

# Silicon Valley Roundtable

## National Association for Business Economics

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### November 2006 Newsletter

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#### **THE 2006 CALIFORNIA ELECTION**

**By Kenneth H. Jacobson**

As the United States approaches the November 7 election, political analysts are predicting significant gains for the Democrats.

Traditionally mid-term elections in the second term of an incumbent president's administration favor the out party in Congress, but this year the Republican majority faces not only an unpopular war, but a series of scandals associated with GOP legislators.

Across the United States, Democrats are capitalizing on President Bush's unpopularity. Scores of Democrat candidates are using photographs of their opponents with the president. In late October, the conventional wisdom is that the Democrats will carry the House by between 15-25 seats and come within an ace of winning the Senate. Republican legislators, who won easily in the 2000 and 2004 election, are hoping that a last minute infusion of cash may save congressional leaders.

California, one of the bluest of the blue states, departs from the national trend in a significant way. With a voter registration lead of one million over the Republicans, Democrats would figure to win a landslide, sweeping all state offices. The outlook, however, is for a narrower win owing to two factors: the remarkable comeback of Governor Arnold Schwarzenegger following his failed 2005 special election initiatives; and the dismal showing of his opponent, State Treasurer Philip Angelides.

Schwarzenegger swept into office in 2003 as an outsider advocating reform. He routed the deposed Governor Gray Davis with powerful business support. In 2005 his ill-fated initiative package to rein in state spending, redraw legislative districts, and make it easier to fire novice teachers and limit the clout of employees' unions, was rejected by voters. After this defeat, the governor quickly changed priorities, staff, and tactics. He embraced much of the agenda of legislative Democrats: a multi-billion public works plan, an increase in the minimum wage, and a mandatory prescription drug plan. He also replaced several advisers from the recall and special election era. Campaign advisers now include Steve Schmidt and Matthew Dowd from the Bush administration, and his new chief of staff is Democrat Susan Kennedy.

The governor's new priorities have alienated conservatives and confused voters. A September Field poll found that nearly half of registered voters now believe that the governor chooses what is popular rather than what he believes is right. But there is no arguing with the political success of his middle-of-the-road strategy. One week before the election he enjoys a double digit lead over his opponent. Political analysts in both parties agree that he is a superb judge of what the public is thinking. His approval rating now hovers around 50 percent on a consistent basis.

Treasurer Angelides, on the hand, leaves the voting public cold. He lacks charisma and appears to fit the stereotype of a "tax and spend" Democrat. In addition, he has the reputation as a micro manager obsessed with

detail. If the governor retains his double digit over Angelides, he may even carry with him to Sacramento a few Republicans in close races, such as Tom McClintock, the candidate for Lieutenant Governor, and Steve Poizner, who is running for Insurance Commissioner.

Senator Dianne Feinstein will retain her seat, as will almost all of the Bay Area House Democrats. One House race that has attracted national attention and a great deal of money is for the seat of Republican Representative Richard Pombo of Tracy. Once expected to cruise to re-election, Pombo, whose district includes much of San Joaquin county and parts Alameda, Contra Costa, and Santa Clara counties, now faces a challenge from Jerry McNerney whom he easily defeated (61 to 39 percent) in 2004. Pombo's first win was in 1992 and he has won easily six more times. He is now a target for environmental groups, such as the Sierra Club, and hopes that the GOP's get-out-the-vote operation and an edge in campaign cash can break the statistical dead heat in the polls,

As usual, Californians face a bewildering set of initiatives on the November 7 ballot. Four involve major tax increases. Proposition 86 seeks a \$2.60 per pack levy on cigarettes on top of an already high 87 cents a pack. Proposition 87 would tax every barrel of oil from an in state well. Proposition 88 would impose a \$50 tax on every parcel of land for public schools, and Proposition 89 would impose an addition two-tenths increase on the current tax on corporation to pay campaign funding costs for politicians.

All four are dreadful measures. Proposition 86 will raise the price of cigarettes dramatically, and will encourage smokers to obtain them through tax-free Indian reservations or through smuggling. Proposition 87 is a poorly crafted piece of legislation that provides tax revenues to fund "alternative energy." This scheme, which failed at the national level under the Carter administration, is a non-starter. Alternative energy will only make sense when its cost is less than the cost of using oil. Eventually the market will handle this problem.

