THE ECONOMIC SITUATION

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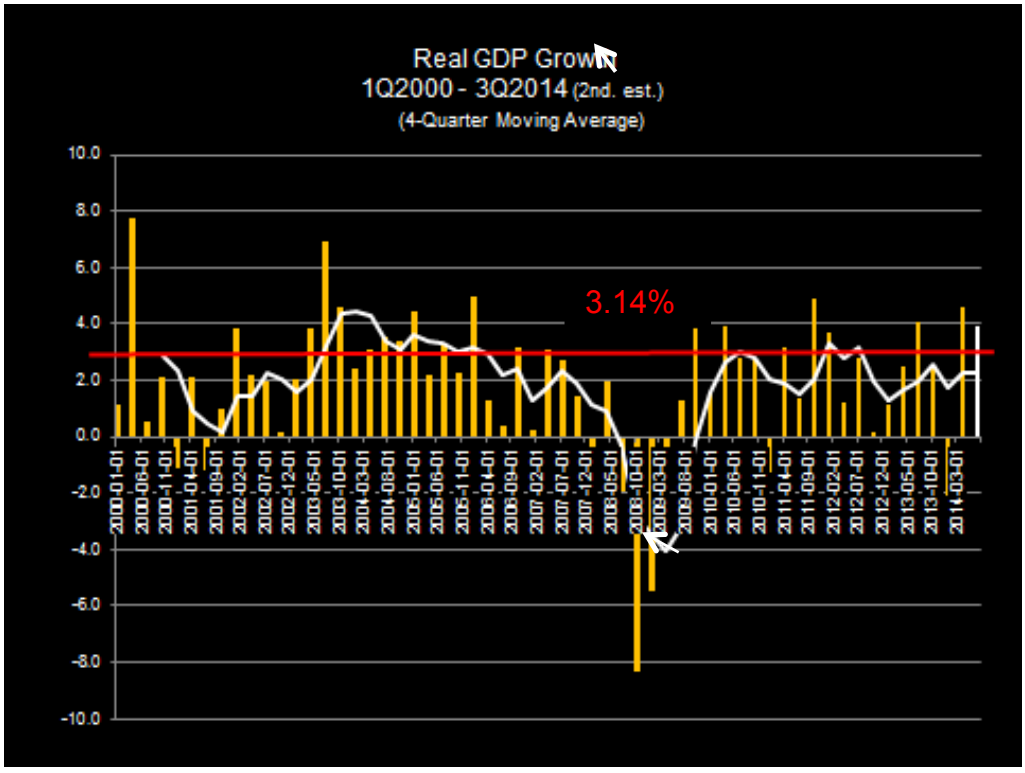


The Economy Is on Its Legs!

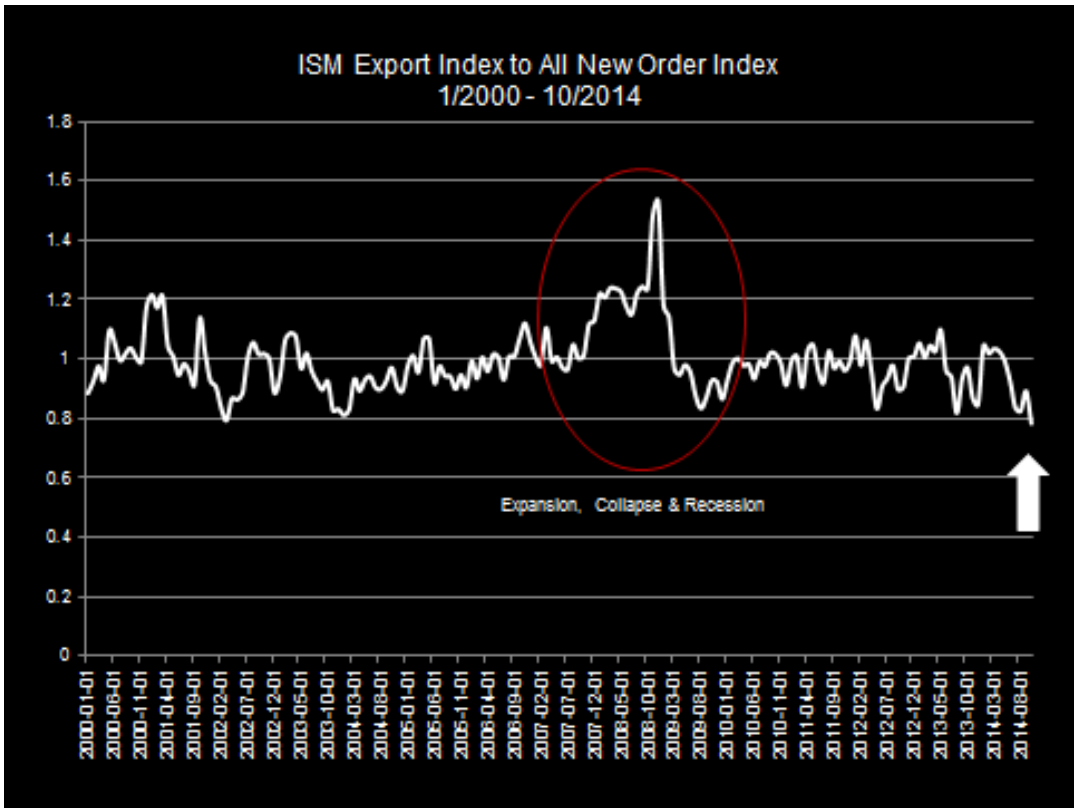
The GDP data in my first chart, above, contain some good news. The recently received 3.9 percent second estimate for 3Q2014 real GDP growth gave two quarters hand running with the pace exceeding the long term 3.14 percent average. The estimate also answered a question about inventory buildup seen in the calculation for 2Q2014 growth. The second quarter had come in with a whopping 4.6 percent growth, but almost two percentage points of that was in unsold goods.

