

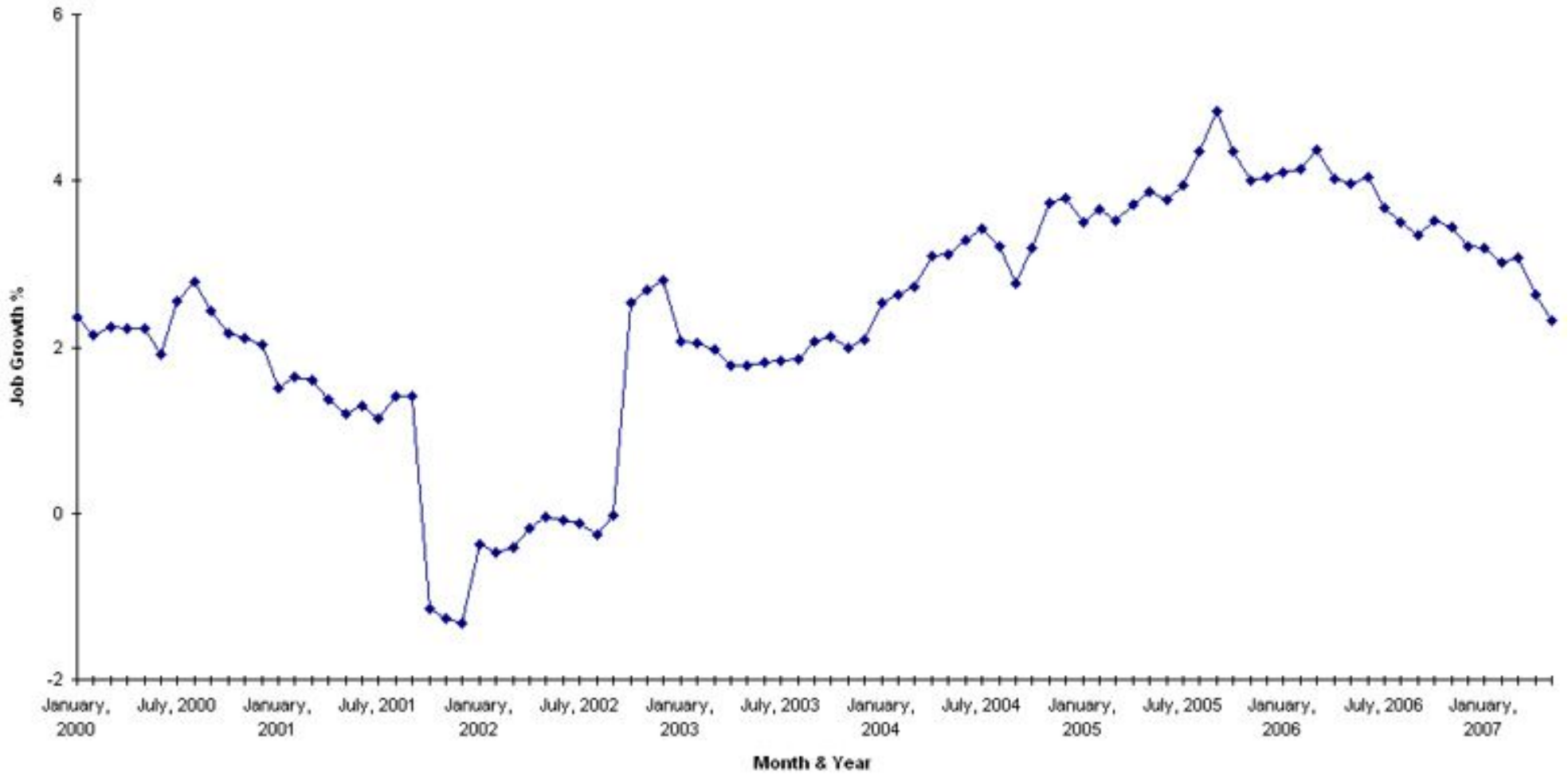
## Mid-Year Update on the Florida Economy

Our 2007 outlook for the Florida economy, released in January, called for continued expansion - although at a much subdued pace compared to recent years. Now that we have arrived at mid-year, it is an appropriate time to re-examine and, where needed, update this forecast.

