Florida TaxWatch Center for Competitive Florida ECONOMIC COMMENTARY #26 March/April 2008
A monthly look at Florida's Economy, made possible by WaMu

Searching for a Bottom

Calling a bottom in any market is, in my estimation, exceedingly more difficult than calling a top. Economists have extensively researched factors that start, propel, and ultimately cause market bubbles to burst, but have paid somewhat less attention to market recoveries.

This research formed the basis of the August, 2005 Economic Commentary, "Is There a Bubble in Your House?" where the peak in Florida's residential real estate market was called. At the time it was a reasonably straightforward assessment as housing prices had by then widely diverged from even the most optimistic forecast of fundamental demographic, economic, and financial factors.

However, the ensuing magnitude of the plunge in housing starts, housing sales, and housing prices has greatly exceeded the direst predictions. Housing starts in Florida are at their lowest level since 1992 and have dropped 64% from the 2005 peak, according to Census Bureau data. The Florida Association of Realtors reports existing home sales have slumped 56% from the 2005 peak while new home sales in the South Census Region are down 45%. The Case-Shiller price index shows that housing prices have toppled about 20% and 15% from their peaks in the Miami and Tampa regions, respectively; these figures represent respective dollar declines of $77,000 and $42,000 from peak median prices.

The above data indicate a bottom in the state's depressed housing market is not yet in sight. Recognition of the necessary conditions for a trough and recovery exist, but scant evidence has emerged that these factors are firmly in place. One key factor, among several, is credit markets returning to a functional state.

Credit markets were first roiled in the summer of 2007 when global financial institutions started to report large losses on Collateralized Debt Obligations (CDOs). CDOs are structured bonds backed by packages and bundles of loans including mortgage loans. The issuance of CDOs had soared in tandem with the housing market boom as lending institutions sold mortgage loans and investors reached for higher yield. The Securities Industry and Financial Markets Association estimates CDO issuance climbed from $157 billion in 2004 to $486 billion in 2007. In retrospect, the complexity of CDOs may have obscured their risk.

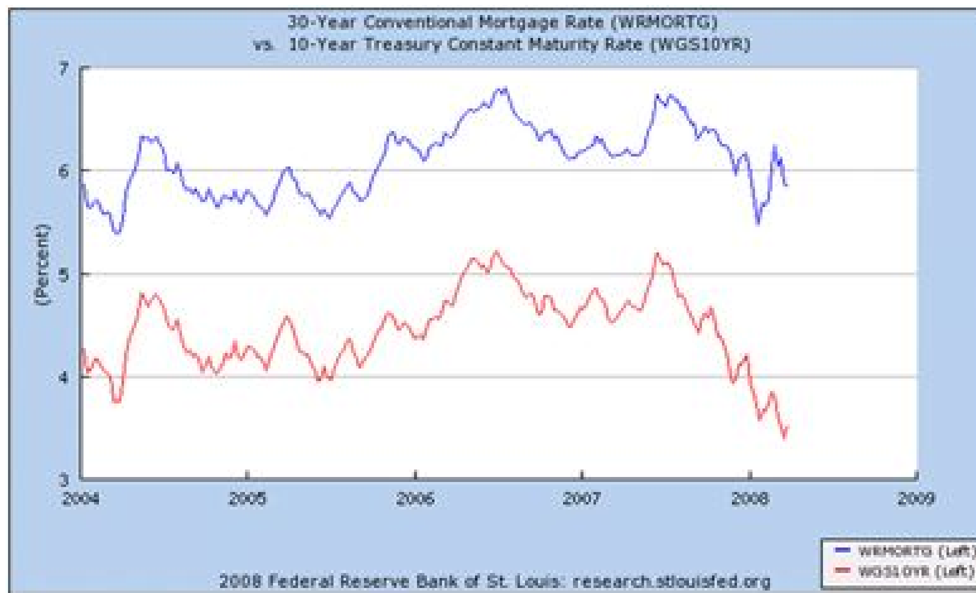
An unanticipated spike in defaults on sub-prime mortgage loans was the proximate cause of the losses suffered by financial institutions. Buyers of CDOs and related bonds quickly fled the market. The specter of higher risk rapidly shifted to other credit markets. In response, financial institutions sought to preserve capital and significantly tightened lending standards in the process. The availability of credit started to grind to a halt and, where it was available, the interest rate - i.e., price of credit - increased significantly; at which point a market critical to the economy's growth became largely inoperable and has been in this state for about six months.

Although some analysts have been critical of the Federal Reserve's efforts to restore credit market balance, the efforts have been innovative, far-reaching, and unprecedented. The benchmark overnight lending rate among depository institutions has been cut three percentage points to 2.25%. In addition, the Federal Reserve radically altered its discount window lending perspective. Previously, the

Federal Reserve interpreted commercial bank borrowings from its discount window as a sign of bank weakness. The Federal Reserve now insists, however, that such borrowings are a sign of bank strength. Additionally, it extended borrowing privileges to securities broker-dealers, making the Federal Reserve the 'lender of last resort' to commercial and investment banks. Auctions of reserves to depository institutions were also instituted. These policies were designed to force-feed liquidity into the financial system.

More recently, the Federal Reserve has considerably widened the eligible collateral it will accept in conducting open market transactions. These transactions are the primary vehicle for providing growth in the economy's money supply. Moreover, the Federal Reserve's role in the Bear Stearns rescue indicates a possible expansion of its lender-of-last-resort function from strictly commercial banks to investment banks as well. These changes are intended to address systemic risk in the financial sector as well as solvency issues.

Monetary policy works with a lapse of time - six to nine months for initial effects to be seen is the rule of thumb. The Federal Reserve's efforts, which started in earnest in September, 2007, should therefore be more visible in coming months.



The accompanying chart indicates some thawing of credit markets is finally occurring. It shows weekly interest rates on default free 10 year maturity Treasury bonds and 30 year conventional mortgages. The chart illustrates the abrupt widening of interest rate spreads as the credit crisis ensued along with some slight narrowing of differentials in recent weeks. Further narrowing will be an important sign that the credit freeze is thawing.

While the Federal Reserve has led the charge to address credit market imbalances, the White House and Congress have proposed a variety of plans to ease the stress on households facing foreclosure and, by extension, the economy in general. These plans focus on stemming the rising number of foreclosures and their adverse effects on the broader economy by, in essence, shifting risk to the government/taxpayers. The amount of risk to be shifted varies with each plan.

In a recent research report, Goldman Sachs Group estimated that U.S. financial institutions could suffer about $230 billion of credit losses due to residential mortgage defaults. It also estimated that the process is roughly half-way completed, suggesting within another roughly eight months the worst of the mortgage defaults and associated credit losses should occur . In a related vein Realtytrac.com data suggest Florida home foreclosures are presently in the 30,000 per month range versus roughly 18,000 per month at the same time in 2007.

Stemming the rising number of foreclosures and the inventory they add to the market are vital to hitting a bottom in Florida's moribund housing market. Without access to credit, a bottom will be difficult to reach. Efforts are underway to re-open credit markets. Progress to date has been slow, which is not unusual in the early stages of a crisis. Further and more rapid progress should be expected in coming

months.

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.

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Victoria Zepp, Executive Director, 850.241.6309, vzepp@floridataxwatch.org

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