Florida TaxWatch Center for Competitive Florida ECONOMIC COMMENTARY #23 December 2007
A monthly look at Florida's Economy, made possible by WaMu

The 2008 Florida Economic Outlook

Florida Economic Outlook

	2003	2004	2005	2006	2007E	2008F
Population (millions)	17.07	17.52	17.92	18.35	18.68	18.98
change (000s)	400	450	400	430	330	300
% change	2.4	2.6	2.3	2.4	1.8	1.6
Employment (000s)						
Total	8,246	8,451	8,711	8,989	9,111	9,220
change	121	205	260	278	123	109
% change	1.5	2.5	3.1	3.2	1.4	1.2
Non-Agricultural	7,250	7,499	7,800	8,007	8,140	8,238
change	81	249	301	207	133	98
% change	1.2	3.4	4.0	2.7	1.7	1.2
Unemployment Rate	5.30	4.70	3.80	3.30	3.80	4.40
Personal Income ($billions)	514.4	565.2	616.8	663.3	705.3	744.1
change ($billions)	18.9	50.8	51.6	46.5	42.0	38.8
% change	3.80	9.80	9.10	7.50	6.30	5.50
Gross Domestic Product ($billions)	559,021	607,201	666,639	713,505	742,045	764,307
change	36,302	48,180	59,439	46,866	28,540	22,261
% change	6.94	8.63	9.79	7.03	4.00	3.00
Per Capita Income ($)	30,290	32,546	34,712	36,665	37,757	39,204
change	588	2,256	2,166	1,953	1,093	1,447
% change	2.1	7.5	6.7	5.6	3.0	3.8
FL as % of U.S.	96.4	98.4	100	100.0	100	100
Housing Starts	213,570	255,893	287,250	203,238	111,000	95,000
change	28,140	42,323	31,357	-84,012	-92,238	-16,000
% change	15	20	13	-29	-45	-14

Executive Summary

This edition of Economic Commentary presents the 2008 economic outlook for the Florida economy. The odds of the state's economy falling into recession in 2008 are currently 40 percent (the same as for the U.S.), with the first six months or so of the new year standing out as the especially critical period. The contraction in the weak sectors of Florida's economy has deepened, and a trough is not yet in sight.

Moreover, while other sectors of the Florida economy have continued to expand, the pace of growth is relentlessly slowing. Spreading economic weakness can be attributed in part to diminished growth in the national economy, but primarily to spillover effects from the increasingly severe contraction in the residential real estate markets. Broadening and deepening economic weakness are classic signs of a recession.

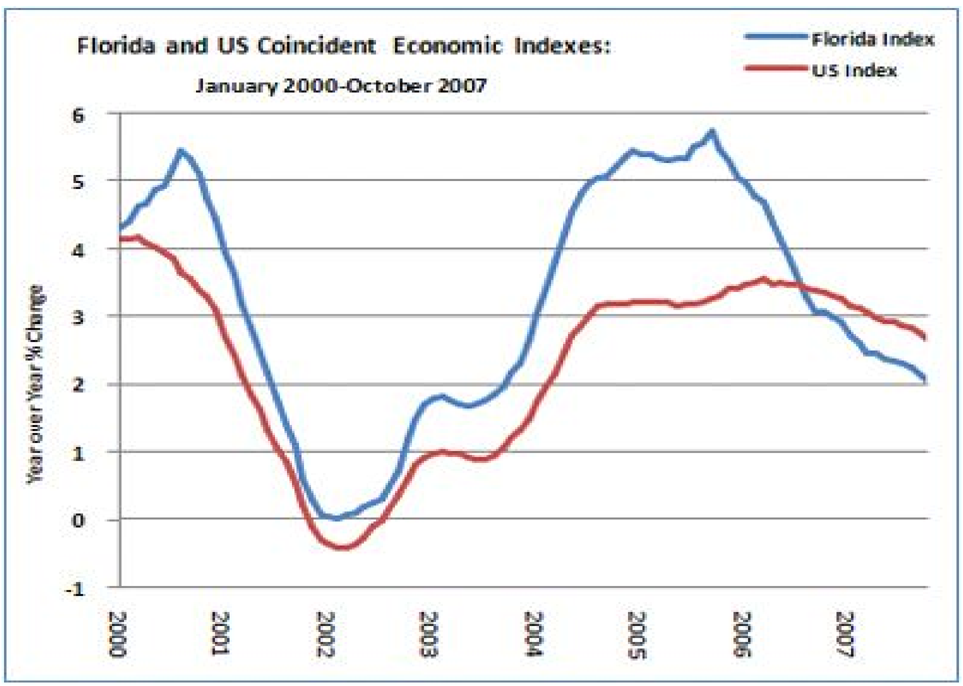
Should a recession occur, the downturn in Florida is likely to be deeper and more prolonged than in the rest of the nation. And, even if a recession is avoided, growth in Florida will likely lag behind the rest of the nation in 2008. Healthy population gains, a bottoming of the residential real estate market slide, an improving national economy, an easing of the liquidity crunch that has seized financial markets and genuine progress in resolving the subprime mortgage fiasco are necessary to stave off recession in Florida in 2008.