Proposition 88's new \$50.00-per-barrel tax on California landowners funds revenues to public schools. The overall revenue from this tax--\$450 million per year—seems small but sets an dangerous precedent by putting the state government, for the first time, in the position to impose and collect property taxes. Finally, Proposition 89 greatly increases the level of public financing of political campaigns to match privately funded campaigns. Those who pay this tax, unlike private contributors, would have no choice about which candidates the state supports.

### **THE CASE AGAINST A SOFT LANDING FOR BAY AREA HOUSING** **By Knud Jacobs**

Those who think the housing market is flattening out and won't have much further downward to go before it bottoms out have not paid attention to what is different this time.

Housing has always been driven by supply and demand, which has largely been a function of income and interest rates. This time, however, the market got an unusually long run thanks to a decent economy and cheap money.

The cheap money was only partly due to historically low interest rates. Currently the real rate is still 1,8 percent below what it has averaged for the last fifty years, even after having risen a full 1 percent during the last year.

What primarily fueled our local housing market were lax lending standards and the widespread use of nonstandard mortgage products. When one looks at what took place and what is still going on, three things jump out:

- Loans against an ever-greater percentage of one's income;
- The use of Stated Income Loans; and
- Adjustable rate loans, especially Option Adjustable Rate Mortgage (ARM) loans.

Lenders are not shy about issuing loans with no down payment that go well beyond the 30-35 percent of personal income that had been considered the norm. Instead 45-50 percent has been widespread, thereby increasing the lenders

risk as there is less margin for the borrower to have unexpected expenses before their only option is to default.

Locally housing prices still don't allow most people willing to spend 40-45 percent of their income on a mortgage to qualify for it. Stated Income Loans allow them a way around this, as they don't have to verify their income. These loans come with a higher rate of interest than similar loans do with a verifiable income, because of the lenders increased risk.

Adjustable rate loans allow people to get into a house at a lower rate than a fixed rate loan. But there is a problem. Not everyone will qualify for a new loan when the current one expires. Even if he qualifies, he may not be able to make the additional payment if rates have gone up.

Option ARM loans is a particularly unpleasant type of adjustable rate loan. Typically four payment options are offered each month. If a borrower chooses the lowest payment option, his principal goes up not down. If he chooses the lowest option too many times, the loan resets to a higher rate of interest. As a rule of thumb, a 1 percent increase in one of the cheaper ARM loans means the borrower's payment goes up 40 percent and a reset of an Option ARM loan can lead to tripling of the monthly mortgage cost.

Locally mortgage brokers are reporting that the use of Stated Income Loans have grown from 30 percent of all loans a year ago to 70 percent currently. Option ARMs now account for 40 percent of all loans issues with almost all of these going to Stated Income Loan borrowers.

With 70 percent of all loans now States Income Loans in a market with already lax standards, it means that people have bought housing for a lot more than they can afford. In the past, it was possible to get a new loan when it was needed because the rise in housing values made additional borrowing possible. But now, with flat to falling home prices, the additional loan option is fast disappearing.

If I'm right that that long-term interest rates will increase, I would not be surprised to see at least

half of those who bought recently will lose their homes.

Lenders only work with borrowers at the start of a downturn when it is viewed as the lowest cost option for them. As a downturn progresses, their lowest cost option is to foreclose as speedily as possible.

As foreclosures start to rise, lenders will correspondingly tighten the lending requirement reducing the pool of eligible buyers.

Considering that we already have a supply of housing on the market that exceeds that which we have seen in the last 15 years, then being hit by a wave of defaulting homeowners at the same time lenders are tightening their lending criteria all but rules out a soft landing.

## **MEXICO'S DILEMMA**

**By William Grindley**

**The Facts:** Mexico held a general election July 2 2006. Nearly 41 million voters went to the polls to elect, on the federal level, a new President to serve a six-year term, replacing President Vicente Fox, who is ineligible for re-election under its 1917 Constitution. It also voted for 500 members of the Chamber of Deputies and 128 members to serve six-year terms in the Senate.

The two top contenders were Lopez Obrador, a former and highly popular mayor of Mexico City and leader of the Democratic Revolution Party (PRD), and Felipe Calderon, a former Secretary of Energy in President Fox's National Action Party (PAN). While there were three other candidates, including a woman who supports abortion rights and has publicly criticized the Catholic Church for oppressing women, the bulk of interest and two thirds of the votes went to the PAN and PRD.