Unsold goods can reflect accurate expectations of higher future sales. Or, sadly, they can represent bad consumer spending forecasts. We now know the answer. The buildup reflected some bad guesses. As a result, 3Q2014 saw a decrease in inventories.

Even so, the economy seems to be on its legs and operating in a three-lane (3 percent growth) economy. It feels good to get off that two-lane (2 percent) road.

There are potholes in the road, but no doubt about it, the future is looking a lot brighter. We see this reflected in major GDP forecasts, which I report here. All of the 2014 forecasts shown in yellow have been raised significantly in the just the last three months.

But here come some of those potholes. First, take note of the 2.2 percent 2014 growth forecasts shown in the table above. That's a lot lower than the current estimates for 2Q2014 and 3Q2014. This means fourth quarter growth is expected to pale a bit. We should look for 2.2 percent or less. Bad weather is one of the reasons for this. Slower growth with our trading partners is a more important reason.



Just as the US economy starts moving out, some of our major trading partners are moving back. Japan has just entered recession. Germany and most of Europe are in negative territory. And China is getting a bad case of the slows.

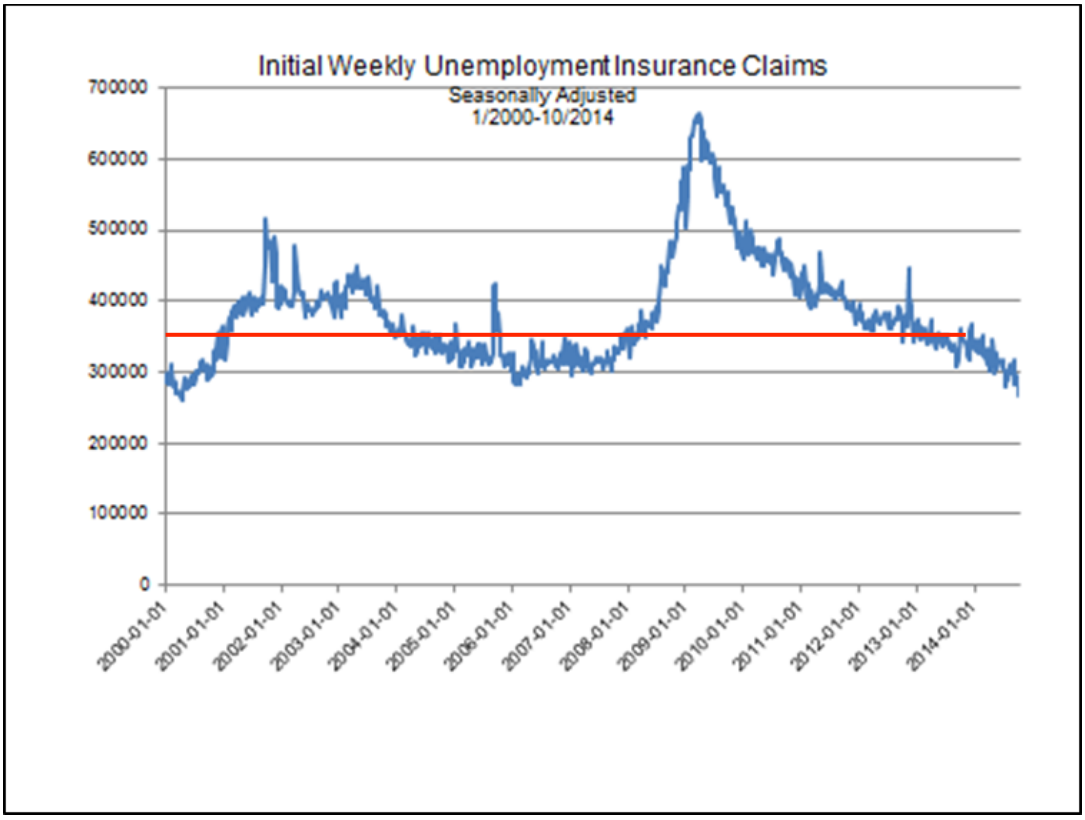
On the other hand, Canada and Mexico are perking along at a pretty good pace. Till now, strong export sales have been an important part of the US recovery. As 2014 comes to a halt and 2015 comes out of the chute, the US consumer will be the driver.

We can see this effect in the chart above, which shows a series of the ratio of the Institute of Supply Management's new export orders index and the all items new order index. Put another way, the white lines shows the export order to total new orders index. Notice that for most of the series, the ratio rests near 1.0. Also note how the ratio surged during the boom before the recessionary bust. The most recent data points show how the export component has fallen.

