CENTER FOR Competitive Florida
A Florida TaxWatch Center of Excellence

ECONOMIC COMMENTARY

A monthly look at Florida's Economy

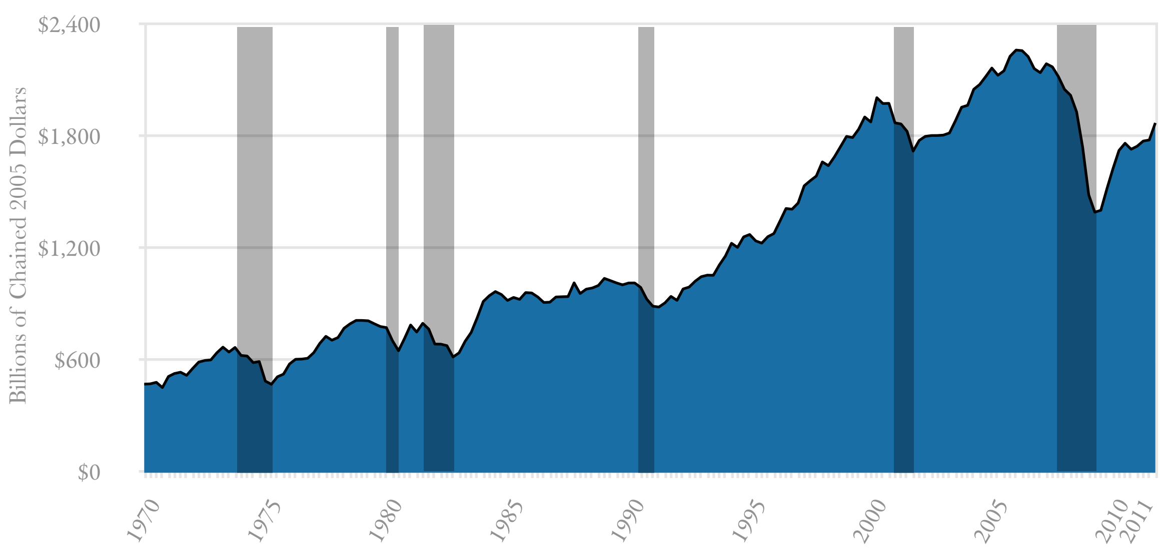
When Will Economic Growth Accelerate?

Although the recession has officially ended, growth is not accelerating as quickly as it did during previous recoveries. This is certainly true for Florida, as documented in the Florida TaxWatch publication *Estimated Job Growth in Florida* co-authored by members the Florida Council of Economic Advisors (FCEA) at Florida TaxWatch. One key economic relationship, whose importance was pointed out by FCEA Chairman Dr. Steve Morrell at a recent Center Advisory Board meeting, is the importance of capital investment during the process of recovering from a recession.

Importance of Capital Investment for Economic Recovery

The below chart, from the St. Louis Federal Reserve Bank, using Bureau of Economic Analysis data, shows the levels of Private Domestic Investment since 1970. Private Domestic Investment is the measure of purchases of fixed assets by private businesses and non-profit institutions, plus the changes in business inventories. Therefore it is a broader measure of investment than capital expenditures because it includes increases or decreases in business inventories. The grey bars on the graph indicate time periods that the U.S. economy is officially in recession. The key relationship shown in the below chart is that each period of recession is preceded by a drop in Private Domestic Investment. In addition, during the recession Private Domestic Investment drops significantly. Most importantly, in each case, the recovery period after the recession coincides with an increase in Private Domestic Investment.

