

THE ECONOMIC SITUATION

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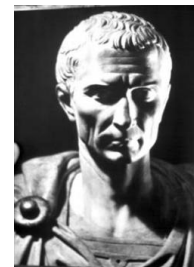
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March 2011

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 - **We are caught between Greece and toothpaste.**
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Ides of March Worries

“Beware of the Ides of March,” the Soothsayer said to Caesar. Commenting to his companions about the Soothsayer, Caesar responded, “He is a dreamer, let us leave him: pass.” With these words, Shakespeare makes memorable the demise of Julius Caesar on March 15, the ides of March.



Should we take heed of today's soothsayers when they warn about government shutdowns, trouble ahead on the nation's debt limits, and the possibilities of default on federal debt? Or should we call them dreamers and push ahead with business as usual?

As I write this March 2011 *Economic Situation* report, the news media are astir regarding these matters. We made it past March 4, the date when the last Continuing Resolution (CR) expired, without closing federal offices worldwide. Now another CR keeps the wheels turning a few weeks while Congress debates budgets, deficits, and debt. As we hear the cliché so often, “the can has been kicked down the road.” The possibilities of another shutdown loom ahead.

What's the record on this, and do shutdowns matter?

Since 1977, there have been some 17 government shutdowns. Most of these have been short, from one to three days, and some of those were over a

weekend. Brief shutdowns don't do a lot of harm, but particular individuals may be hurt a lot, if they were hoping to get a renewed passport, approval for an export shipment, or timely payment for a bill. Time matters in a tightly linked global economy. But it was the 1995, 21-day shutdown, that showed how much harm closed government offices can do, which is another way of saying how intertwined government has become with the lives of citizens and business. Twenty one days is a long time when you are managing a large construction project that requires a federal permit. And even longer, when two firms have a merger pending that must be approved by the FTC and SEC. Time is definitely money. And the longer the shutdown duration the larger the incremental cost.

Even so, we all recognize the high stakes game being played with our economy by Congress; the debating parties have few chips to use in their struggle.

We are caught between Greece and toothpaste

What about raising the debt limit, another Ides of March concern?

The limit on federal debt has been raised routinely at least once a year since 2002. Indeed, the federal government was so good in spilling red ink in 2008, that the limit was raised twice. Once again, the time has come to move the fence lines so that we can fund our deficit habit. There is little choice about this in the short run. The debt limit will be raised before Treasury and the Fed run out of options for funding operations. At least this is what derivative prices tell us.

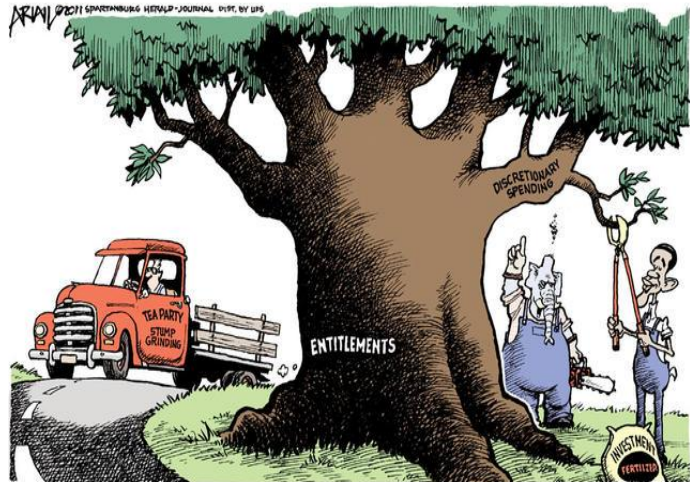
A few days ago, when I was puzzled by the debt question, I asked Spartanburg financial advisor Dan Foster what was going on with prices for credit default swaps (CDSs) for federal debt. Recall, a CDS is a derivative instrument issued by a party who guarantees timely payment on the covered security. If timely payment on the underlying security, in this case a Treasury bond, is viewed as being less certain, the price of the CDS will rise. Dan gave me prices for CDSs on 5-year U.S. Treasury bonds. On February 23, 2011, the CDS was selling for \$47,400 for \$10 million in bonds. Dan put this in perspective by giving CDS prices for Spain and Greece. They were respectively \$259,000 and \$910,000 for blocks of \$10 million in bonds. But to make another point, Dan gave me the price for a CDS on Colgate-Palmolive bonds. The price was a lowly \$38,500, again for \$10 million.