As expected, economic activity in Florida has slowed noticeably thus far in 2007. Charts 1 and 2 (see below) present reasonably broad-based and current pictures of the state's economy. Chart 1 shows the percentage change in total employment compared to the same month of the prior year from January 2000 through May 2007 (the latest date for which data are available). From its peak growth of close to 5.00 percent in September 2005 and high growth rate in excess of 4.00 percent during the first quarter of 2006, job growth in Florida has been on a clear downtrend. The fall-off in employment gains has been especially pronounced in the last few months, decelerating to a 2.31 percent annual pace in May 2007.

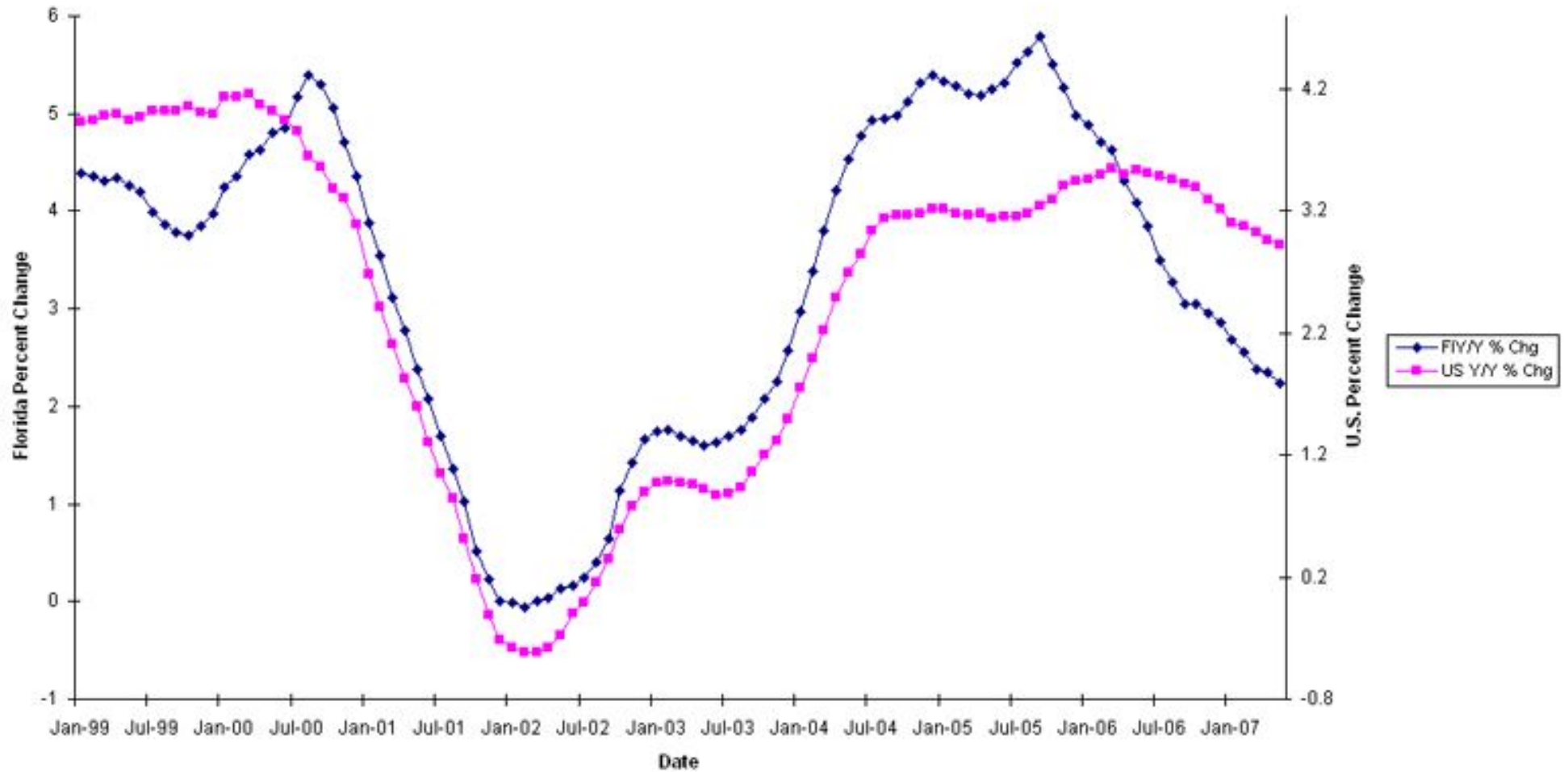
Chart 2 illustrates indexes of coincident economic indicators for Florida and the U.S. The indexes, developed by the Federal Reserve Bank of Philadelphia, are designed to provide gauges of current economic conditions. Chart 2 depicts the percentage changes in the indexes for Florida and the U.S. compared to the same month of the prior year from January 1999 through May 2007. As was the case with employment, the coincident indicators reveal economic growth in Florida peaked in the latter part of 2005, when the index stood 5.79 percent above its year-earlier reading. Since then it has subsided markedly, and now stands about 2.25 percent above its year earlier level. Moreover, the deceleration in the index of contemporaneous economic indicators has been more persistent than that for job growth. Additionally, since August 2006, the advance in the U.S. index has not only exceeded that of the Florida index, but the margin between the two has also consistently widened.