Private Domestic Investment



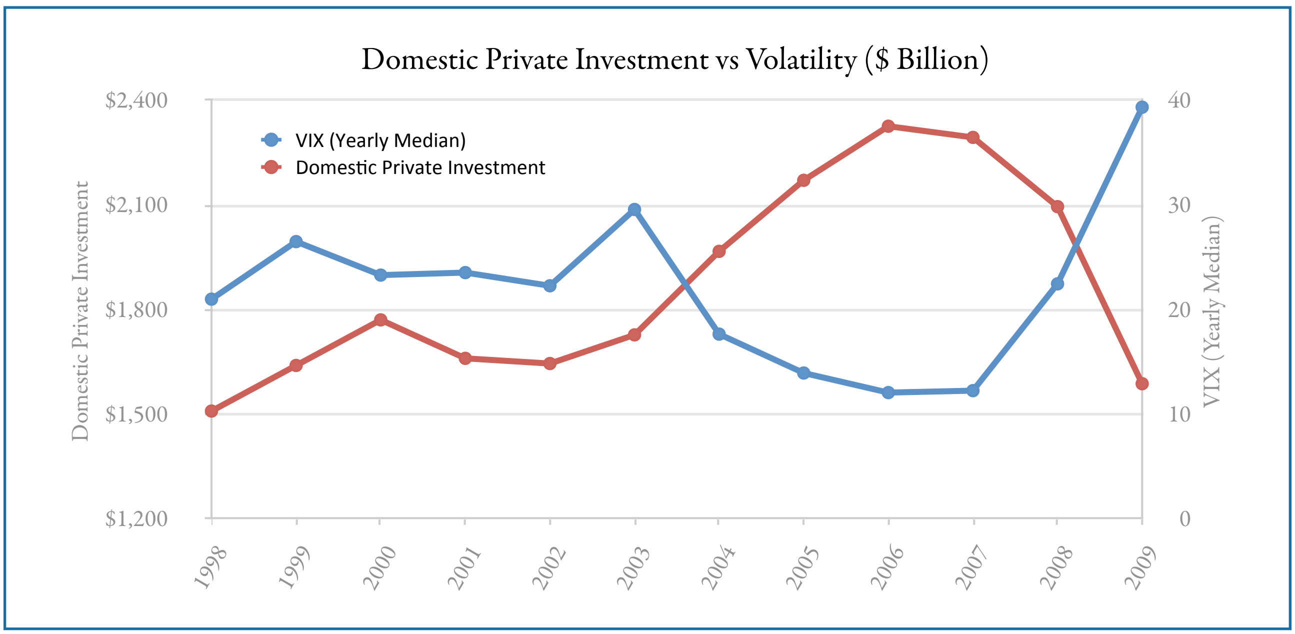
* Shaded areas indicate US recessions   Source: Federal Reserve Bank of St. Louis, Real Gross Domestic Investment, 3 Decimal (GPDIC96)

Most striking is the drop in Private Domestic Investment during the 2008-09 recession. That drop in investment is by far the largest amount during any recession since 1970. The chart indicates that investment of this type has recovered some since the most-recent recession, but it has not reached the peaks achieved before the previous two recessions.

The Negative Impact of Volatility on Capital Investment

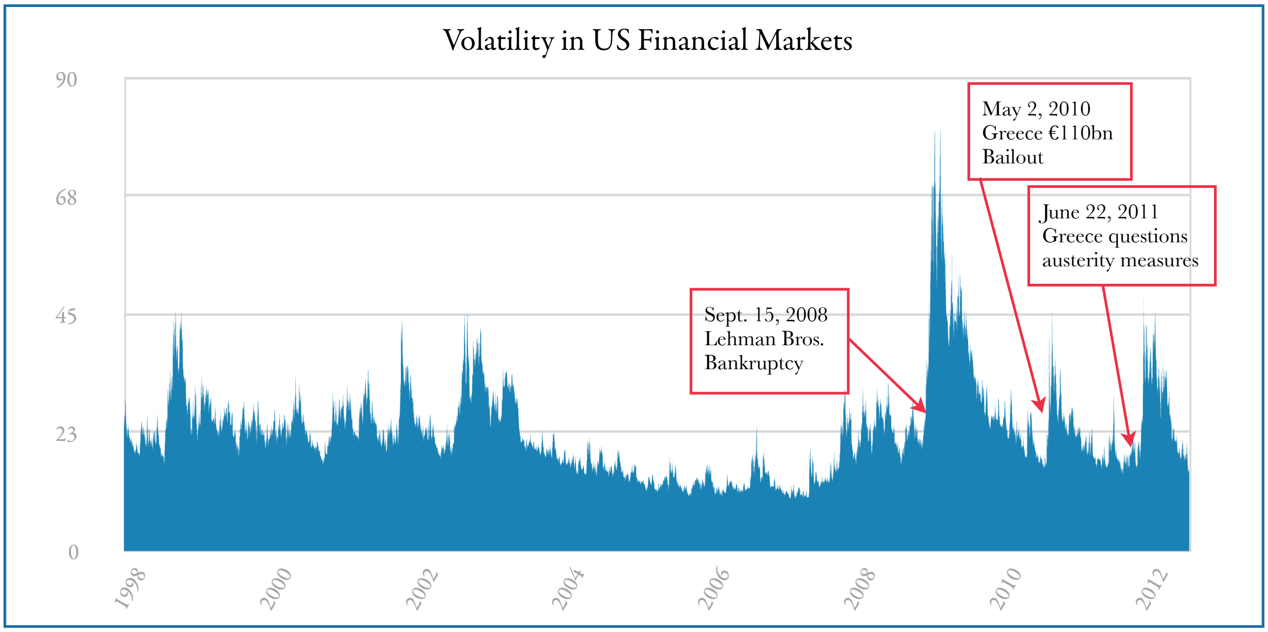
One of the key things that decision-makers take into account when investing is the volatility in financial markets at the time investment decisions are made. Capital investments take place at higher levels in times of more certainty. Financial market volatility can be measured by the VIX, which is an index of the market's expectation of volatility for the S&P 500 for the next 30 days with higher value meaning more volatility (i.e., levels of the VIX increase significantly during times of economic uncertainty). The charts uses data for the VIX obtained from the Chicago Board Options Exchange