The U.S. stands between Greece and toothpaste in the eyes of the world's CDS issuers. Our likelihood of default is small, but not quite as small as Colgate-Palmolive. I can't help but note that Colgate-Palmolive has to generate positive cash flow or make plans to leave the field, and the firm cannot print money when things get tough. It's amazing what a bankruptcy constraint can do to cause one to shape up.

But does all this mean that the U.S. debt problem shouldn't concern us, that we can keep going our merry way and everything will work out?

Hardly.

Nothing could be further from the truth. In a word, the U.S. is in horrible shape, such bad shape that we can hardly estimate the extent of the problem. (But not as bad as Spain, Greece, and a few other European countries.) What we know is that thus far the political planets have not yet aligned to take on Medicare, Medicaid, and Social Security.



We cannot get out of this hole by playing games with “discretionary” spending. At this point, all of it must be discretionary. Let’s use our discretion: A mind is a terrible thing to waste.

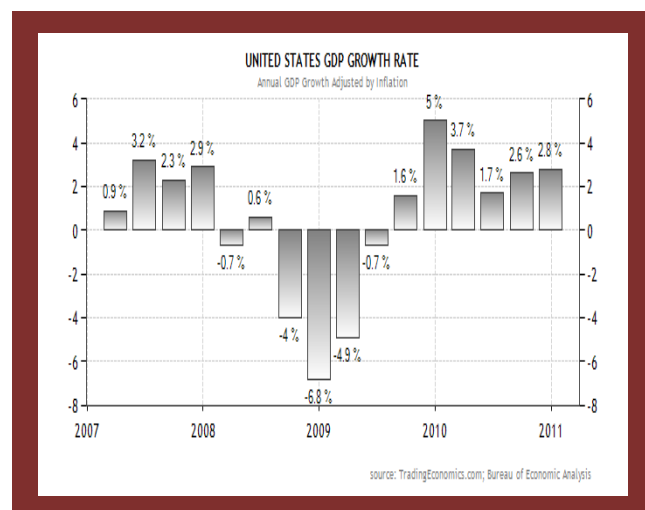
Remember Caesar and the soothsayer? “He is a dreamer let us leave him.” Not this time.

What about GDP Growth?

When the Commerce Department issued revised 4Q2010 GDP estimates a few days ago, sack cloth and ashes became the dress of the day. Backing away from the first estimate’s 3.2% real growth, Commerce whittled the number to 2.8%. (See the accompanying chart.)

There were three negative factors in the revision—declining inventories, falling government spending, and rising imports.

The inventory decline offers promise of better times. Inventories of finished goods fell across the economy, while final sales rose nicely. Let’s hope owners and managers of firms were surprised. If so, this suggests that 1Q2011 will be helped when inventories are replenished. Government spending was down, driven by declining state and local government activity. We should expect to see more of this weakness. Just a handful of states have balanced budgets; the rest are cutting back. Meanwhile



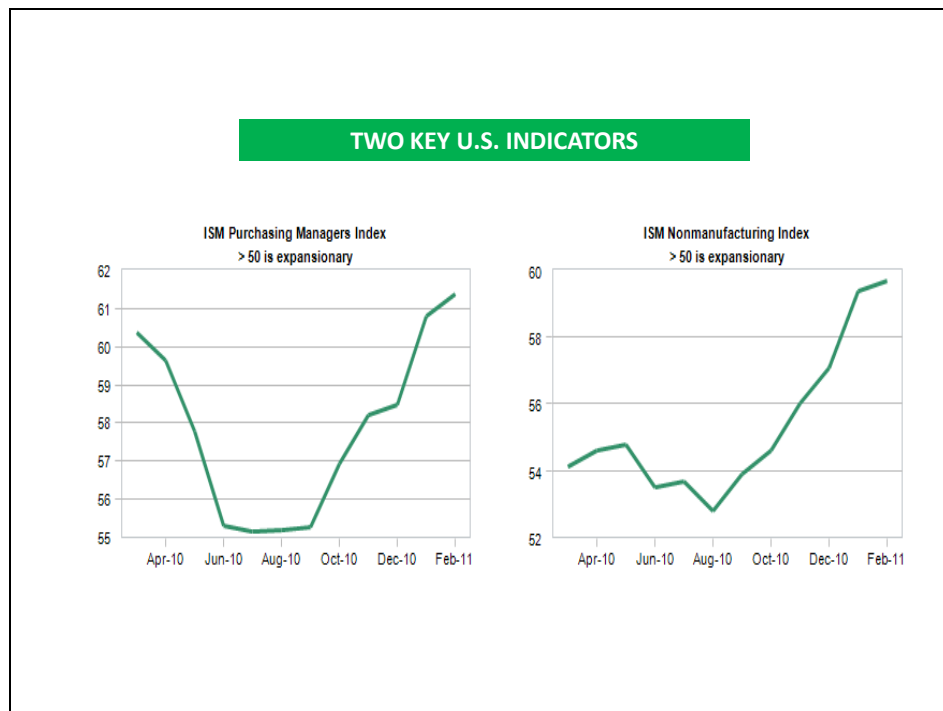
federal stimulus dollars are drying up. Increased imports formed the other negative in the revised GDP numbers, and this was due largely to higher priced oil.