**CHART 1:**  
**Florida Year-over-Year Job Growth**



Source: Agency for Workforce Innovation

CHART 2:  
 Florida and U.S. Coincident Economic Indexes: Year-over-Year Percent Changes: January, 1999 - May, 2007



Source: Federal Reserve Bank of Philadelphia

Other data paint a similar picture of a slowing Florida economy. For the first quarter of 2007, personal income, one of the broadest measures of economic activity, stood about 6.08 percent above the level for the same period in 2006. This was the smallest advance since 2003. Nominal and inflation-adjusted GDP for Florida expanded in 2006 at rates of 7.03 percent and 4.25 percent respectively, the slowest paces of advance since 2003.

The salient question for the balance of 2007, in light of the above data, is whether or not the deceleration in the state's economy will soon hit bottom or, instead, continue to spread, deepen and turn into an outright contraction. Whether a recession will occur is a close call. An unexpected, adverse shock such as spikes in either interest rates or oil prices, a severe hurricane, and systemic problems in the sub-prime mortgage market could tip the balance from slow but positive growth to a recession with its attendant shrinkage of jobs and

incomes.

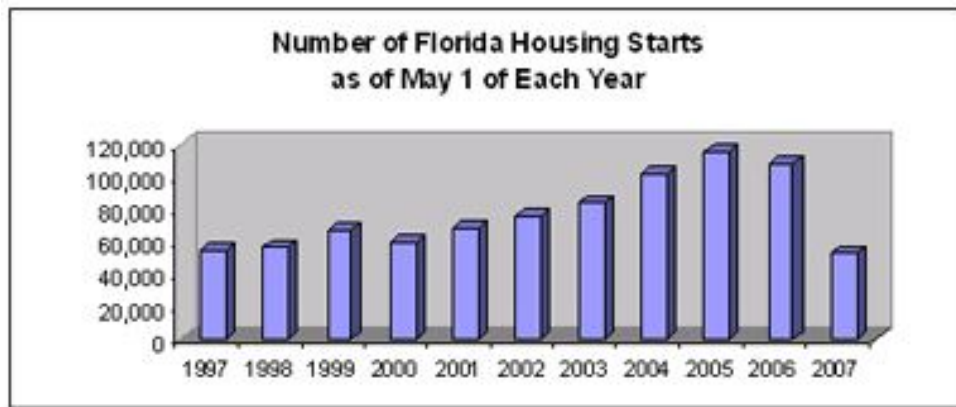
Florida's economy continues to be curbed by several factors, all of which we noted and discussed in our January outlook. These factors included meager growth in the U.S. economy, higher interest rates, reduced population gains, and most importantly a severe recession in the state's residential real estate and construction sectors.

