Report On The Cash Management And Economic Outlook For The State Of California

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Message from State Controller
KATHLEEN CONNELL

The first quarter of this fiscal year has brought numerous financial uncertainties to California and to the nation. However, there is still time to act and limit the depth and duration of the rough economic times ahead.

As Controller, it is my role to monitor and manage the State's finances, to determine when we are headed for shortages, and to take steps to ensure that cash resources are available to pay bills in full and on time. I have used my experience and the expertise of my staff and my Council of Economic Advisors to develop this report on California's financial status.

The current California recession had its roots in the year 2000. The excessive reliance of California's economy on the booming high-tech industry—its revenue, its high-paid workforce and its wealth—created the false sense that it was invulnerable to any downturn. The events of this year have revealed the unsustainability of that economic boom.

California's financial situation has been further weakened by the energy crisis that began in the summer of 2000. The decision by the State to purchase energy exposed the State's own balance sheet to considerable risk that cannot be resolved without the sale of bonds to repay the $6.2 billion borrowed from the general fund. These events combined to deplete the California budget surplus of 2000-01, which had been accumulated largely due to stock options from Silicon Valley. The depletion of the budget surplus left the State of California vulnerable.

During this time of vulnerability, terrorists struck the United States, creating further uncertainty. The airline industry and tourism have been the hardest hit, with attendant effects on other related industries. Consequently, layoffs are occurring nationwide.

The good news includes two important elements. First, this recession may be deep, but it will be brief, with a recovery beginning in the first half of 2002. Second, California will not experience a cash shortage during the current fiscal year ending June 30, 2002.

My Council of Economic Advisors submitted their forecasts for the current calendar year, which are included in this report. All indications are that a federal stimulus package and continuing low interest rates will give the economy the help that it needs to recover from this mild recession.

If the federal government implements an effective stimulus package, California can also manage its cash flow next fiscal year. We have several alternatives that can be exercised to successfully manage our cash flows. We can tap Borrowable Resources or issue Revenue Anticipation Notes or Revenue Anticipation Warrants, to name just a few of the more common options.

In this report, you will see different cash flow scenarios and my office's analysis as to how they could impact the State in the current fiscal year and beyond. This analysis, combined with the Economic Outlook in this report, provides a complete picture of where California will be as we head into and out of the recession. As a state and a nation, we must act to ensure that the economy bounces back, but the tools to implement this recovery are within our reach.

KATHLEEN CONNELL
Controller, State of California

Cash Management Outlook

In developing the various cash flow scenarios (see the chart on page 4) the following methodologies and assumptions were used:

"Baseline" Cash Flow Scenario

The State of California generally prepares three cash flows for each fiscal year. The first is included in the Governor's Budget that is released in January of the fiscal year preceding the fiscal year being projected. The second cash flow is prepared as part of the Governor's May Revision. The May Revision cash flow is prepared because when the Governor's Budget cash flow is developed, significant income and sales tax receipts are not known for the prior fiscal year. Thus, this May Revision brings greater precision to the beginning cash balances in the cash flow. The final cash flow is released following the enactment of the Budget Act. It incorporates the expected expenditure information included in the Budget Act, the bill that dictates spending in the State.

The Controller's Office used the most recent cash flow, contained in the Official Statement for the sale of the $5.7 billion Revenue Anticipation Note, as the foundation for the "Baseline" cash flow depicted in the chart on page 4. This cash flow was updated for actual receipts and disbursements for the months of August and September. In addition, the $5.7 billion Revenue Anticipation Note was added as a receipt in October 2001 and a disbursement in June 2002. Even though the Revenue Anticipation Note is treated as a borrowable resource for some cash flow presentations, in reality it is more of a receipt and disbursement from the General Fund. Finally, the repayment of the $6.2 billion General Fund loan to the Department of Water Resources for the purchase of electricity was removed. Based on these adjustments, the "Baseline" cash flow scenario depicts a negative cash position as of June 30, 2002, but not to the extent that borrowable resources are exhausted.

In order to illustrate what the "Baseline" cash flow would look like assuming repayment of the $6.2 billion General Fund loan, another line has been added to the chart on page 4 with the repayment projected to occur in March 2002. With this repayment, the General Fund would actually end in a positive cash position for the year ended June 30, 2002.