One wouldn't call 2.8% growth steamroller recovery, but it is beginning to smell that way. We need 3% or better to see improved employment numbers. There is also a serious inflation warning in the latest GDP report. The GDP deflator rose 2.1% in 4Q2010, which is almost double the previous quarter's growth. I should note that 2.1% is just what the Fed ordered. Let's hope they are happy.

The purpose of economic activity is to make each individual happier, not the Fed.

But when the Fed isn't happy, no one can be happy...for long.

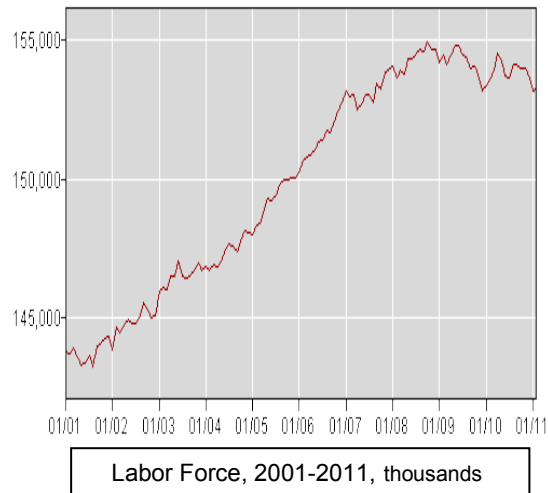
We see a prettier picture in some other important data. Shown just below are the Institute of Supply Chain Management's indexes. January and February brought strong increases in both indexes. They are riding well about 50, the zero growth point, well into expansion territory.



Enter an improving labor market picture.

The Bureau of Labor Statistics' March labor situation report brought some good news and some not so good news. The bad news was seen in a declining labor force, formed perhaps by discouraged workers and redefinitions of work. As shown in the nearby chart, the estimate of the number of people who count themselves in the labor force has fallen about 1.7 million since October, 2008.

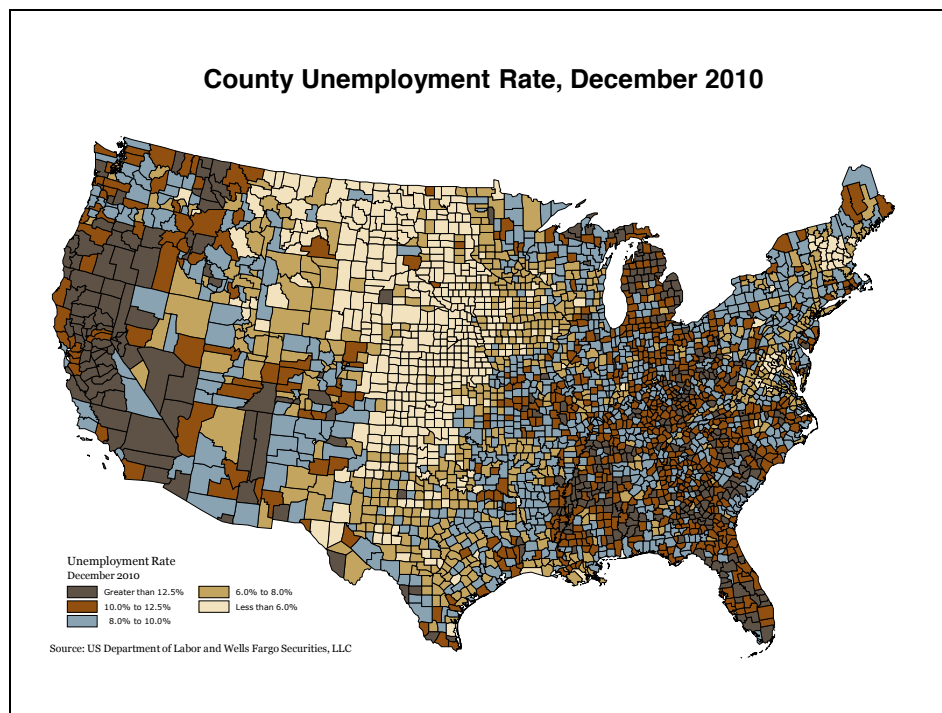
Part of this is likely driven by the end of unemployment benefits for some; to receive benefits, the individuals must be looking for work. Another part may be driven by redefinitions of who and how many work in a household. In any case, a smaller labor force generally produces a smaller national product, which means slower growth in GDP and income.