Low unemployment claims: another reason for optimism

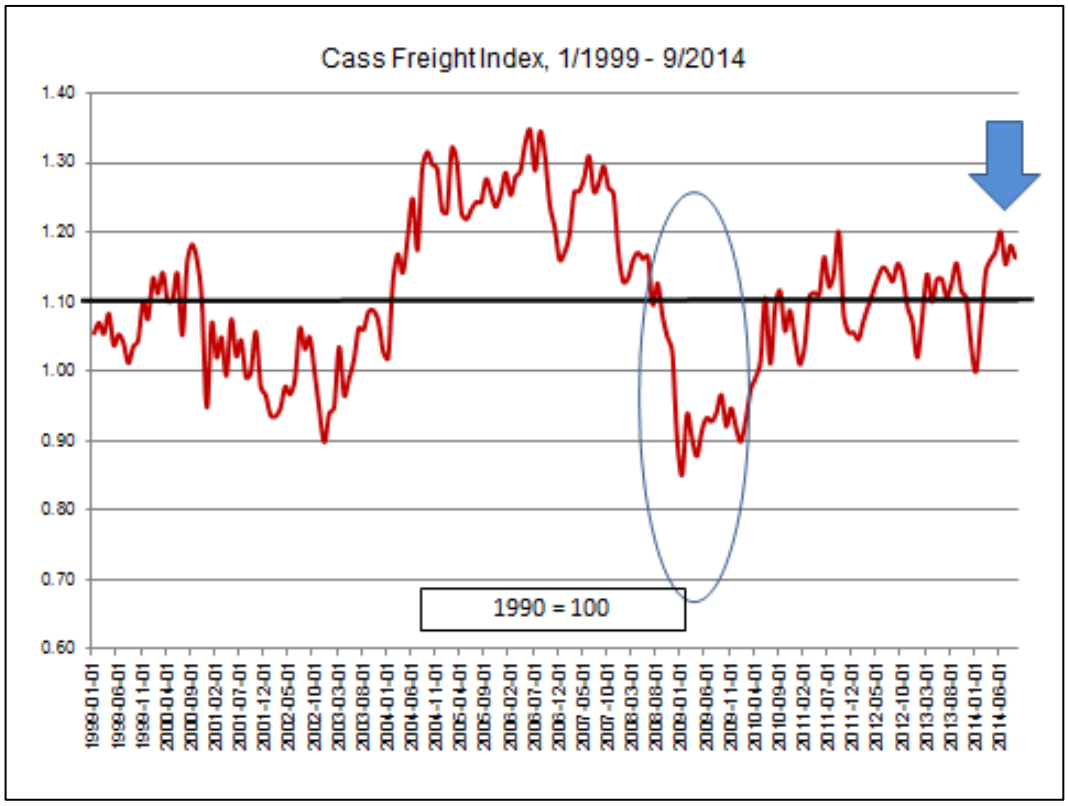
The count of initial unemployment insurance claims—a real number, not an estimate—gives yet another reason to be optimistic about future prospects for better living. We can think of the red line in the chart below as identifying a norm or long-term average. Note that the current low level of claims gets us into glory land territory. But no, we should not be overcome with joy. The lower claims do not tell us that the 2.9 million long-term unemployed have nothing to worry about. But yes, the number does tell us that, at the margin, growth of

the ranks of unemployed is shrinking. Indeed, in October 2013, there were 4.0 million who had been unemployed for 27 weeks or more, the long-term unemployed.



Freight shipments are also on the move

The Cass Freight Index, which I report next, is also based on real data. Created in 1990 by Cass Information Systems, It is based on actual freight shipment data processed by Cass for 1,200 divisions of over 400 US manufacturing companies. The index covers some $23 billion in annual freight charges. The chart below covers volume, not expenditures. As indicated, shipments are on the rise, but they have a way to go to reach the records set during the 2005–2006 boom. Again, note the Great Recession sag and the rather rapid initial recovery in 2008–2011, which is followed by steady-paced activity.



Raising the Minimum Wage?

President Obama has continually called for an increase in the **federal** minimum wage law, which currently sits at $7.25 per hour. I emphasize federal because half the states have higher minimums or voter-mandated plans to raise their minimum to a higher level.

President Obama believes $10.10 is a better number. Most likely, operators of firms that currently pay a minimum of $10.10 or more agree with the president. They would love to force their competitors to meet a higher challenge. These, along with leaders of organized labor—who dislike low-cost labor competition—are cheered when religious organizations join the chorus praising President Obama's proposal.

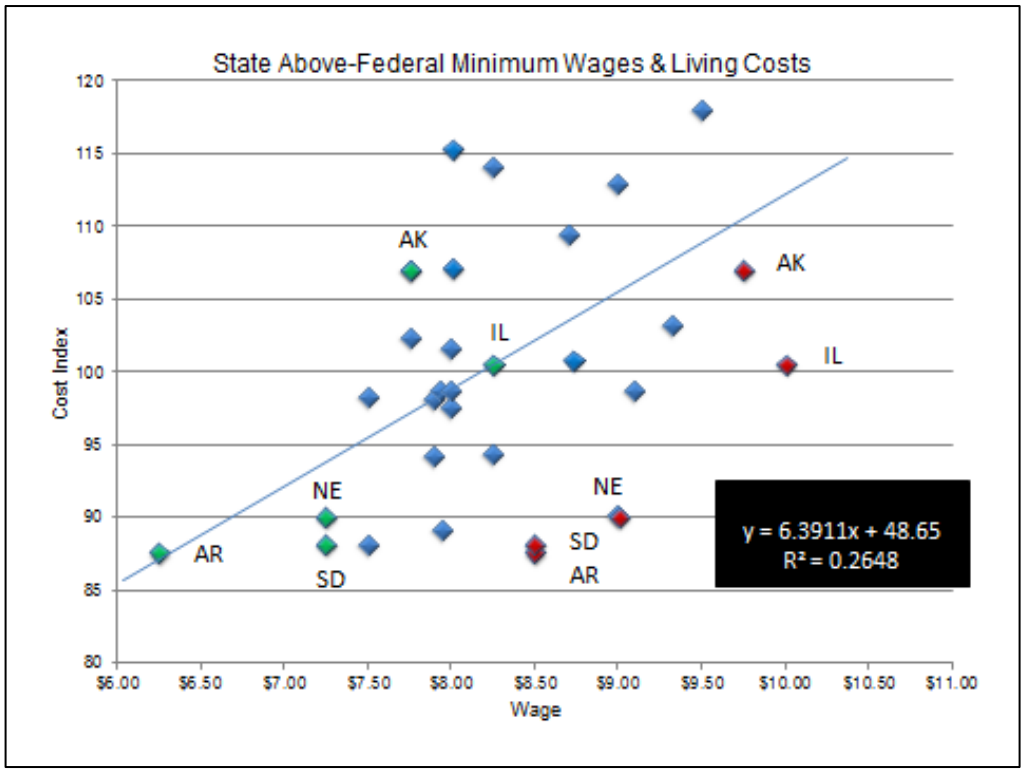
Those with clerical collars typically assert the issue is really about morality, not economics. They argue that setting a higher minimum wage is just the right thing to do. Thus, another example of Bootlegger/Baptist interaction in support of a regulation that feathers some nests while salving the souls of those who support moral mandates.