However, all is not gloom and doom. Florida's international commerce, especially trade in a variety of services, should expand briskly in 2008 and will bolster jobs and output in segments of the trade, transportation, financial and business

Chart 1

Source: Florida Agency for Workforce Innovation

Chart 2



Source: Federal Bank of Philadelphia

services sectors. Business investment spending, a key to boosting productivity, should increase moderately. The health care sector will continue its long-term development. Federal defense and security expenditures will soften the downturn from other sectors. New proposals for meaningful property tax reform have the potential to stimulate growth. Solutions for skyrocketing homeowners insurance are being pursued. Adjustments to the State budget are being effectively managed, though an estimated 2.2 to 2.5 billion dollar additional shortfall for the state's budget will likely contribute to slower economic growth in 2008. And finally, beyond the headlines, fundamental structural changes are likely occurring in Florida's economy. Such changes bode well for the state's future.

This 2008 Florida Economic Outlook starts with brief assessments of the national and international economies. Attention is then turned to the Florida economy.

Nationally – Recession Odds Peak in March

Federal Reserve Bank of New York economists have developed a highly accurate (though not infallible) statistical model predicting the probability of a national recession within a 12- month horizon. As of November, the odds of a recession within the coming 12 months stood at about 38 percent – a very high probability by historical standards. This probability peaks at roughly 41 percent in March 2008, levels off in the 30 percent range during the summer of 2008, and then steadily declines to about 11.50 percent by November 2008. Clearly, the next six months or so are the critical period for the U.S. economy to avoid recession.Several factors have driven the odds of a recession upwards. They include the nationwide slump in residential real estate markets and new residential construction; the loss of wealth associated with falling real estate values; higher energy prices as crude oil flirts with a $100 per barrel price; and turmoil in global and national credit markets. In this environment consumer wealth has flattened and consumer confidence has been shaken. Concerns have mounted that consumer spending on interest rate sensitive/big ticket items and discretionary purchases will noticeably ease; business expansion plans will be temporarily shelved; and that job and income gains will falter as a result.

Though the odds of a recession are relatively high, the consensus among economists is that the U.S. economy will somehow muddle through the riskiest part of 2008 and continue to grow ? albeit at a rate in the 2.00 percent range versus a trend or normal rate of expansion of closer to 3.50 percent. Climbing exports and a provident Federal Reserve are the keys to avoiding a national recession in 2008. Sustained, solid economic growth in the rest of the world and a U.S. dollar which has depreciated by about 25 percent since 2002 should bolster U.S. exports and the U.S. economy. Adroit handling of the national and international liquidity crises by the Federal Reserve will gradually reactivate normal lending and borrowing channels, providing consumers and businesses access to credit once again.

In this regard the Federal Reserve?s approach to the combination of a slowing economy, threats of inflation and the global liquidity crises deserves special mention. During the Greenspan era, the approach to financial market and economic turmoil was to aggressively ease the overnight interest rate (the federal funds rate); to provide massive amounts of liquidity to the economy via the financial markets; and to keep the federal funds rate at a low level for extended periods. Under Ben Bernanke?s chairmanship, however, the approach is more innovative and also, perhaps, riskier. His approach calls for more measured reductions in the federal funds rate to stimulate the economy without accelerating inflation, and to address the financial market turmoil with precisely targeted injections of liquidity by way of the Federal Reserve?s Discount Window lending.

Apparently, financial market participants do not (yet) understand this new approach. They anticipate the federal funds rate will be lowered to 3.50 percent from its current level of 4.25 percent, and are likely to be keenly disappointed when it levels off at 4.00 percent. Additional financial market volatility could ensue. It is a tug of war between creative, innovative and possibly naïve economists with roots in academia versus wizened, wily Wall Street.