February employment gains of 192,000 formed the good part of the report. Finally, it seems, we are seeing healthy job growth. Together, larger employment gains and fewer people declared to be in the labor force generate a lower unemployment number. With 8.9% unemployment, we cracked the 9.0% floor, largely due to a declining labor force.

In February, health care and education employment led the pack with 34,000 additional jobs. Manufacturing and construction formed a close second, with 33,000 additional jobs each. Local government took a large hit, showing a decline of more than 300,000 jobs. Based on state deficit struggles, we should see more weakness in the months ahead.

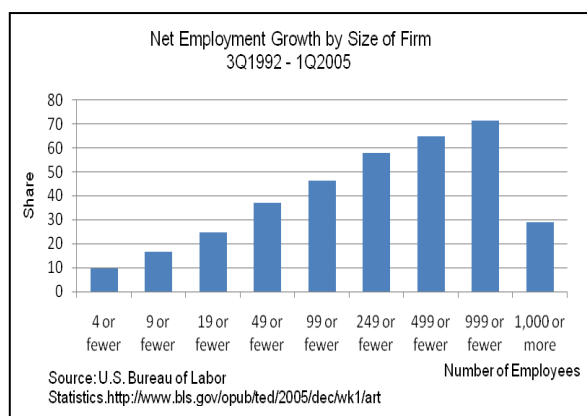
A map showing December 2010 county unemployment rates for the U.S. provided by Wells-Fargo economics puts the picture into a geographic perspective and also helps to identify regional strengths and weaknesses. The middle of the map is brightest. These are the energy and hard grain states. They are generally states with relatively high educational attainment.



Where are the jobs?

When we get a meaningful job recovery it will come from smaller business. Why? That's where the jobs are.

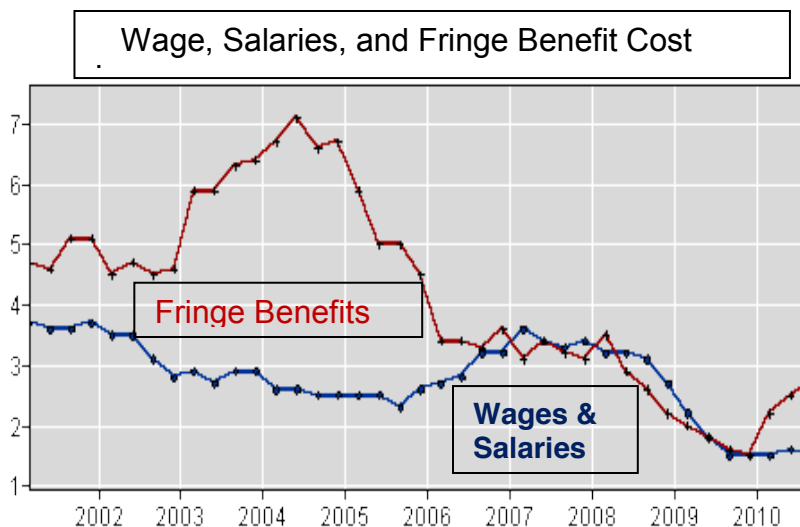
The accompanying chart reports employment growth by firm size across 1992-2005, a somewhat "normal" period of time. More than 50% of the growth came from firms with 249 or fewer employees. Better than 30% came from firms with fewer than 49 employees.



