Factors That Tested the Southeast Economy in 2007

Like most of the nation, the Southeast confronted an array of negative economic forces during 2007.

These forces included the downturn in Florida's residential real estate market, a slowing in property markets elsewhere, high energy costs, weaker consumer spending, and a prolonged drought. All of these factors combined to apply the brakes to the region's previously robust economic growth.

Signs of a slowing economy were numerous: Employment growth decelerated, banks saw profits and lending growth decline, retail sales began to slacken, and real estate activity fell on virtually all fronts.

In the second half of 2007, the Southeast created the fewest jobs it had produced in a six-month period since the first half of 2003. The rate of job growth for the year decelerated to 1.1 percent, down from 1.7 percent in 2006.

Florida, the region's economic driver, which accounts for 40 percent of the six-state region's workforce, saw employment growth decelerate in each quarter of 2007 when compared to the year-earlier period.

The Sunshine State had been among the nation's most dynamic jobs creators for several years (see chart 1). From the fourth quarter of 2003 through the fourth quarter of 2006, Florida added jobs at twice the national rate. Only California added more jobs over those three years, and only five states created jobs at a faster rate. Unfortunately, that momentum has slowed. The average rate at which Florida added jobs during each quarter of 2007 slowed to less than a third of a percentage point and to a meager 0.1 percent in the fourth quarter. That performance matched the overall region's fourth quarter job growth.

Florida's slowdown in payroll employment growth is spread across metropolitan areas and economic sectors. Construction employment growth, not surprisingly, has slowed most. From the start of 1998, more people worked construction jobs in Florida in each successive quarter in thirty-three of thirty-four quarters. But construction employment declined for six consecutive quarters

An Economic Timeline of the Southeast: Highs and Lows

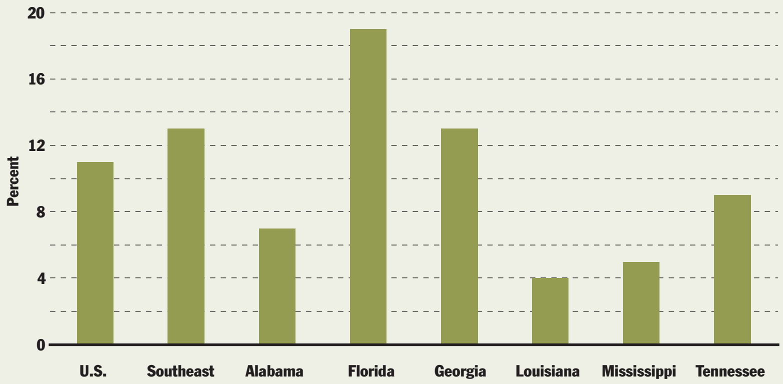
1980: The population of the six southeastern states grows to 30.4 million.

1983: Nissan opens the first foreign-owned auto plant in the region in Smyrna, Tennessee.

1984: Median household income is $41,430 (in 2006 dollars) for the United States but only $33,343 for the six southeastern states.

Chart 1

U.S. and Southeast employment growth, 1997 to 2007



Source: U.S. Bureau of Labor Statistics

from mid-2006 through the end of 2007, according to figures from the U.S. Bureau of Labor Statistics.

Across all industries in the region, the unemployment rate climbed to 4.5 percent in the fourth quarter of 2007, up from 4.1 percent in the same period the year before.

Consumer spending slows

Slowing employment growth and declining home values could eventually begin to constrain consumption. But for much of 2007, consumer spending in the region held up reasonably well. Consumer spending tends to mirror personal income, and personal income has remained healthy in the Southeast, though some slowing of growth has been evident, notably in Florida.

Retail sales throughout most of the region remained healthy through the first half of 2007. But early in the year consumer spending growth stalled in Florida and showed signs of slowing elsewhere as the year progressed. As measured by sales tax collections, retail sales began to decline in Florida, Georgia, and Mississippi late in 2007. Regionwide, sales growth has slowed from robust increases in 2005 and 2006.

Retail sales began to slow as the housing downturn worsened in 2007.

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1985: Employment in the apparel industry has fallen 11 percent since 1980 while textile employment has dropped 15 percent.

1990: Buoyed by Florida, homeownership in the six southeastern states averages 68 percent, surpassing the nation's 64.2 percent.

1992: Construction employment payroll in Florida, Georgia, and Tennessee hits $12 billion.

1996: Tourists visiting Florida spend more than $48 billion.

1997: Daimler Chrysler's Mercedes plant opens in Vance, Alabama.

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In particular, the retail automotive market in 2007 signaled that troubles in the housing market, along with higher gasoline prices, could be causing consumers to close their wallets. Strapped automobile owners often repair their vehicles rather than buy new ones. And as measured by new vehicle registrations, vehicle sales fell significantly in the Southeast during 2007, down 8.8 percent, compared to a national dip of just 3.3 percent. While Florida led the regional decline, all southeastern states except Tennessee posted fewer registrations than in 2006.

Florida remains the nation's second-largest car market behind California. But this state that had been an economic powerhouse for many years slowed markedly on several fronts in 2007.