Cash Flow Scenario for the "Most Likely Case"

In this scenario the "Baseline" cash flow, as described above, has been modified for assumptions associated with a weakening economy. Thus, receipts for income, bank and corporation, and sales taxes were adjusted based on discussions with several economists. The overall reduction in receipts for the 4th quarter of calendar year 2001 and the 1st and 2nd quarters of 2002 is approximately $2.3 billion. Since the cash flows already reflect actual amounts for the 3rd quarter of 2001, a $1.3 billion decline in tax receipts from original estimates, the cash flow for this scenario represents a total decline in receipts of approximately $3.6 billion.

Cash Flow Scenario for the "Worst Case"

This scenario assumes that total receipts included in the Official Statement, for the sale of the Revenue Anticipation Note will drop at least 7% - $5.3 billion. This would be in addition to the decline in cash receipts for the 3rd quarter of calendar year 2001 of $1.3 billion, for a total decline in receipts of $6.6 billion. This represents a total decline of approximately 9% in receipts from those in the Official Statement. Even with this decline, the General Fund does not exhaust available borrowable resources for the 2001-02 fiscal year.

Summary

From a cash management perspective under all scenarios described above California has adequate resources available, both external and internal, to ensure that its bills will be paid for the 2001-02 fiscal year in a timely manner.

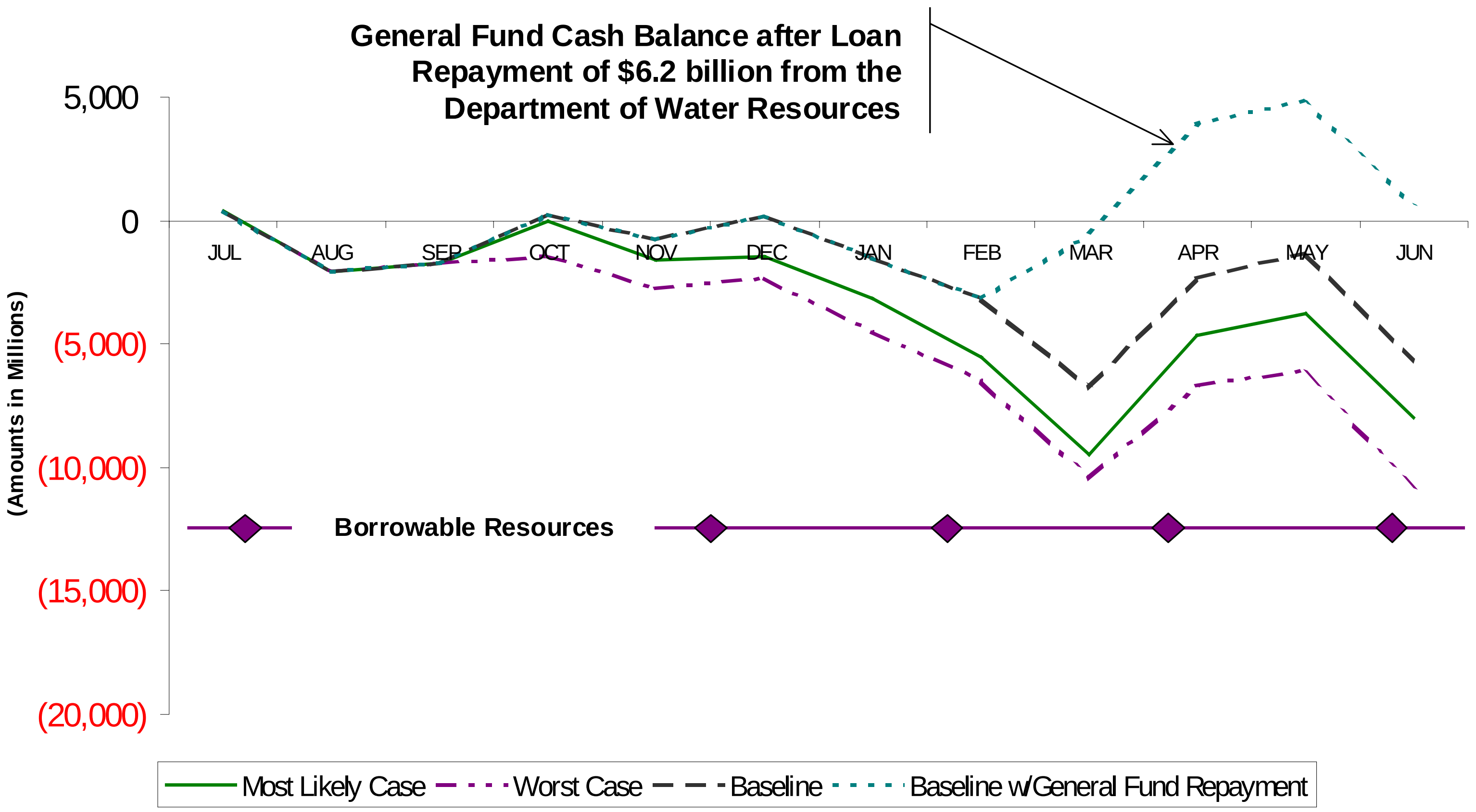
As indicated in the "Most Likely Case," disbursements are expected to exceed receipts by $11.3 billion, assuming no repayment of the General Fund loan of $6.2 billion. However, this cash gap will still not deplete the State's currently projected internal borrowable resources. If repayment of the $6.2 billion is assumed, the net shortage of receipts as of June 30, 2002, will be $5.0 billion. Even under the "Worst Case," where disbursements exceed receipts by $14.3 billion, the State does not exhaust internal borrowable resources in the current fiscal year.