While all this may be interesting, or at least curious, there is something unspoken that needs to be considered. According to the US Bureau of Labor Statistics data and what voters decided on November 4, there are now 25 states with a current minimum or a voter-targeted future minimum wage that is higher than the $7.25 federal number. The higher numbers range from $7.50 an hour in Maine and Missouri to new target of $10.00 an hour in Illinois.

Notice that there are no state minimums that reach to President Obama's $10.10 appeal, but there are some cities with rates well above his number.

What might explain the minimum wage variation across the states? To probe into this, I gathered BLS data that tracks price parity across the states. The index assigns a value of 100 to the all-state average. This is not a cost of living index, but it is as close to that as one can come at low cost. I mapped together data for the 25 above-federal minimum wage states for their minimum wage and the living cost proxy for those states.

I report the results in the next chart, where the November 4 minimum wage increases are marked in red and the original positions of those states that changed are marked in green. I also show the regression equation and trend line for the array of points prior to the wage increases. In other words, the red observations are omitted from the calculation. As the regression indicates, higher living costs are associated with higher state minimum wages. It is obvious that the increases generated a more dispersed set of observations.

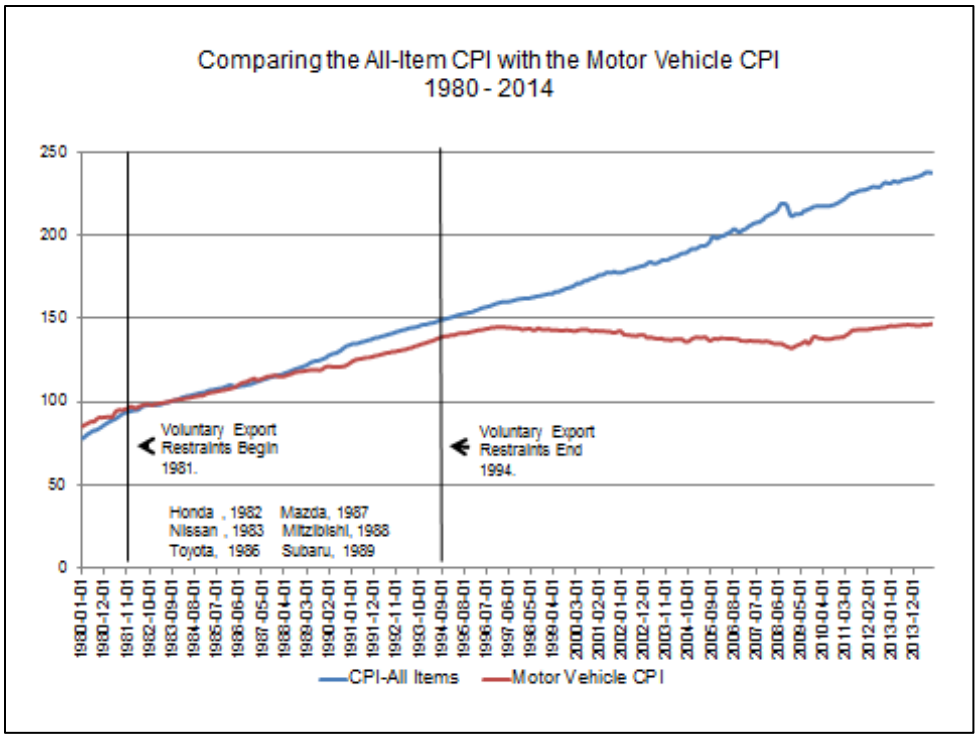


This very simple analysis suggests that the minimum wage rates set by state citizens systematically capture cost of living differences. A federal mandate forces a one-size-fits-all solution and generates winners and losers in the process. By related logic, I argue that those who push for higher federal minimum wages are driven at least partly by Bootlegger/Baptist forces that see an opportunity to raise rivals' costs or provide payback to important union interest groups while pointing to moral high ground.

Competition Matters

It's too bad the US auto industry isn't getting into the health care or food business. If they did, we might all enjoy much lower prices on two of our larger budget items.

Consider the next chart, where I have mapped the all-item consumer price index (CPI) against the motor vehicle CPI, both of which are maintained by the Bureau of Labor Statistics. hat a story. The all-items index just keeps heading to the northwest corner of the chart, but the vehicle index will not follow along. The price level for vehicles has hardly moved in 20 years. But the data tell a different story for the years prior to 1994.



What happened?

The answer, pure and simple? Competition happened.

In the late 1970s, the US Big Three were almost bankrupt. Rising oil prices, inflation, and related recessions were killing the domestic industry. But Japanese producers with their small, fuel-efficient cars were filling American highways with Hondas, Toyotas, and Nissans. They were making hay in the sunshine. After a lot of lobbying by the Big Three, in 1981 Washington responded with a negotiated agreement with the Japanese government to limit Japanese shipments to 1.68 million vehicles annually. The US and Japanese governments created a Japanese export cartel. The limitation, which finally expired in 1994, was raised to 1.85 million in 1984 and then to 2.3 million in 1985.