Housing woes spread gloom through the economy

Much of that slowing is linked to the end of a residential real estate and construction boom. Evidence of housing market problems was widespread throughout the Southeast. For example, fewer existing homes sold in every state in the region in 2007 than in 2006, with sales down 18 percent for the region as a whole.

FACT:

Existing home sales were down 18 percent for the Southeast as a whole in 2007.

Like the rest of the nation, the Southeast experienced rising numbers of mortgage delinquencies and home foreclosures during the past year (see map 1). The increase was primarily driven by a lack of house price appreciation (see map 2). For owner-occupied homes with little equity, delinquency and foreclosure generally arose from adverse life events, like a job loss or divorce. For investor-owned properties, particularly in Florida, the combination of little initial equity, coupled with falling house prices, was a significant cause of mortgage distress.

Exiting a long boom, Florida's residential real estate market slowed most. The Sunshine State's existing home sales were off 27 percent for the year, the result of a blend of fast-rising homeowner insurance premiums, higher taxes, and general economic weakness. But Florida was not the only state with a deteriorating housing market during 2007.

The housing slowdown worsened in late 2007. Florida home sales slackened most in the fourth quarter, while Georgia and Louisiana sales fell off substantially, and every state experienced lower sales than in the previous quarter and the year-earlier period.

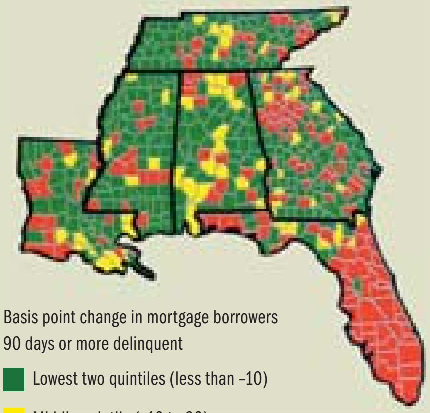
Weakening demand for homes, due in part to tighter credit standards, led builders to plan fewer new builds, which meant fewer construction jobs and lower sales of building materials and home furnishings. Again, slowing was most pronounced in Florida.

In 2007, Florida single-family home builders secured 52 percent fewer permits than the year before, while permits for condominiums were down substantially as well. For the region as a whole, single-family permits fell 40 percent in 2007 from 2006, declining in all six states, according to the U.S. Census Bureau. This drop followed a smaller decline in 2006, which was also attributable mainly to a dip in Florida. Prior to the housing downturn, Florida had been the only southeastern state in which the number of single-family residential building permits issued had climbed in every year from 2000 through 2005.

Map 1

Change in mortgage delinquency by county in the Southeast

(Q4 2004 to Q4 2007)

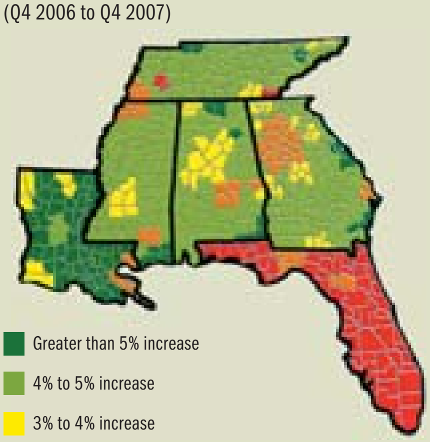


Source: TrenData from TransUnion LLC

Map 2

Change in house price index by county in the Southeast

(Q4 2006 to Q4 2007)



Source: House Price Index from the Office of Federal Housing Enterprise Oversight

Banks' challenges rooted in real estate

Housing woes profoundly affected the Southeast banking industry in 2007. As the year progressed, banking conditions began to deteriorate; earnings declined amid worsening loan quality and lower revenue. Eroding asset quality was most apparent in real estate–related lending, according to Bank Call Report data and Atlanta Fed analysis. Nevertheless, the region's banks remained well-capitalized, a fact that should help them weather these challenges.

Cumulative earnings for the region's banks declined markedly in the second half of 2007. Fourth-quarter profits decreased 50 percent from a year earlier after falling 24 percent year-over-year in the third quarter.

Slimmer profits were brought about mainly by lower revenue and higher loan-loss provisions—funds banks set aside to cover bad loans. Loan-loss provisions more than tripled in the last three months of 2007 from a year earlier.

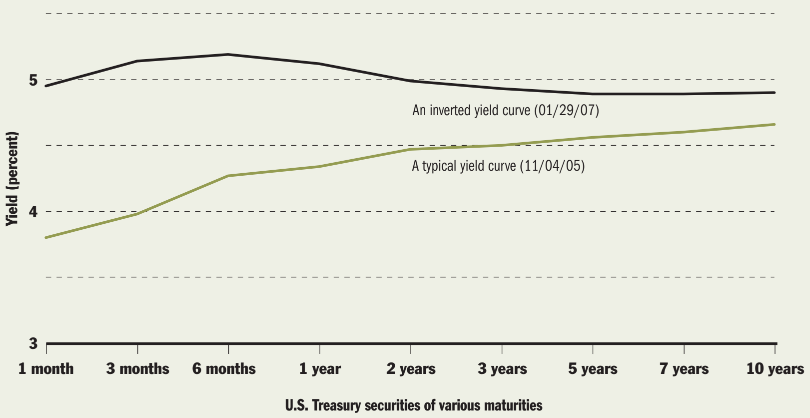
Across the region, loan-loss provisions consumed more than 20 percent of net operating revenue, surpassing the previous cyclical peak of 9.5 percent during the 2001 recession, according to Atlanta Fed analysts. Meanwhile, the volume of loans charged off by banks climbed, providing warning signals of trouble to come, particularly in residential mortgage loans and loans to builders and real estate developers.