The chart below shows yearly U.S. data for Domestic Private Investment from the years 1998 through 2009 on the left-hand axis and the median yearly value for the VIX for each year since 1998 on the right-hand axis. One can clearly see the inverse relationship between volatility (VIX) and capital investment (Domestic Private Investment).



Given that Domestic Private Investment tends to be significantly higher during periods of lower volatility, the causes of volatility should be examined. In order to see what events have caused significant uncertainty in U.S. financial markets, the below chart identifies some of the key events and the dates they occurred.

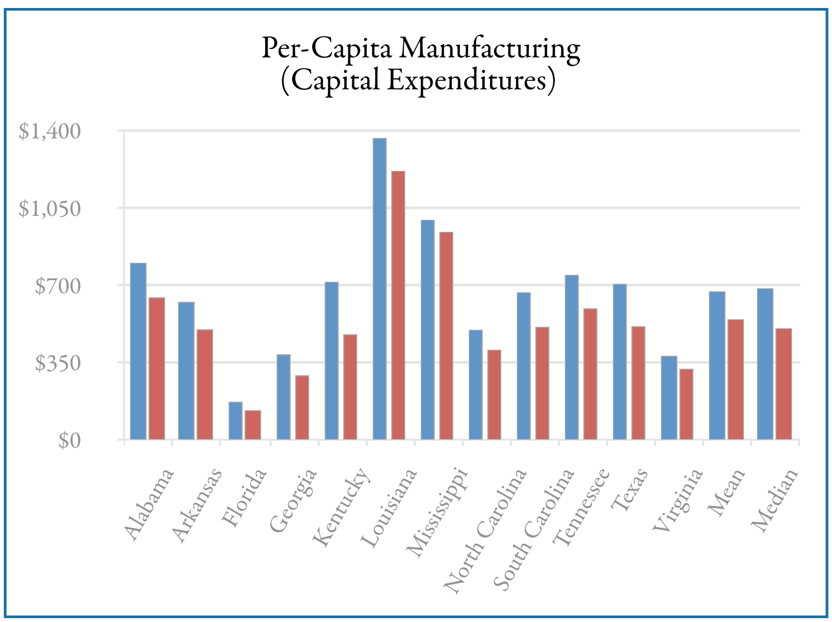
The chart on the following page shows that the VIX was affected significantly by the U.S. financial crisis in 2008-09. But, just as the U.S. economy was showing signs of possible recovery, the financial situation in Greece and other Euro-zone countries developed. A second time period of increased volatility occurred when Greece was scheduled to vote on a bailout package and the outcome was anything but certain. These swings in volatility in the financial markets have added to the uncertainty for investors, contributing to the sluggishness of the recovery.



Fortunately, the austerity measure passed, and the VIX appears to show indications of dropping to levels that signify a much more stable investment environment. If the trend continues, we may see sustained increases in Private Domestic Investment – something necessary for increased productivity and sustained growth of the economy.

Positive Effect of Capital Investment on Productivity

Capital investment is important because it increases the productivity of labor. This increase in labor productivity is highly correlated with high wage jobs. Those high wage jobs produce extra disposable income, more taxable sales, and increased economic activity. An example of Florida's situation is shown in the following chart. It shows the per-capita amount of capital expenditures in manufacturing using data from the Annual Survey of Manufacturers. It shows that not only is Florida behind the other southern states, that Florida's capital expenditures dropped between 2008 and 2009, the most recent year that data is available.



Conclusion

Recent events in both the U.S. and Europe have significantly affected financial market volatility and decreased capital investment as measured by Private Domestic Investment in the U.S. Although the problems have not been solved in the Euro zone, volatility has returned to lower levels. The recent decreases in volatility in U.S. financial markets are likely to lead to an increase in Private Domestic Investment. This increase in investment will help increase economic activity and labor productivity and in the U.S. These increases should accelerate growth in both the U.S. and the Florida economies.

Florida TaxWatch Center for Competitive Florida Advisory Board

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