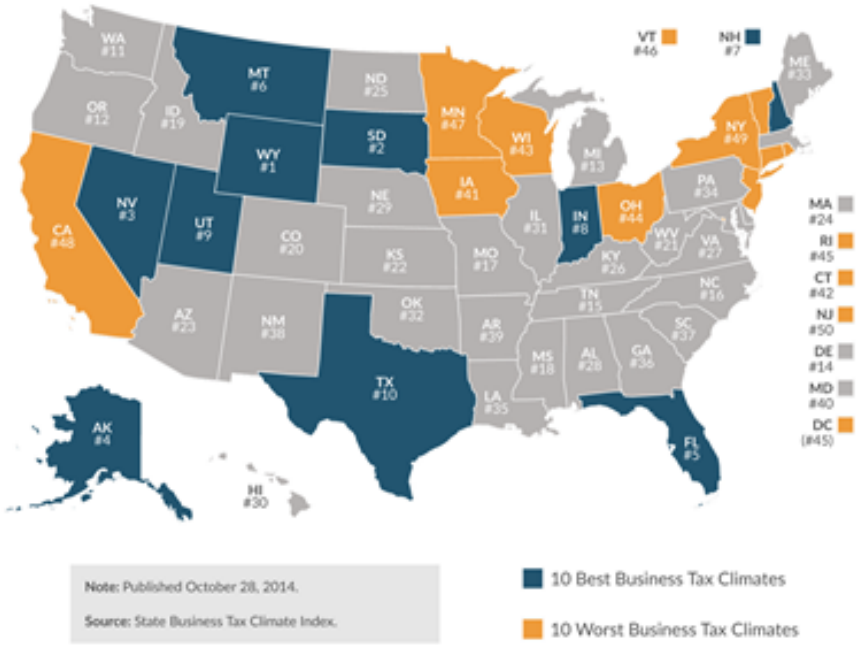
Japanese producers did two things: they raised their prices and made lots of profits, and they started building US plants. Competition on US soil became intense. The chart shows when the export restraints started and stopped. I also show the years when individual Japanese producers opened their first US plants.

Competition brought innovations in design and production that in turn delivered higher-quality vehicles, cost containment, and prices that did not follow the path of other product prices in the US economy.

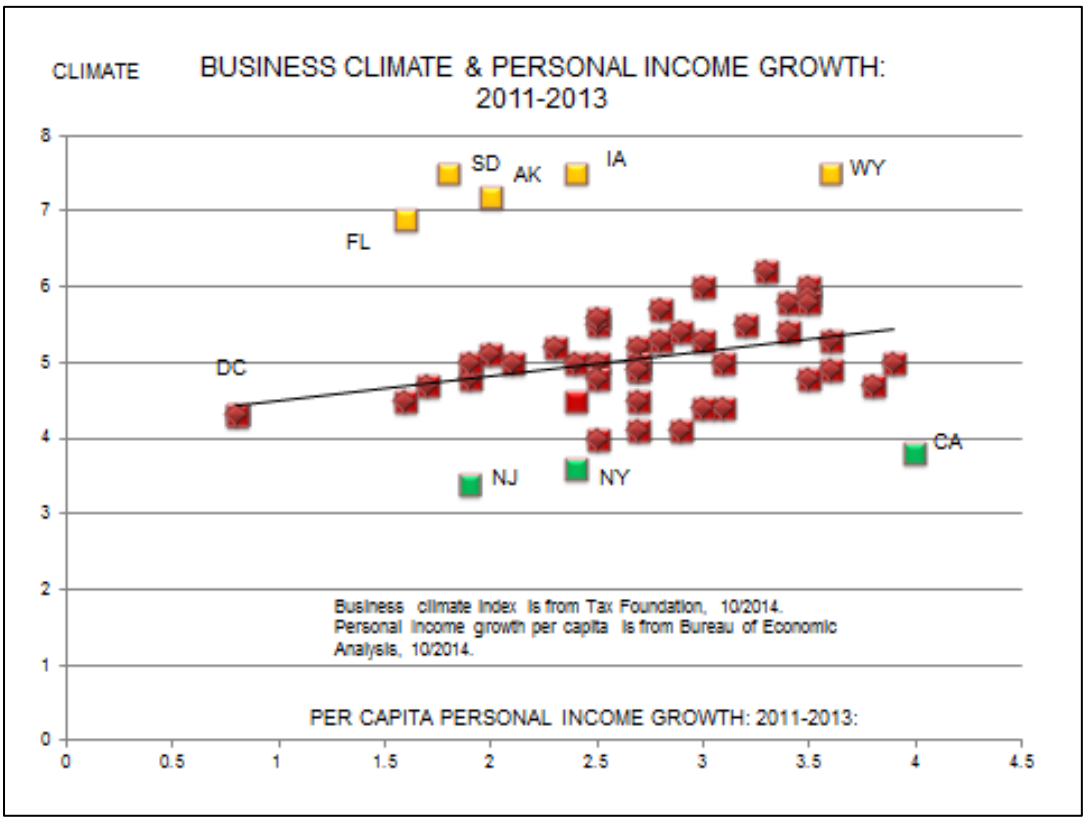
Yes, competition can do wonders. Pass the word.

State Taxes and Prosperity

In late October, the Tax Foundation released its 2015 Business Tax Climate Index for the 50 states and the District of Columbia. The index attempts to take into account the burden for all forms of taxation—property, income, capital gains, etc.—as well as the level of taxes, breadth of base, and their neutrality. With the release, the Foundation provided an outline map showing the states that rank in the top and bottom of the overall distribution. I include the Foundation's top-10, bottom-10 map here.



When I saw the Foundation report, I was curious about how the index would map into growth in state per capita personal income. I gathered Department of Commerce per capita income data for 2011–2013 growth and mapped this to the Tax Foundation Index. This is reported in the next chart.



The outliers immediately catch our attention. I have marked two outlier groups. Those states that have a high business tax climate index are market in yellow. Those with a low index are marked green. Notice that in each category, there are states that have high levels of per capita personal income growth. There are specialized situations in both cases. California, with its massive Silicon Valley/high-tech economy may be a case in point. There we see high growth and low business climate.