The volatility of the yield curve, with its periodic inversions in 2007, put additional stress on banks. The shape of the yield curve determines the difference between the interest banks earn from long-term loans and the interest they pay for short-term deposits. Typically, when the yield curve flattens, bank profits are squeezed, especially when the curve is "inverted," meaning that banks are paying more for deposits than they are earning on long-term loans (see chart 2).

Meanwhile, lending growth remained modest late in 2007. Sixth Federal Reserve District banks reported slight increases in commercial lending and construction and development lending, with an uptick in credit card lending. But tighter underwriting and continued slow home sales led to a 7 percent,

Chart 2

The yield curve



or $9 billion, year-over-year decline in residential mortgage lending in the fourth quarter.

The banking industry saw both some fundamental changes and shrinking profits in 2007, and 2008 is likely to be another difficult year as more adjustable rate mortgages are scheduled to reset. On balance, banks in the Southeast did not have as much direct exposure to subprime mortgage defaults as financial institutions in some parts of the country did. Upcoming mortgage resets, though, could mean additional delinquencies and foreclosures, pushing banks to increase loan-loss reserves and thereby squeezing profit margins further. This outcome may be mitigated, however, by lower current mortgage rates as a result of the Fed's rate cuts.

Most of the region's financial institutions may be well positioned to withstand these challenges. At the end of 2007, more than 99 percent of the Southeast's banks were classified by regulatory capital standards as being sufficiently capitalized.

Rising energy costs hurt most, help some

Along with problems in real estate markets, energy costs were another force constraining the region's economy in 2007. Retail gasoline prices, on average,

As 2007 progressed, banking conditions began to deteriorate.

"In the fourth quarter of 2007, banks charged off consumer loans at a rate of 2.61 percent compared to 1.80 percent in the first quarter of 2006."

Deepwater drilling continued to increase off the Gulf Coast through 2007.

rose 8 percent nationwide from the year before. Increased demand and a significant decline in domestic gasoline stocks drove the record gasoline prices, and that momentum seems likely to continue into 2008.

Oil prices are high and volatile, geopolitical tensions continue to threaten the oil supply, consumers are facing higher costs at the pump and at home, and businesses face higher fuel expenses. Still, a glimmer of good news might be the increased deepwater exploration for oil off the coasts of Louisiana, Mississippi, and Alabama.

Made practical by higher oil prices, deepwater drilling continued to increase off the Gulf Coast through 2007. The number of rigs in ultradeep water—at least 5,000 feet—in the Gulf of Mexico hit a record high in August 2007, according to the Louisiana Department of Natural Resources.

Gulf Coast oil extraction potential was further enhanced in October 2007, when the federal Central Gulf of Mexico Lease Sale generated the second-highest total bids in U.S. leasing history.

Drought parches much of the region

Back on land, the worst drought in decades took its toll on the Southeast in 2007. In a region that has grown rapidly in recent years, rising demand for water and a constrained supply are squeezing some local economies. While it is difficult as yet to judge the economic impact of the drought, media reports detailed job cuts and lost revenue in industries that depend heavily on rain, such as landscaping and commercial nurseries. The implications of water shortages on future growth in the region are still to be assessed.

In the longer term, areas with persistent water supply concerns could be less likely to attract manufacturers and other businesses that depend on a consistent water source. In reaction to the drought, certain parts of the Southeast, such as metropolitan Atlanta, are considering stronger water conservation and planning efforts to ensure long-term supplies. In late 2007 and early 2008, some municipalities had begun increasing water rates, partly to encourage conservation.

Still recovering from Katrina

Nature continued to exert influence of a different sort in southern Mississippi and Louisiana in 2007 as the area sustained its post-Hurricane Katrina rebuilding efforts throughout the year. In Louisiana, insurance availability and higher costs put a damper on redevelopment efforts. The recovery of the 177,000 jobs Katrina carried away in the state also remains slow.

On the other hand, the state's critical tourism industry improved rapidly. To the east, after being nearly destroyed by the hurricane, the gaming industry in Mississippi has rebounded powerfully and is contributing to the state's coffers. By the end of 2007, the Mississippi Gulf Coast had regained all but 1,500 of the 25,000 jobs lost because of Katrina.

Tree stumps now sit on the sun-baked shores of Lake Lanier, north of Atlanta, as drought takes its toll.

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FACT:

Crude oil inventories began to decline in July 2007 and reached a two-year low in October.