Florida Outlook I – The Downtrend Intensifies

Despite what may be the worst housing market in the state’s storied history, the Florida economy has managed to expand so far in 2007. Several pieces of data confirm the expansion:

- Personal income rose 6.45 percent in the first half of 2007 compared to the same period in 2006.
- The Federal Reserve Bank of Philadelphia?s index of coincident economic indicators for Florida, a measure of current economic conditions, advanced an average of 2.13 percent during August, September and October 2007 compared to the same period in 2006.
- Total employment increased by 125,000 jobs or 1.43 percent in the August-October, 2007 time frame versus the same period in 2006. Employment gains were recorded in a number of industries including trade, transportation, utilities, financial activities, education, health care, leisure and tourism and state and local government.

While the Florida economy is not currently in recession, virtually every economic indicator for the state exhibits a seemingly unyielding downtrend. A number of indicators have already turned negative; others have slowed to the point where they are flirting with zero-to-negative growth; and others have slowed noticeably. Negative growth indicators include:

- New Housing Starts. As measured by building permits, new housing starts are on pace to be about 111,000 units in 2007. This will be a whopping 45 percent decline from 2006, and a 61 percent contraction from the 2005 peak. 2007 housing starts in Florida will be at their lowest level since the national and state recessions of 1991-1992. In a related vein, the value of new housing starts has plunged about $27 billion, or 58 percent from the 2005 peak.
- Published news reports put Florida's foreclosure rates to new highs in the third quarter 2007. Also, property tax defaults are on the rise, up 41% from the year before.
- Housing Prices. Falling housing prices on the order of seven percent (depending on the measurement method) were recorded for the 12 months ending in September 2007.
- Statewide Taxable Sales. Data provided by the Office of Economic and Demographic Research (EDR), show decreases (compared to the same month of the prior year) for 11 consecutive months beginning in November 2006 and continuing through September, 2007.
- Taxable Sales. Items closely related to the slumping housing and real estate markets, and to lower consumer wealth associated with falling housing prices, have recorded the steepest declines. Taxable sales of building materials (building investment) have been receding at year-over-year rates of 20 percent. Taxable sales of autos and accessories, and consumer durables have been dropping at rates of close to 10 percent each.
- The EDRs Index of Retail Activity turned negative in May 2007 and the falloff has intensified with each passing month.

Indicators whose growth has slowed close to zero include:

- Employment Growth. As illustrated in Chart 1, statewide job growth has slowed for 12 successive months and is now slightly above 1.00 percent.
- Unemployment. The number of unemployed Floridians has jumped by more than 100,000 -- from 290,000 in October 2006 to 393,000 in October 2007. 22,000 construction jobs and 3,900 jobs in building materials and garden supply stores have been lost since October 2006.
- Unemployment Rate. Florida's jobless rate has increased a full percentage point, from 3.20 percent to 4.20 percent, during this period.
- The Philadelphia Federal Reserve's Index of Coincident Economic Indicators for Florida. As depicted in Chart 2, this measure of current economic conditions has trailed that for the U.S. in every month since August 2006. Florida's economy has been underperforming the U.S. for the past 15 months, after outperforming it for the prior six years.

Indicators whose growth has slowed noticeably include:

- Statewide personal income. Growth has slowed from about 9 percent in 2005, to about 8 percent in 2006 to about 6.45 percent in 2007.

The Florida Outlook II – Searching for a Bottom in 2008

In the short term (2008-2009) one key to arresting the pronounced downtrend in Florida's economy and preventing a recession is for the beleaguered residential real estate market to hit bottom. The trough in residential real estate will not be reached until the substantial excess supply of housing is largely eliminated.

Reducing the surplus of housing will require several adjustments. On the demand side, these include continued falling prices; healthy population growth; and meaningful progress on property tax and insurance reform. In addition, further cutbacks in new construction will be required to limit the increase in supply.

Some of these adjustments are in progress, but also appear to be in their early stages. While the decline in housing prices has accelerated, it has yet to boost demand – perhaps because prospective buyers anticipate additional price cuts. For example, The Case Schiller Index, The OFHEO Index and the National Association of Realtors data all show price declines in the vast majority of the metropolitan areas they cover. Price reductions recorded on single family homes for the past twelve months were 11.1 percent for the Tampa MSA in the Case Schiller Index; 11.7 percent for the Punta Gorda MSA in the OFHEO Index; and 12.4 percent for the Sarasota MSA in the NAR data. However, demand remains anemic. Existing homes sales in the state contracted 32 percent from the third quarter of 2006 to the third quarter of 2007 according to the NAR, versus a national decline of only 14 percent. New home sales in the South census region shrank 22 percent from a year earlier. The downslide in Florida was likely larger. The implication is that prices will decline further in 2008.

