Florida TaxWatch Center for Competitive Florida ECONOMIC COMMENTARY #28 June 2008
A monthly look at Florida's Economy, made possible by WaMu

Testing the Great Moderation

Fluctuations in the U.S. business cycle moderated considerably beginning sometime in the early 1980s. While the business cycle has not vanished, over the last 20-25 years economic recessions have occurred less frequently than in the past and, when they have occurred, they have been shorter in duration and less severe in terms of the magnitude of decline in economic activity. For example, U.S. GDP growth was 55 percent less variable from 1984 through 2006 compared to the 1965 through 1983 time frame, according to research by economists at the Federal Reserve Bank of Cleveland.

Economists have dubbed this dramatic change the “Great Moderation”. Researchers have been trying to identify its causes for some time. Three broad explanations have been identified: Better economic policy (especially monetary policy); structural changes that have made the US economy less vulnerable to adverse economic shocks; and simple good luck - specifically, the absence of sizable, adverse shocks to the economy.

The current economic climate is providing a strenuous test of the “Great Moderation” for both the U.S. and Florida economies. The combined and cumulative effects of the bursting of the housing bubble, collapsing housing starts, plunging housing prices, the global credit crisis, surging oil and commodity prices, and renewed inflation worries represent the most potent headwinds the U.S. and Florida economies have confronted since the mid-1970s.

Charts 1 and 2, developed by the esteemed economist Dr. David Denslow of the University of Florida and the Florida Council of Economic Advisors at Florida TaxWatch, illustrate for Florida in particular the seriousness of the current economic downturn. The data in the charts are an index of coincident economic indicators developed by economists at the Federal Reserve Bank of Philadelphia. One purpose of the index is to provide a barometer of current economic conditions. Indexes have been developed for each state and the U.S. economy.

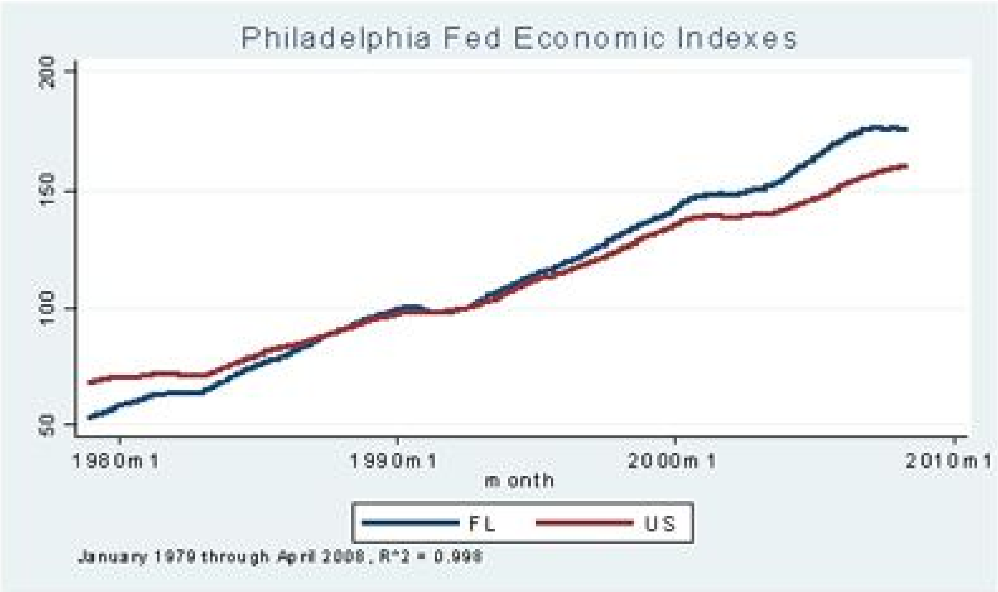
Florida and US Coincident Economic Indexes: Cycles

Source Dr. David Denslow, UF, Council of Economic Advisors at Florida TaxWatch, Federal Reserve Bank Philadelphia

Chart 1 depicts the historical fluctuations (measured as deviations from trend) in economic activity for the U.S. and Florida economies. In other words, it shows the ‘business cycles’ in the U.S. and Florida. There are several noteworthy features in Chart 1:

- From 1979 to mid-2006 the timing of business cycles in Florida very closely tracked national ones. That is, expansions and contractions, as well as peaks and troughs, in the Florida and U.S. economies occurred at virtually the same times.
- The magnitudes of the upswings and downswings in the Florida and U.S. economies were also roughly the same from 1979 through mid-2006, save for the 1990 - 1991 recession where Florida experienced a more severe contraction and the 2003 - 2006 expansion where Florida enjoyed a more robust recovery.
- Beginning in mid-2006, however, a clear and noticeable difference emerged between the U.S. and Florida business cycles. Florida's economy peaked in July, 2006 while the U.S. economy did not peak until 13 months later in August, 2007.
- Since their respective peaks, the cumulative declines (measured as the cyclical deviations in the indexes) in the Florida and U.S. economies have been about 8 percent and 1 percent, respectively. The Florida index has recently turned negative - a visible sign that the state's economy is in recession.

Florida and US Coincident Economic Indexes: Trends



Source: Dr. David Denslow, UF, Council of Economic Advisors at Florida TaxWatch, Federal Reserve Bank of Philadelphia

Chart 2 shows the trends in the Philadelphia Federal Reserve indexes for the U.S. and Florida economies. Cyclical movements are smoothed out in this chart, permitting a clearer view of long-term economic growth in the U.S. and Florida. Again, there are several striking features in this chart:

- By the late 1980s, Florida's long-term economic growth rate had caught-up with that of the U.S.
- The Florida and U.S. economies expanded at approximately the same rates from the late 1980s until the late 1990s.
- Starting in the late 1990s, Florida's long-term economic growth rate increasingly surged ahead of that for the U.S.

The severity of the current downturn in Florida compared to the U.S. suggests that, unfortunately, Florida's long-term pace of expansion might soon reverse course and even dip below that of the U.S. In other words, the "Great Moderation" may not be applicable to Florida at this time.

Economic recessions - even severe ones - do end, and a host of factors that are not yet the 'talk of the town' are likely paving the way for renewed growth in Florida. The challenge is to ensure that state and local economic policies support, rather than impede, Florida's long-term economic health.

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