"Not Dead Yet!!"

By Elliott Pollack

To paraphrase Mark Twain, "The report of Phoenix's death has been greatly exaggerated." The Phoenix Metropolitan Area, for the first time in years, is in a period of economic distress both in absolute and relative terms. However, the distress is purely transitory, caused primarily by the ripple effects of a 75% decline in building permits over the last three years combined with the national slowdown in economic activity. The underlying fundamentals remain strong as does the long term outlook.

Builders in Greater Phoenix, like in many communities, built more homes than demographic growth could support during the housing boom. Now, fewer homes must be built so that the excess supply built during the boom can be absorbed. Not only is that excess supply in the hands of homebuilders and investors, but also with banks, as foreclosures have reached record levels in absolute terms. In addition, if you cannot sell your home in Phoenix you probably cannot sell it in California, or Michigan, or other places that people move from to come to Phoenix. As a result of this, combined with the decline in jobs, the population flows are expected to substantially diminish. The good news is that this, too, is likely to be transitory.

The effect of the decline in housing is significant. As of June 2008, construction jobs were still being lost at a tremendous rate. It is likely that when 2008 employment figures are revised next March, the employment decline will actually be greater than the present data is suggesting.

Dynamics of Growth

Do not confuse this with any long-term stagnation or decline in Phoenix's relative growth. Such errors were made during the last real estate debacle (primarily commercial vs. the current residential problem) in 1988 through 1992. Jobs grew in Greater Phoenix during this current expansion that started in November 2001 at a growth rate that was three and a half times stronger relative to the national economy. Again, this is due to the region's strong economic fundamentals.

In determining whether an area will grow or not, one has to look at the basic factors contributing to growth. If none of the underlying dynamics of the area have changed, one would expect growth to continue over the long-term. Factors such as climate; lifestyle; geographic location; pro-growth attitude; competitive tax structure; focused incentives; and relatively low cost of living; as well as business and government headed in the same direction, suggest that the long-term dynamics remain in place.

Why do we Grow?

For additional perspective, let's consider why some places within the United States grow and others do not. The long answer will require another article. But, a brief summary is in order. Some areas grow over long periods of time, as measured in multiple decades for our purposes. It is that group, those that grow consistently over time, that we are interested in examining.

The discussion begins with two basic tests. You don't get to progress to the second test unless you pass the first. The first test is simple. Do the people want to live in that area? This covers a list of things. Is the climate nice? Is the area livable in terms of political environment? Does it have a social infrastructure conducive to growth (i.e. is it a meritocracy)? The quality of life factor is important to consider. But, like beauty, it is in the eye of the beholder. Fortunately, there is an objective measure to consider. The real answer is that people vote with their feet. The places that continually enjoy rapid population growth can be assumed to make the first cut in our analysis. People simply want to be there. The first cut also partly explains why areas of the country that supposedly have great business climates, South Dakota for example, do not enjoy rapid population growth.

The second cut is more complex and is examined extensively in the book Barriers to Riches[1]. Is the business and political climate of a local area conducive to business expansion relative to the area's competitors? The basic questions must be asked. Are there specific local policies that result in constraints on work practices and the application of better production methods? Can firms operate profitably relative to alternative locations? Does the area embrace business expansion and competition?

For Greater Phoenix, the answer to the first test has been a resounding yes. People want to live here. Fortunately, the environment and social climate of the southwest remains appealing to individuals. The focus, therefore, has to be on the second test. Boiled down it asks, is government getting in the way? We have direct control over the extent that our government encourages or discourages business expansion. In the end, the more competitive we are, the better will be the quality of our expansion. Specific local policies can result in constraints in work practices and the ability of individual firms to earn a reasonable profit.

All Jobs are Not the Same

If "policies that result in constraints on work practices and on the application of better production methods at the firm level" affect decisions at the international level, they certainly could at the state or metropolitan area level. That is especially true when it is applied to base (or export) jobs as opposed to domestic sector jobs. Export sector jobs, generally higher paying jobs, are jobs that are created because a company's product is sold primarily outside of the local area. These companies could locate in other states if they so desired because they don't serve the local market. On the other hand, domestic sector companies serve local markets so they have to locate locally. A domestic sector company; a retailer, insurance agency, title company, lawyer, or barber; are chasing local income. From an economist's standpoint, these are someone else's "ripple" effect. Think of it this way. The ghost towns of the old west became ghost towns because their reason for existence ended. For example, the mine petered out, there was a drought and agriculture moved away, or the rail head moved. Their base industry failed.

The reason Greater Phoenix exists, for the most part, is its manufacturing, tourism and export service base, not its retail base. Thus, the ability to attract those base jobs is key to an area's growth and wealth. In that regard, why these base industry companies locate in Greater Phoenix as opposed to another city in another state is primarily due to the same factors described in Barriers to Riches. The ability to implement the latest technologies and make a reasonable profit without a great deal of costly government interference is key. Yes, there are other relevant factors such as proximity to markets. But, generally, the important point is, can we attract

[1] Parente, Stephen and Prescott, Edward C., (2000) *Barriers to Riches* (Cambridge, Massachusetts: MIT Press).

sufficient labor at a reasonable cost (do people want to live here) and can we make money (policies that result in constraints including red tape, work practices and taxes)?