As second home and investor demand for housing has evaporated, population growth becomes even more critical to Florida?s housing markets. The highly respected demographers at the University of Florida?s Bureau of Business and Economic Research expect population gains in the 300,000 per year neighborhood for the next several years. Increases of at least this magnitude will be necessary for the slide in the housing markets to end. 2009 would then be a year of "bouncing along the bottom," with a recovery not expected until 2010.

Property tax relief appears probable, though there is uncertainty about which of several plans might be adopted. Depending on the legislation, the effects on housing markets could range from marginal to sizable. Insurance reform has a national dimension, and with an election year looming, the prospects for reform are dim.

On the supply side, new housing starts will continue to skid in 2008. A 20 percent decline to the 90,000 unit level – the lowest in almost 20 years – is anticipated for 2008.

The re-pricing of subprime mortgages poses an added risk to Florida?s housing markets in 2008. Nationally, roughly 1.5 million adjustable rate, subprime loans with a face value of about $330 billion are scheduled for interest rate resets by the end of 2008. A disproportionate number will be reset by mid-2008. Most of these loans were made from late 2004 until early 2006, apparently at "starter" rates in the 7 to 9 percent range with substantial prepayment penalties and possible resets of an additional 5 percentage points!

Moreover, the interest rate reset on an unknown but non-trivial number of such loans is tied to the London Inter-Bank Offer Rate (LIBOR) rather than a U.S. Treasury index. LIBOR rates, likely owing to the global liquidity crises, have remained stubbornly high while Treasury yields have decreased. For example, 90-day LIBOR rates have slipped about 45 basis points at a time when 90-day Treasury yields have dropped about 100 basis points. Add falling housing prices to this mix, and a recipe for a spike in foreclosures may be on the horizon. Additionally, the Bush Administration’s plan to ease the subprime crisis applies only to owner-occupied housing. Investors who purchased one or more housing units on a speculative basis and used subprime loans as their financing source could soon be walking away from their investments. All of this will exacerbate Florida’s residential real estate recession.

The Florida Outlook III – Structural Change

A recession in 2008 will be a test of what economists have coined "the great moderation." This term refers to the empirical fact that recessions have become less frequent and severe since the mid-1980s. Downturns in the economic cycle also seem to take place when fundamental structural changes are occurring in the economy. Such structural changes, while often painful, are necessary for sustained growth in a dynamic society.

Innovation and "factor price equalization" often drive structural change in economies. The latter term refers to the tendency of mobile resources (people, financial capital, equipment) to move to places where the cost of living and doing business is lower. In the process, which may take an extended period of time, lower-cost locations eventually become relatively more expensive and lose their former low cost advantages. The cycle is then repeated elsewhere.

Florida may be experiencing such a structural change. An attractive climate, low cost of living, low taxes and plentiful employment prospects have propelled Florida's robust, in-migration driven population growth for decades. These new residents, retirees prominent among them, have in turn fueled the demand for a wide range of goods and services and enlarged the state's economy.

But Florida's low cost of living and low tax status advantages may increasingly be things of the past. Housing costs have spiraled and property taxes have escalated. At the same time, other states (and nations) have promoted – with some success – their lower housing costs and property taxes to compete more vigorously with Florida for new and existing residents.

If Florida?s low-cost advantage as a place to live is eroding then, as Professor Dave Denslow of the University of Florida has insightfully noted, it will become less attractive to people of moderate means but, possibly, more attractive to those of greater means. If this includes people with more "human capital" -- including global entrepreneurial talent -- then it could serve as a catalyst for new, higher value-added industries to emerge in Florida and drive the economy in the process.

By Stephen O. Morrell, Ph.D., Florida TaxWatch Senior Research Fellow and Professor of Economics and Finance, Andreas School of Business, Barry University, Miami Shores.

ECONOMIC COMMENTARY is made possible through the support of WaMu

The TaxWatch Center for Competitive Florida...Resolving issues vital to Florida´s global economic competitiveness.
Victoria Zepp, Executive Director, 850-241-6309, vzepp@floridataxwatch.org

CENTER FOR Competitive Florida
A Florida TaxWatch Center of Excellence

Florida TaxWatch Center for Competitive Florida Advisory Board