It is premature to discuss cash flow projections for the 2002-03 fiscal year until the release of the proposed Governor's Budget in January 2002. However, current economic forecasts do not support the notion of a long-term recession in California. To the contrary, as is explained in more detail in the economic section of this report the projection is for a V-shaped recession with graduated improvement beginning mid-2nd quarter of 2002.

In conclusion, the State is not running out of cash. Based on the various scenarios prepared by the Controller's Office, sufficient cash is always available in the State's Treasury.

General Fund Cash Balances, 2001-02

Estimated Balances Per the State Controller's Office



The Economic Outlook

Overview

The economy was decelerating for several months before the September 11 attacks on New York and Washington. The immediate impact of the attacks was a severe, but short, drop in economic activity. Sales, travel and equity markets contracted in the last two weeks of September, but have begun to rebound. While a major part of the softness in the economy now is a continuation of the deceleration that began in late 2000, the tourism and travel industries are still depressed and retail sales are still below their pre-9/11 levels. As the economy was already in a fragile state before the attacks, it is clear that a federal stimulus package is now needed to jump-start the economy. The Controller urges that all of California's public representatives stress this to the Congress and Administration.

Assuming that federal spending continues to increase, along with a Federal Reserve policy of downward pressure on interest rates, the Controller's Council of Economic Advisors believes that the California economy will begin growing again in the second quarter of 2002. The Controller's Council does not expect that the revenue contraction of this fiscal year, ending June 30, 2002, will extend into the 2002-03 fiscal year.

The Outlook

The most recent update of the Controller's Council was received October 27-28. These most recent updates for the year 2001 are shown below. Overall this can be summarized as slow growth for the remainder of 2001. The impact of the 9/11 attacks is assumed to be initially dramatic, but short-lived. The attacks did not substantially change the Council's pre-9/11 forecasts. The slow growth is primarily attributed to trends already underway—a global slowdown, under-utilization of manufacturing capacity, and a weakness in business investment.

Forecast of Economic Growth in 2001

Economist / Organization	Employment Growth (%)	Unemployment Rate (%)	Personal Income Growth (%)	Residential Building Permits (x1000)
Ross DeVol, Milken Institute	1.9	5.2	4.6	148
Robert Kleinhenz, CA Assoc. of Realtors	2.0	5.2	5.4	152
Cynthia Kroll, UC Berkeley	1.7	5.4	3.5	135
Jack Kyser, LA County Economic Development Council	1.9	5.2	1.8	134
Tom Lieser, UCLA Anderson Forecast	1.8	5.2	4.3	145
Tapan Munroe, Munroe Consulting	1.5	5.5	5.3	140
State Controller	**1.8**	**5.5**	**4.5**	**150**
Year 2000 Values	**3.8**	**4.9**	**11.5**	**148**

In preparing this most recent update, the members of the Controller's Council were asked the following three questions:

1. What type of recession do you perceive may occur?
2. What will be the length of such a recession?
3. What is California's greatest exposure?