Real GDP in the U.S. economy expanded at a paltry 0.7 percent annual rate in the first quarter of 2007, compared to an average and solid gain of 3.40 percent during the previous three years. U.S. growth was even slower than we expected. Consumer expenditures and state and local government spending were the primary positive contributing sectors to the U.S. economy. Nationally, consumer spending is important for Florida's tourism industry and has helped buoy it in 2007. Exports are also a source of growth for the national and Florida economies, but both goods and services exports barely expanded in the first quarter of 2007.

Analysts expect the U.S. economy to rebound and grow in the 2.00 to 3.00 percent range for the remainder of 2007. This modest uptick, if it materializes, should help to brake the slowdown in Florida. However, there is reason for less optimism. As we wrote in January, the risks are that monetary policy will prove in retrospect to have been "too tight for too long." There are no indications at present that monetary policy will ease in the coming months, unlike what we expected in January. Moreover, interest rates have edged upwards thus far in 2007. The bellwether 10 year Treasury bond yield has risen from 4.60 percent at year-end 2006 and currently is about 5.00 percent; yields on corporate Baa-rated bonds and conventional fixed rate mortgages have also advanced about 40 basis points in 2007 to 6.70 percent and 6.63 percent, respectively. Additionally, business capital spending, a key catalyst for economic growth, has been flat and is likely to remain so for the balance of the year. Furthermore, the national slump in housing is likely to worsen. In my estimation Florida's economy will receive only a modest boost at best from the national economy for the rest of 2007.

Global economic growth, including Florida's main international trade partners, should continue on a healthy path for the duration of 2007. These gains will support activity in Florida's agriculture, services (such as tourism, health care and financial) and manufacturing sectors. However, the structure of Florida's economy is such that the global commodities, natural resources and, to a lesser extent, manufacturing booms trigger considerably more growth in many other states. Additionally, post 9-11 constraints on international visitors to Florida continue to hamper the state's international trade in services.

The key to whether or not Florida experiences an outright recession versus a period of sub-par growth depends largely on developments in the state's residential real estate markets. The state's housing markets and residential construction sector are in recession. The recession is proving to be more severe than we originally anticipated. The following data illustrate the scope of the downturn:



Source: U.S. Bureau of the Census

- Housing starts for the first five months of 2007, as reported by the U.S. Census Bureau, were 53,046 units - a plunge of 51 percent compared to the same period in 2006 and a collapse of almost 54 percent from the peak five-month period in 2005. Housing starts for the first five months of 2007 are at their lowest level since 1996. The inflation-adjusted dollar value of new housing has tumbled by roughly comparable percentage amounts. Chart 3 (see left) shows the number of housing starts for the first five months of each year from 1997 through 2007.