PRD was formed by those disillusioned by Mexico's long-ruling Institutional Revolutionary Party (PRI) in 1989 to build a left-of-center party focused on social issues and favoring nationalism as opposed to trade and foreign investment as a means for improving Mexico's economy. It envisions economic growth through integration with the United States along the lines of the

European Union (EU) model. PRD has a strong support base in the capital city and among the poor of central and southern Mexico.

PAN, a conservative, business-friendly party advocating reduced taxes, or in Calderon's case a flat tax, smaller government and reform of Mexico's creaking welfare state. It views the North American Free Trade Association (NAFTA) and the North American Development Bank positively as sources of economic development. PAN followers like the financial stability PAN President Fox is credited with achieving in an economy that has at times been wracked with devaluations and hyperinflation. Its support base is strongest in the country's wealthiest and most urbanized regions of northern and central Mexico.

Polls had put PRD in the lead and early returns favored López Obrador, but by early morning on July 3 PAN's Felipe Calderón overtook him by approximately 0.33 percent of the vote. Mexico's Federal Election Institute (IFE) had expected volatility in the vote counts and said official results would be released only when all polling stations had been counted. Northern states, which strongly favored PAN, were ominously slow in counting ballots.

On July 6, having narrowly lost the preliminary official count, López Obrador demand a recount of all ballots. On July 8 an election committee of 70 monitors from the EU stated that they found no irregularities at the 130,000 polling stations; while other election monitors found many examples of fraud and irregularities and demanded a full recount. That same day, Obrador's supporters met at Mexico City's enormous central square, El Zócalo, to start what Lopez Obrador called "the defense of the popular vote".

The PRD also wrote a 900 page complaint to IFE on alleged election irregularities, including allegations that 40 percent of the vote packets nationwide had been reopened illegally; that 900,000 nullified votes were from areas that voted more strongly for Lopez Obrador; and that there were 1,621,187 votes added to or missing from 72,197 polling stations--55% of total number nationwide. For the next two weeks, Lopez

Obrador's supporters crippled central Mexico City, setting up camps in the Zócalo, blockading the stock market building, to Mexico's main tax office, the international banks' headquarters and government offices, as well as throwing open highway toll gates and seizing the podium in Congress thereby blocking President Fox's State of the Union address.

On September 5, IFE certified Calderón's victory by a margin of 233,831 votes. The final tally was PAN's Felipe Calderón with 35.8 percent and PRD's López Obrador with 35.31 percent--a difference of 0.58 percent. The was the result of a legal process that included the annulment of tens of thousands of votes and a recount of ballots cast in 9 percent of Mexico's polling places. Candidate Obrador refused to recognize the decision and said he would create an "alternate government" before the December 1 inauguration.

**Short Term Results:** Recently the visible results of Lopez Obrador's supporters' protests have been muted. A concurrent and somewhat related social justice issue has been another manifestation of the political radicalization of southern Mexico.

Simultaneous with the Obrador protests, a movement of striking teachers, leftists, students and indigenous groups have come together to demand the resignation of Oaxaca Governor Ulises Ruiz, accused of rigging the 2004 election. On October 21, they marched into Mexico City. Police or armed groups have killed five people and on October 29, thousands of police marched into Oaxaca, effectively ending the protests for the time being.

While Mexico's financial markets had feared a long-running political crisis, so far they have shrugged off the street demonstrations, and the MERVAL, the stock market index, is up over 1 percent since IFE results were announced. Mexico's peso has also risen about 1 percent against the US dollar, buoyed by news that Mexico will prepay \$9 billion of debt with international lenders.

**The Good News:** For more than 70 years, PRI governed Mexico. Democracy and human rights were consistently undermined, and the country

was ruled in the interests of its large land owners first, then later its industrial elites and a few, selected union groups that gave legitimacy to the ideology of a workers-governed state. In 1997, PAN began to gain power at the state level and in 2000 won the presidency. Although voters wanted change, President Fox, without a Congressional majority, found it difficult to root out corruption and reduce inequality, his two campaign promises; while drug-related and violent crime problems have proved intractable in the past six years.

Despite Fox's problems, this election was once again a repudiation of PRI's seven decades of corrupt and incompetent governance. Roberto Madrazo, PRI's candidate, came in third with only 22 percent of the vote. While PRI still holds some power in Congress, the party that Mario Vargas Llosa called "a perfect dictatorship" in 1990 is in danger of becoming a relic of Mexico's failed past.