The responses were as follows:

Ross DeVol, Milken Institute

The recession will be a more dramatic V Shape than would have occurred before 9/11. This will not be a particularly deep recession—California will match the course of the U.S. economy. The fourth quarter of 2001 will be the worst period of the recession. Recovery will occur in the 1st and 2nd quarters of 2002. Southern California will be the anchor of the recovery. San Francisco will have pain, but the Central Valley economy will be strong.

Robert Kleinhenz, California Association of Realtors

The recession will have a steep downslope with a more gently angled upstroke. The downturn will be short, two and possibly three quarters in length. Both the 4th quarter of 2001 and the 1st quarter of 2002 will be weak. This would thus resemble a U-shaped recession. The federal stimulus package will be important to the speed of the recovery.

The state economy is not expected to perform as well in 2002 as it did in 1999 and 2000, but will gradually return to activity levels that are consistent with the long-term growth rate of the economy. As to exposure, the Bay Area/ Silicon Valley Region is the most vulnerable. The industries most impacted are tourism and the trade-related sectors.

Cynthia Kroll, Haas School of Business, U.C. Berkeley

The recession has already begun and will be U-shaped, lasting two to three quarters, but it will not be a 1990's type of recession. Global uncertainty is a problem for the economy. Low interest rates and increased federal spending will help with the recovery. The weak links in California are the high-tech and travel industries. The Bay Area will be hard hit, as it has both of those industries in recession. The travel industry slowdown will be felt statewide.

Jack Kyser, Los Angeles County Economic Development Council

This recession will be more unusually V-shaped than would have been the case before September 11. A recovery in the 2nd quarter of 2002 is dependent on a federal stimulus package. The 4th quarter of 2001 will be the bottom of the recession. Local governments will see a slowdown due to a general retail sales drop. Loss of tourism will mean the hotel occupancy tax and retail sales will be soft, adding to the local government revenue slowdown. There is a possible increase of employment in Southern California from increased national defense spending—in particular the Joint Strike Fighter and a possible order for more B-2s. A recent economic E-mail survey conducted by the Los Angeles County Economic Development Council after September 11th indicates a large concern with both capital financing adequacy and cash flow.

Tom Lieser, UCLA Anderson Forecast

There will be a V-shaped pattern in monthly economic data following 9/11. Economic output will be down in both the 4th quarter of 2001 and the 1st quarter of 2002. California is not looking at a 1990's type problem. The recovery should begin in the 2nd quarter of 2002, except Information Technology. Recovery in that sector is not expected before 2003. There is concern regarding California's international sector, in light of the global information technology slump.

Tapan Munroe, Munroe Consulting

The recession will be V-shaped, with the low point in the 4th quarter of 2001. Recovery will begin in the 1st quarter of 2002. The San Francisco Bay Area is the most vulnerable region.

The High-Tech Industry

In addition to other factors, the California General Fund is vulnerable because of the significant decline in equity values that occurred over the last 6 months, particularly in the technology heavy NASDAQ. In the past two fiscal years, the exercise of stock options by Silicon Valley employees has been a source of considerable revenue for the General Fund. This occurred at the time when the technology sector was rapidly growing and stock prices were sharply rising.

At a meeting in Silicon Valley in mid-October, executives from technology firms were asked the following questions:

1. What is the outlook this year and next for the high-tech industry?
2. Has the September 11 attack had an impact on your business?
3. What is happening to stock options within your firm?

The following is a summary of their collective responses.

The slowdown in the high technology industry started approximately one year ago with the softening of sales in Europe. That softening accelerated into general weakness in the industry by early 2001. Layoffs, which began in earnest in the summer of 2000, have continued to the present, but the most recent are the continuation of announcements made earlier in the year. Many job cuts are occurring as a result of attrition.

There are few forecasts of growth among high-tech firms until the spring of 2002. In general, the industry is trying to retain R&D spending and staff as they feel a recovery of the sector will occur with the development and delivery of new products, which sell well.

The exercise of stock options has declined dramatically this year and will likely resume when the stock market has clearly recovered.

There has been no discernible impact of the September 11 terrorist event. Though there may be some increased business activity from security enhancements, including the replacement of equipment. That activity will be spread over a longer time period beginning in 2002.