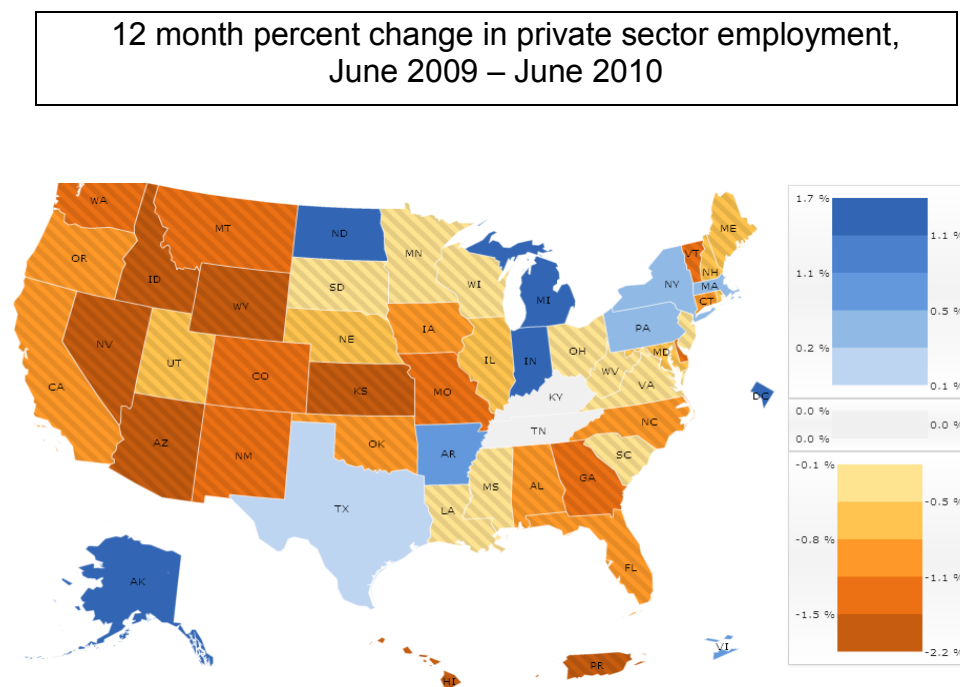
The smaller business sector has come alive in just the last few months. Data from ADP, which maintains a huge data base on customers, indicate that firms with fewer than 50 workers added 100,000 net new jobs each month in December, January and February. Most of these smaller firms are in the services sector. In February 97,000 of the 100,000 came from that sector. But the 50-and-smaller employers have a lot of catching up to do. Between April 2008 and February 2010, the sector lost 2.7 million jobs.

And why is it so hard to bring on a few more workers? Uncertainty about the economy and about tax and regulatory policy is one major reason. Shrinking lines of credit due to tighter banking regulations is another. And then there are

rising costs of hiring. As shown next, fringe benefit costs, which represent a large share of the cost of hiring another worker, are rising rapidly. Much of the increase is associated with health-care cost.



Job growth across states is another way of determining where the jobs are. The next chart shows employment growth by state for the year that ended June 2010. The blue states with positive growth are few in number.



But I need only one job!

I often hear this remark when talking with rising university seniors. Fortunately, even in these darker periods there are millions of job opening occurring each quarter. There are also millions of job “closing” each quarter. Here is the point. In February 2011, the Bureau of Labor Statistics published a quarterly report on job creation in the U.S. economy. The report contains the story of what I call the American job churn, the massive and dynamic process of openings, closings, hiring and layoffs that generates over time more, fewer or the same number of jobs in the economy.

A quick sifting of data in the BLS report reveals that in the three months ending June 2010, there were 700,000 jobs gained in the U.S. economy, the first positive quarterly gain since the recession began in 2007. This came about by 6.9 million job openings and 6.2 million gross job losses. The losses were generated by closing establishments (1.1 million) and losses from ongoing establishments (5.0 million). The gains were from opening establishments (1.2 million) and expanding establishments (5.7 million). How about that? More than a million new establishments opened in the quarter that ended in June 2010.

By comparison, in three months ending March 2005, long before the recession started, there were 7,620,000 job gains and 7,220,000 losses. The recession took the edge off the process, but there were still almost seven million new jobs added in the quarter.

But I need only one job. Surely there is one to be found out of almost 7 million that open each quarter.

Oil and gold one more time

With the unrest in the Middle East, people have suffered, economies have collapsed, and oil shipments have been threatened. Robert Ariail's nearby cartoon raises the economic question. Will the U.S. economy be placed in a tailspin? The immediate answer, given what we know now about disruptions, is No. The Saudis have opened their valves to offset the losses from Tunisia and other Gulf producers. But it's Katie bar the door on oil prices if the Saudis get caught in the Mid-East revolution.