While the PRD claims that NAFTA and similar trade agreements have driven campesinos from their lands since US farmers can produce and export to Mexico cheaper, with PAN continuing in power there is not likely to be much change in Mexico's relations with its NAFTA or EU trading partners. Likewise, with an open investment regime under PAN, Mexico's larger, more successful businesses become takeover targets -- as was the case of Cifra by Wal-Mart and Banamex by Citigroup. While TelMex, CEMEX and other Mexican businesses have succeeded in buying competitors abroad, the opportunities for US and EU businesses to invest in Mexico will continue.

**Is Political Progress Real?:** Instead of fossilized PRI control of a closed, protected and largely statist economy, Vicente Fox's PAN administration continued the move to more openness started by three prior PRI presidents, de la Madrid, Salinas and Zedillo. Each of these leaders pushed Mexico's economy towards privatization, deregulation and globalization. A President Calderon is expected to continue that effort.

But did President Fox, with the power of Mexico's now-privatized business interests, move towards more openness or fairness in helping Mexicans know more about Mexico or decide their future at the ballot box? Whether politically forced to, or complicit with the owners of Televisa and TV Azteca, (which command more than 95 percent of Mexico's television audience) in early 2006, the administration pushed through a law that increased the power of Mexico's media barons to shape public perception of their nation and their choices of political candidates. Even protests by government agencies, politicians and the UN High Commissioner for Human Rights and the Inter-American Commission on Human Rights released statements that the law violated international agreements signed by Mexico.

Much of what PRD has protested in the ensuing months is that the PRI elites have simply been replaced by the PAN elites. By having media control, the interests of PAN-friendly business will lead to the same sort of corrupt structures and outcomes that PRI built in its reign. PRD also argues that the election 'fraud' disenfranchised and discouraged Mexico's voters, and brought the heretofore-trusted IFE into disrepute.

More ominously, PRD believes that the process by which they were 'robbed' of power will push PRD to make alliances with PRI operatives and loyalists that will bring Mexico a two party system that, as in the United States, limits voters' choices. And they argue that the mildly-leftist policies of Lopez Obrador are similar to those carried out by President Ignacio de Silva in Brazil and Prime Minister Jose Luis Zapatero in Spain, rather than those of Venezuela's Hugo Chavez and Evo Morales of Bolivia. They warn that in the future Mexico's voters will be more radicalized because they gained little or nothing from having compromised their ideology to try and win the just-lost election.

PRD also argues that with PAN's continued commitment to economic liberalization policies similar to those of the "Washington Consensus" started twenty years ago under President de la Madrid, Mexico has little chance to eradicate poverty. Two decades of opening Mexico economy to become one of the most open in the

world has done little or nothing to address the extreme poverty of over half its population. The PRD points out that the United States is still the safety valve for Mexico's society--a way out of deep poverty for displaced workers--while PAN under Fox has acquiesced to the US conservatives demands to "protect" its border.

**Broadening the Political Base:** If this election was "stolen," then Mexico's governance dilemma is how to maintain legitimacy in the face of rising political awareness among Mexico's lower classes.

In many ways Mexico's July election was similar to that of Garcia vs. Humala in Peru or Naboja vs. Roldos in Ecuador where policies of economic liberalization promoted by traditional political elites of rich, non-indigenous candidates stand challenged by left-of-center candidates of indigenous and humble origins. The rise and fall of these leftist candidates, and victories by similar candidates in Bolivia and Venezuela signal a 'blow-back' on globalization by the vast majority of indigenous peoples who have not seen their or their children's' lives improved after a generation of privatization and trade and investment openness. While they may have embraced change to the corruption and incompetence of their closed economies, they lost their 'rice bowls' in the open economies.

And that half of Mexico's voters who feel disenfranchised by what they have experienced are not stupid. They understand that to gain and maintain power, the new political elites of their now not-so-new open societies must control the press and television. But these voters are now better educated. They live in urban societies with declining birthrates, and they have access to information through the telephone and Internet--something unimaginable even six years ago. So, to gain legitimacy and maintain the franchise of democracy, President Calderon, as well as his successors and their counterparts throughout the world, must match their rhetoric with prosperity or face the opposition of a better-informed electorate. Mexico's recent election may well be one of the last there that can be conducted--and perhaps controlled--in the interests of only PAN or PRI's ruling class.