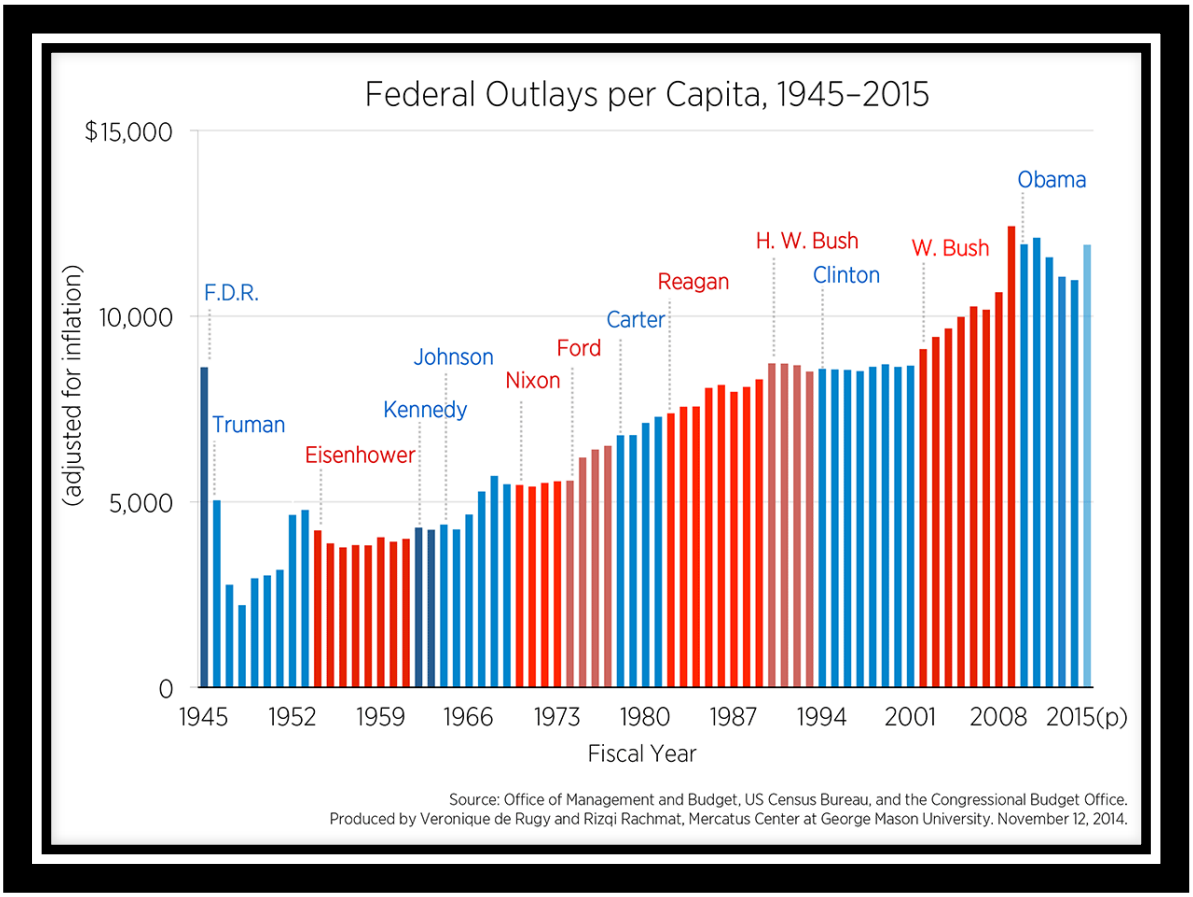
When the yellow and green outliers are removed, the remaining states form an array that shows higher income growth with higher business climate rankings. Notice that while the slope of the regression line shown in the chart is not steep, the differences in income growth are large. There is a substantial difference in future income levels as between a growth rate of 2.5 percent versus 3.5 percent. Starting with $50,000 in personal income in a base year, the income level generated in 10 years will rise to $64,000 with 2.5 percent compounding and to $70,000 with 3.5 percent.

How Much Government Is Too Much?

I won't try to answer this important question, but I will certainly take sides with those who believe that the share of national income allocated to federal government activities is far too large. Maybe it's because of having had a brief experience leading the business side of a federal agency. Maybe it's because of having lived for eight decades and experienced times with a far smaller government sector. Or maybe it's because of living across the tracks in Clemson from a "shovel-ready" stimulus projects—this one a new railroad bridge—that is now in its fourth year with no sign of completion in sight and hardly any activity underway.

For whatever reason, I was captivated by a recent government spending chart produced by Veronique de Rugy and Rizqi Rachmat with George Mason University's Mercatus Center. Their chart reports real per capita federal government expenditures for the years 1945 to the current administration's proposed 2015 spending. Remember, the data are real—inflation adjusted—per capita expenditures.

Take a look at the next chart. What jumps out?



The flat data bars for George H. W. Bush and Bill Clinton are followed by the unprecedented (at least since 1945) high-stepping, post–9/11, George W. Bush bars. Then, the fact that per capita spending has more than doubled in my lifetime also gives me pause.