- At the current pace, housing starts for the full year of 2007 in Florida would be in the 125,000 to 130,000 range. This would be the lowest level of housing starts for Florida since 1996-1997, when the state's population was about 3 million people less and when it had roughly 1.25 million fewer households than at present.
- The National Association of Realtors estimates housing sales in Florida are proceeding at a 347,000 unit annual rate thus far in 2007. This estimate, which could prove overly optimistic, nonetheless represents a decline of some 200,000 units or 37 percent compared to the peak in 2005.
- A variety of price measures show falling housing prices throughout Florida. The Case Shiller Home Price Index reports that as of April 2007, home prices in Miami (which includes Miami-Dade, Broward, and Palm Beach counties) had dropped 2.61 percent from the December 2006 peak, while home prices in Tampa (which includes the four county Tampa MSA) had shriveled 5.70 percent from its June, 2006 peak. The Office of Federal Housing Enterprise Oversight's price indexes for 18 Florida MSAs shows that for the first quarter 2007, home prices slumped in 12 MSAs by an average of 1.44 percent and rose in only 6 MSAs by an average of 1.12 percent. The National Association of Realtors reports median prices of single family homes shrank in 6 of the 10 Florida MSAs it follows by an average of 5.42 percent, and increased in only 4 MSAs by an average of 2.79 percent. The downturn in the median price of condominiums was even larger.

A collapse in housing demand starting in late 2005 - early 2006, as opposed to unbridled increases in housing supplies, appears to be the primary cause of Florida's housing recession.

While difficult to accurately measure, it is nonetheless important to gauge the magnitude of the supply-demand imbalance in order to estimate its economic impact. An admittedly crude measure can be derived by comparing housing starts (the change in supply) with household formation (the change in demand). Housing starts (single family, apartments, condominiums) in Florida totaled about 1,262,000 units from 2000 to 2006 -- an average of 210,000 units per year. Florida's population increased by about 2,100,000 people and the number of households rose by approximately 857,000 during this period, an average of 142,000 per year. This indicates an excess of new supply relative to new demand of about 68,000 new units per year for a total surplus of 405,000 units. Judged by market conditions within the state, the problem at first blush appears to have emerged on the so-called supply side of the market.

However, an adjustment to housing demand should be made for second home buyer demand. Estimates here vary widely. A 2006 survey

by the National Association of Realtors indicates 36 percent of all home sales nationally were for either investment (22%) or vacation (14%) purposes. Applying these percentages to Florida increases demand by about 50,000 units per year - a total of 300,000 units - and shrinks the surplus from 405,000 units to about 105,000 units. This is a manageable surplus. However, it also suggests the source of the housing recession is not primarily on the supply side of the market, but rests on a collapse in demand.

A more than doubling of housing prices, compared to a 30 percent gain in personal incomes, combined with skyrocketing insurance premiums and property taxes (especially for first-time and second-home buyers), and higher interest rates are the likely culprits behind the sharp falloff in housing demand. Reviving demand to end the housing recession is unlikely for the foreseeable future. Housing in Florida must become more affordable for both primary and second-home buyers. Rejuvenating demand will require sustained population and household increases, lower and less-volatile home prices, higher household incomes, lower interest rates, and an end to rapidly escalating insurance premiums and property taxes.

This will be a difficult combination to achieve. Anecdotal data suggest Florida's population growth is slowing - perhaps significantly. Housing prices will continue to fall through 2008, exacerbated by foreclosures associated with the sub-prime mortgage market, investors and/or speculators selling properties at losses, and buyers who are waiting for the market to reach bottom. Household incomes are likely to rise at subdued rates and a sharp decline in interest rates is unlikely. Substantial changes are needed to dampen increases in insurance premiums. Recently enacted legislation rolling back property taxes and the proposed constitutional amendment should help demand, but are not panaceas.

Construction spending (residential, non-residential and government) accounted directly for almost 8.00 percent of Florida's nominal Gross Domestic Product of \$714 billion in 2006. The indirect impacts on a variety of industries were also substantial. Construction could recede to the 5 percent range of GDP in 2007 - 2008, shaving directly some \$20 billion from the GDP. The remaining 92 percent of the Florida economy must grow by about 3.00 percent to offset the slump in the residential markets and stave off recession. Three-to-five percent growth for the rest of the state's economy is feasible, leaving overall growth in the one-to-two percent range. This would be the weakest growth in Florida in the last ten years.

**Coming Next Month:** The 2007 Economic Outlook for Florida

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