## **THE SAN FRANCISCO BAY AREA ECONOMY: ON TRACK TO SURVIVE THE HOUSING SLOWDOWN**

**By Anne Ramstetter Wenzel, M.A.**

**The San Francisco Bay Area economy continued to grow moderately in the third quarter of 2006**, as demonstrated by rising employment, high levels of venture capital investment, and improved profitability of publicly traded companies. San Francisco and San Mateo counties' largest publicly traded firms experienced revenue increases of more than 30 percent, on average in the 2<sup>nd</sup> quarter of 2006, from 2<sup>nd</sup> quarter 2005 levels: In Santa Clara County, revenue for the largest publicly traded firms increased a more modest 7 percent.. San Francisco Bay Area payroll employment increased 1.5 percent in January through August 2006 over 2005 levels, and growth was experienced all over the nine-county Bay Area, as illustrated by the table below:

**Hiring plans remain strong in the San Francisco Bay Area**, with 39 percent of companies surveyed by the Bay Area Council in July 2006 saying they plan to increase their local workforce in the next six months. While hiring plans are down from the high 43 percent level reported in Spring 2006, hiring plans are strong on a seasonally adjusted basis: In July 2005, 38% of firms reported plans to increase the size of their Bay Area workforce, up from 30 percent in July 2004 and just 10 percent in July 2003.

**Office vacancy rates continue to fall throughout the San Francisco Bay Area.** The office market recovery, which began at the start of 2004, has been helped by growing employment. Second quarter 2006 San Francisco Bay Area average office vacancy rate was 13.1 percent, down from 14.8 percent in the second quarter of 2005 and 20.3 percent in the 2<sup>nd</sup> quarter of 2003. Bay Area average asking rate per square foot has also increased, to \$2.37 in the 2<sup>nd</sup> quarter of 2006, up from \$2.14 per month in the 2<sup>nd</sup> quarter of 2005. Although improving, the San Mateo County office market remains the weakest, with a 2<sup>nd</sup> quarter 2006 office vacancy rate of 17.1

percent, down from 20.1 percent during the 2<sup>nd</sup> quarter of 2005.

**The housing market has weakened, but affordability still remains at historically low levels.** The good news is that housing price appreciation, as reported by the U.S. Office of Housing Enterprise and Oversight, slowed in the 2<sup>nd</sup> quarter of 2006 in all areas of the San Francisco Bay Area, and housing price appreciation is expected to slow further through the end of 2006. Housing price declines will likely occur in the first half of 2007.

**Venture capital investing in the Bay Area totaled \$2.4 billion in the 2<sup>nd</sup> quarter of 2006, up 14 percent from year-earlier levels.** The software industry remains the largest single recipient of venture capital funding, but the entertainment and energy industries have been receiving a larger share of total funding in 2006. The media and entertainment industry has seen venture capital investing increase from \$149 billion for the first half of 2004 to \$415 million for the first half of 2006, according to PricewaterhouseCoopers' *MoneyTree™ Report*. Venture capital investment in the industrial and

energy sector increased from \$35 million in the first half of 2004 to \$243 million for the first half of 2006.

The economic outlook is bright for the San Francisco Bay Area, despite the housing market slowdown. The recent drop in long-term interest rates has slowed the fall in the housing industry, but housing construction and finance employment will begin to decline by year-end. However, job growth in nonresidential construction, business services, and the biotechnology and web search portal industries will fuel personal income and retail sales growth and further reduce commercial office vacancy rates. Continued profitability for a majority of Bay Area firms, strong venture capital spending and job growth in business services, health care and leisure and hospitality all ensure that the Bay Area economy will continue to grow in 2007.

*The above is a summary of the October 2006 San Francisco Bay Area Economic Outlook, published by Econosystems. To subscribe, visit [www.SFBayAreaOutlook.com](http://www.SFBayAreaOutlook.com).*

<b>San Francisco Bay Area 2006 Payroll Employment</b>		
Metropolitan Area:	Number (Jan. thru Aug. Averag	Growth*
San Francisco-San Mateo-Redwood City Metro Div.	954,750	1.4%
Oakland-Fremont-Hayward Metro Division	1,053,450	2.4%
San Jose-Sunnyvale-Santa Clara MSA	876,138	0.5%
Napa MSA	67,763	2.4%
Santa Rosa-Petaluma MSA	191,463	0.4%
Vallejo-Fairfield MSA	131,313	2.3%
<b>BAY AREA TOTAL:</b>	<b>3,274,875</b>	<b>1.5%</b>
*January through August 2006 increase in average employment from 2005 levels. Excludes the self employed.		
SOURCE: California Employment Development Department.		

**San Francisco Bay Area Venture Capital Investing  
by Industry, 2006 1st Half: \$4.7 billion, 562 deals**