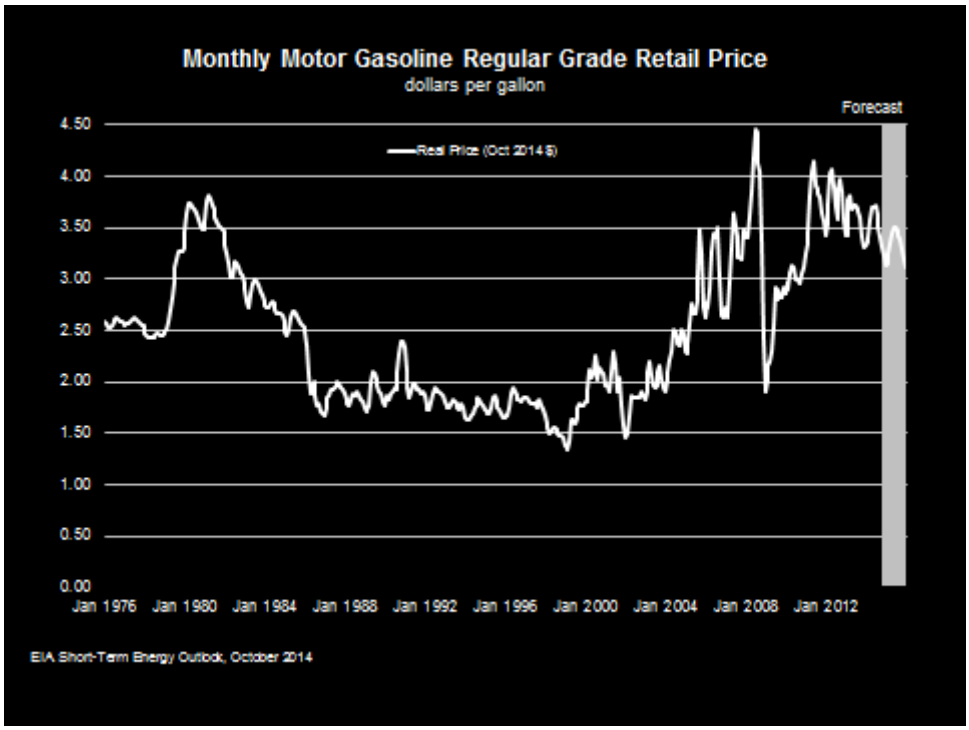
But my interest in the chart was piqued when I recalled Milton Friedman's sage advice about taxes and government activities. His concern was not so much about the magnitude of taxes, but rather the magnitude of government. And his problem was not based on a dislike of government programs. It was based on the inefficiency of government and the fact that, generally speaking, it costs twice as much to get the same work done by government as by private citizens competing in the marketplace.

Yes, I think lots of people, not everyone, but lots of people looking at this chart would say the federal government is just too large.

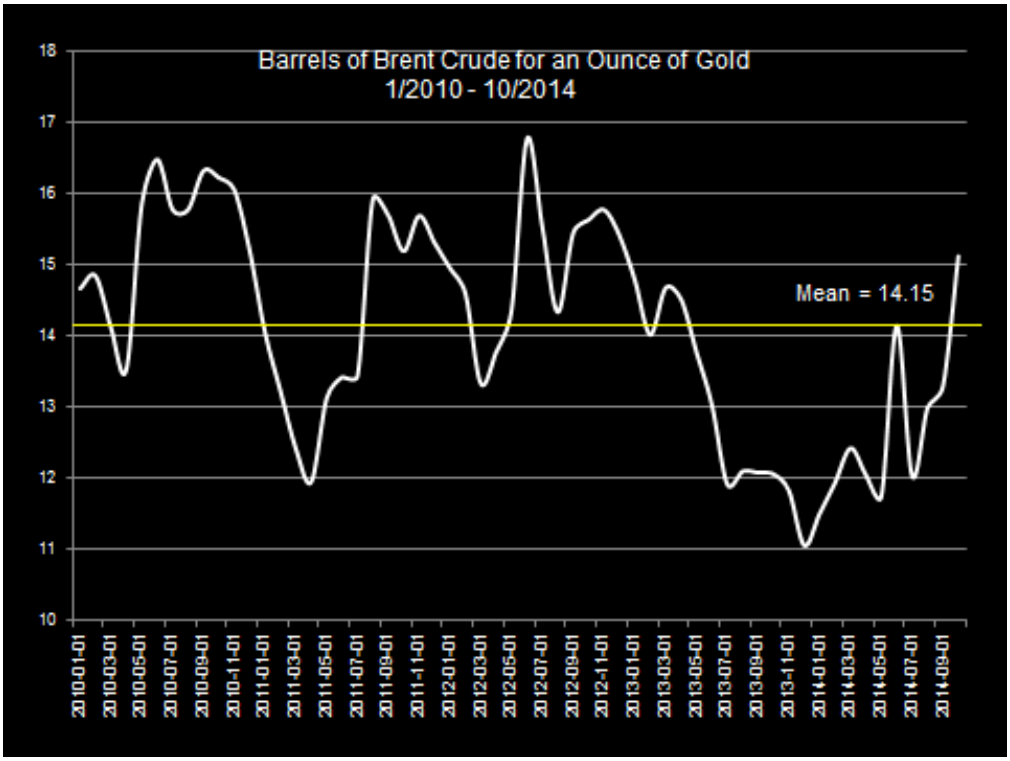
America's Energy Revolution

Not many commentators are talking about peak oil anymore. This is the notion that all the recoverable oil reserves have reached their peak and that cheap petroleum products saw their better days in the last century. Woe is us!

But with the real price of gas at the pump falling to four-year lows (see the chart below), natural gas extractions so abundant that huge amounts are flared at the well, and the United States now the world's leading producer of crude oil, it's real hard for petro pessimists to be taken seriously. Of course, there is more to this than just the large increase in production. Weak demand is part of the equation also.



In any case, I just had to refresh my perennial oil/gold chart that shows how many barrels of oil an ounce of gold will purchase. Regular readers will remember that the calculation eliminates currency valuation problems by showing the price of one commodity in terms of another. Here's the new chart:



We should celebrate when the white line crosses the longer-term 14.15 barrel average. That is when oil is officially in the cheap territory. But history tells us that cheap territory will be followed—at some point—by expensive territory. The line does oscillate around the mean. But nothing in the chart enables us to offer a forecast. All we have before us is the now. However, included in the now are things that may generate higher-priced oil. One of these is the political instability for some countries that comes when their chief source of wealth gets cheap and total revenue falls.