Phoenix appears to be taking a beating in terms of relative growth this year. However, the last time it took such a beating was during the last real estate debacle from the RTC days in 1988 through 1992. While it is relatively worse this time around, it is because the housing bubble was more concentrated than was the 1988 – 1992 real estate problem. Arizona is one of the four states that was most affected on the upside by the housing bubble, the others being California, Nevada and Florida.

Phoenix-Mesa MSA Employment Growth
Ranking Among All Metro Areas Greater than 750,000
1984 - 1990

Year	Phoenix Ranking	# of MSA's over 1 mil.
1984	1	28
1985	1	30
1986	4	31
1987	11	32
1988	7	34
1989	12	34
1990	8	35

Source: US Bureau of Labor Statistics

Phoenix-Mesa MSA Employment Growth
Ranking Among All Metro Areas Greater than 1,000,000

Year	Phoenix Ranking	# of MSA's over 1 mil.
1991	4	20
1992	5	20
1993	2	20
1994	1	20
1995	1	21
1996	1	23
1997	2	23
1998	1	24
1999	3	26
2000	8	26
2001	6	28
2002	5	28
2003	3	29
2004	4	29
2005	1	30
2006	1	31
2007	10	32
2008 YTD July	28	32

Source: Arizona Department of Economic Security, U.S. Bureau of Labor Statistics.

Now, a correction is in order. When growth does slow, in this case on a temporary basis due to conditions in the housing and financial markets, industries that support that growth slow as well. Note that Greater Phoenix did very well in the years prior to the 2000s, when sub-prime mortgages were not the rule. It will do well again once the excess supply of housing is diminished and housing and capital markets return to conditions that are more normal. When will this happen? Probably not this year, maybe not next, but certainly in the foreseeable future.

Outlying Areas

Currently, the press is having a field day saying that the areas at the edge of the metro area will no longer grow because of gasoline prices. What is more likely to happen is that instead of the freeways being filled with pick-up trucks and SUV's, five years from now the freeways are likely to be filled with the Prius's and their hybrid competitors. And it doesn't even need to be extensive hybrid use. If one trades in their H2 for a sports sedan that gets 22 miles per gallon, it completely erases all of the increase in gas prices during the past couple of years in terms of impact on the pocket book. In the short run, oil usage is relatively inelastic, but in the long run becomes quite elastic.

Also keep in mind that jobs opportunities tend to follow people. Unlike many cities, Greater Phoenix does not have one job core, it has several. And, jobs tend to migrate out to where the labor shed is. That will continue to be the case. Many of the areas that are the outlying today will be the job centers of tomorrow.

High-Rise Living

Greater Phoenix has been a community where high-rise condominium living has been a relative rarity. Yet, primarily due to the success of one high-rise project at 24th Street and Camelback Road in Phoenix, a number of high-rise units were constructed during the real estate boom. An example of how deep the market is, however, can be seen by what happened at the Scottsdale Waterfront at Scottsdale and Camelback Roads. It is probably the metropolitan area's premier location, and it is a great project. It is in two buildings consisting of 198 units. In March of 2005 when the developers started taking reservations there were more than 2000 reservations taken for those 198 units. However when the rubber hit the road, it took until March of 2008 for the last two units to be sold.

Many of the high-rise projects throughout the area have been put on hold or have been cancelled due to market conditions. Some will never be built. Some (in Tempe and Downtown Phoenix) may be turned into student housing. Indeed, since 2001, 7,400 units have been added to the high-rise condo inventory. Only 3,700 of those are sold or have a hard contract and 3,700 remain unsold or unreleased. That compares to total single family housing starts during that period of 330,000 units. Thus, even during the strongest period of housing starts on record, high-rise condos only accounted for 2.2% of all the housing construction in Greater Phoenix. It is likely high-rise condos will continue to be a niche market, accounting for a relatively small percentage of total housing. The predominant housing style in Greater Phoenix will remain a single family home on a 45 to 75 foot lot on the periphery of town where land is plentiful and where people can have their piece of the American dream at a price that, at least now that the bubble is over, is affordable by historic standards.

Greater Phoenix Outlook

A combination of events such as the national recession, the local housing bubble, and the rapid rise in food and oil prices, have all worked against Greater Phoenix in the short term. This has been true in many communities though. But, the national economy will recover as it always does. Housing supply and demand will get back into balance. Oil prices, if they remain high, will cause people to substitute vehicles that get less mileage for vehicles that get more mileage. And the average person will still commute to work in a car. Overall, while Greater Phoenix, like many other places in the country, is going through a difficult period at present. Do not bet against it in the long run.