfectly consistent with our forecast on that. But, so you all know, okay, I'm bragging a little bit. We're going to be wrong. We know we're going -- in this business, if you're right over half the time, you're doing good. And so we're -- you know, the University every now and then tries to hype our accuracy over the past three years -- but no no, we don't do that. So, yes, sir?
Audience member: I’m going to ask you to do something that you probably hate to do. Project where either, states or locales or what kind of business that people who are [inaudible] today should direct their careers toward.

Dr. Watkins: I think one big thing is, something to do with government. Government's becoming so big that either lobbying the government or dealing with the government approval process for things, somehow is -- you know, compliance officers, regulatory people, you know, attorneys who work on employee law are fully employed all the time. So, you know, that’s one big one. The other is it's not so much what they train for, but train for the ability that you can retrain yourself constantly. You know, when I was these people's age, a lot of people -- our parents, had worked for one company their entire career. Nobody I know has done that. And the rate of change is so fast and the rate of technological change. So I think it has to do with flexibility. And this is one of the things that worries me about California.

So I got married at a really young age. I was barely 21, like by a week. My wife was 19. And we had, you know, a year of college between us. And, only in California could you do what we did. We went to the community college. You went to state college. Eventually you went to the university college. And between the two of us, we got quite a few degrees.
And what worries me about the way California reacts to its budget problems is that's becoming harder and harder to do for young people. If the community college, I know -- so the way that works is UC gets cuts X, state universities get X plus something and the community college, X plus twice whatever they cut the others. So -- but the community college is by far the most efficient for the first two years in terms of cost per classroom and student.

And when I was doing -- I could have a job. I could go nights or weekends and so could my wife, and we could get those degrees. Nowadays, every time you get a budget cut, what do they do? They cut the evening and weekend classes so it's harder and harder for a working person to upgrade their skills. But I think you need the flexibility, and I think, you know, I really worry about California's higher education system.

**Audience member:** And geographically?

**Dr. Watkins:** Geographically, any place from North Dakota to Texas, the heartland, in flyover country. No place you want to live [Laughter].

**Audience member:** Do you have a second choice?
Dr. Watkins: You know, the coast of California, at least high tech and stuff. I mean, there's a huge center there, absolutely. Yeah.

Audience member: [Inaudible response].

Dr. Watkins: Is that it? All right, thank you guys very much.