The October 25 issue of the *Economist* names the countries that are now beyond the budget breakeven point. These include Iran, Ecuador, Venezuela, Algeria, Nigeria, Iraq, Russia, Angola, and Saudi Arabia. Being beyond breakeven doesn't mean revolution for all these countries, but it could for some. "Beyond" means that unless there is lots of money in the bank, as with Saudi Arabia, for example, then heavy subsidies must end. Put another ways, Santa Claus needs another reindeer. Political disturbances create additional production uncertainty in the affected countries, and that leads to higher prices, all else equal.

Meanwhile, the position of the United States as a strong producer will be enhanced, as will the underlying strength of the dollar.

What about fracking?

Hydraulic fracturing, or fracking, has spurred the opening of vast quantities of petroleum and natural gas worldwide. As with any new underground mining technologies, there are uncertainties about the effects. Huge amounts of water are involved in the process. After all, it is hydraulic. Also, there are chemicals to be dealt with. It is human nature to be cautious about these uncertainties. In the extreme, there are calls for banning the use of the technology. For example, when Edwin Drake drilled that first Pennsylvania oil well in 1858, a local preacher tried to stop the enterprise, saying that the oil was put there for a divine purpose: the oil was there to fuel the fires of hell!

E. L. Drake
1819–1880

Undeterred, Drake kept on drilling, and the oil kept on flowing. We have no way of knowing if hell became a bit more comfortable.

Is there an alternative to banning?

Instead of banning a process that is undoubtedly producing some benefits to mankind (but with unknown costs), defining and enforcing property rights offers another way for dealing with the uncertain risks. The common law doctrine of public and private nuisance is one way to do this. Under common law, the liability burden can be placed on the producer, not the downstream parties. State attorneys general can bring action on behalf of a large number of similarly situated complainants, and individuals themselves can sue if their individual environmental rights are harmed.

A version of this approach involves legislation requiring producers to post bond, in cash or gold, in an amount sufficient to lay concerns to rest. Of course, common law is state, not federal, doctrine. This allows for competition, with different interpretations reflecting different norms across states and communities. When in place, common law protection of environmental rights can create an environment where producers are induced to avoid unwanted costs.

Bootleggers and Baptists one more time

While the relative merits of common law protections may be worthy of consideration, it is still most likely that the United States as well as other countries will adopt command-and-control regulation, along with other fracking limitations. Doing so reduces competition of existing oil and gas producers, which lines the pockets of the energy bootleggers. (Once again, we have a Bootlegger/Baptist situation, with the environmentalists doing the “Baptist” heavy lifting.)

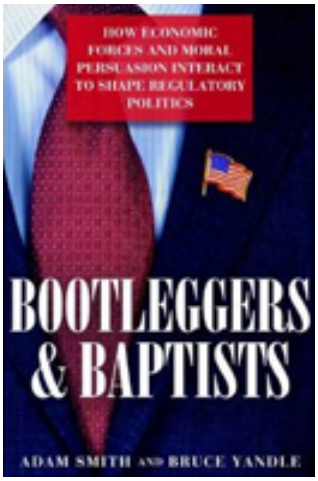
Russia's President Putin is now pushing for just such control or bans that will limit competition from other countries while fracking goes full force in Russia. In a 2013 London conference, Mr. Putin made an environmental appeal, urging nations far and wide to protect water quality by banning fracking. Those endorsing his viewpoint include the United Arab Emirates, along with others.

At the time Putin was leading cheers for actions to ban the use of hydraulic fracturing for recovering natural gas and oil, France had already imposed a ban. Bulgaria was soon to follow. Germany was seriously debating the matter and would subsequently favor a ban, and other nations, as well as US states were eyeing the antifracking bandwagon.

So why would Mr. Putin join the Baptist choir? Perhaps it's because he had his eyes on Ukraine, where the Yanukovych government was set to sign a $10 billion contract with Chevron to explore and develop shale gas from that nation's vast shale holdings. Production estimates for the Ukraine indicated the country would be self-sufficient by 2020 and a major exporter after that.

Something for the Bookshelf

Steven Johnson's latest book, *How We Got to Now* (Riverhead, 2014), deserves to be at the top of your reading list. Following on his *Where Good Ideas Come From* (Riverhead, 2010), Johnson offers a delightful discussion of six innovations that he believes made the modern world. After reading his stories, I think you will agree with his choices. I will not spoil the verbal trip for you by identifying all six innovations, but I will give you just a sample by naming one: glass. Just part of the story here relates to glass lenses. A tiny part of the story focuses on eyeglasses, which were spurred by Gutenberg's 15th century printing press and recognition by ordinary people that they couldn't see well enough to read the type. But lenses stacked in different ways yielded telescopes and microscopes, which exploded the notion of what constituted man's world and the universe of inquiry. Here, I have illustrated Johnson's notion of the adjacent possible, a "kind of shadow future, hovering on the edge of the present state of things, a map of all the ways in which the present can reinvent itself."[1] Johnson's fertile mind presents a delightful collection of stories about innovation that will be hard to beat.



I have referred to Bootlegger/Baptist theory throughout this report. Now, I just can't resist shamelessly promoting a new book I coauthored with my grandson, Adam Smith. Adam Smith is an economist on the faculty of Johnson & Wales University in Charlotte. Our book is *Bootleggers & Baptists: How Economic*

[1] Steven Johnson, "The Genius Tinkerer," the *Wall Street Journal*, September 26, 2010, http://online.wsj.com/articles/SB10001424052748703989304575503730101860838.

Forces and Moral Persuasion Interact to Shape Regulatory Policy, published in September by Cato Institute. The book develops the theory and applies it to shed light on regulatory episodes as diverse as TARP, Obamacare, EPA environmental rules, and marijuana legalization. I believe that B&B theory helps us to understand the way the world of politics works, but it doesn't equip us to change the way things work.