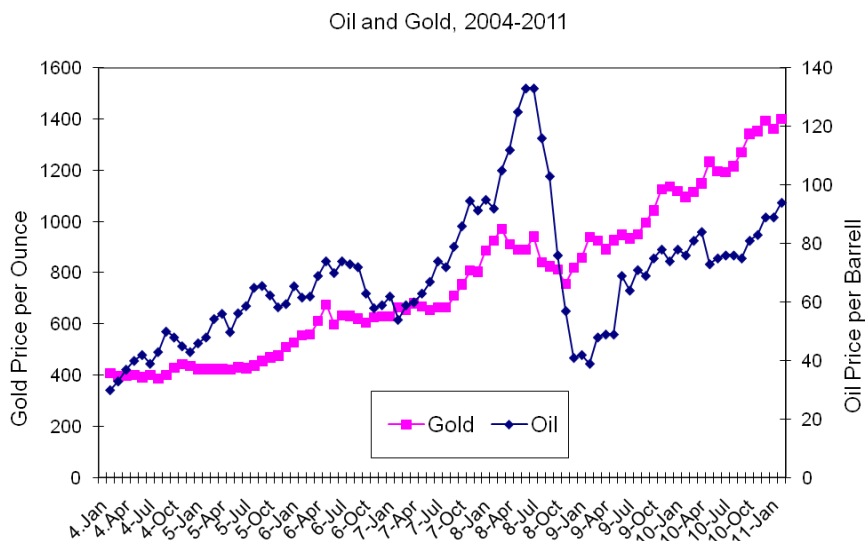


According to *The Economist*, there is a one-quarter percent drop in world GDP growth for every 10% increase in the price of crude oil. With oil fetching a bit more than \$105 and the world growing at something like 4.5%, \$150 oil would drop world growth to a slower 3.5%. But since the U.S. is pumping 3.0%, not 4.5%, we would likely see 2.0% growth.

Since the vast majority of oil production is now under control of sovereign states and therefore geo-politics, unvarnished market economics gives a bit less guidance in forecasting what happens next. According to Ian Bremmer, author of *The End of the Free Market*, "The biggest multinationals (private oil companies) collectively produce just 10 percent of the world's oil and gas and hold about 3 percent of its reserves.... The fourteen largest state-owned energy companies control twenty times as much oil and gas as the eight largest multinationals."

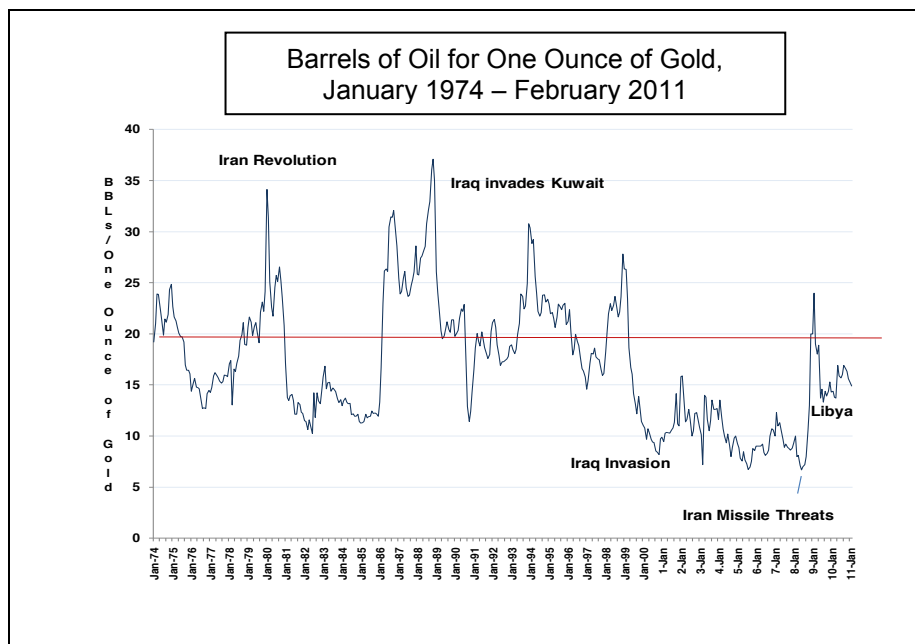
Uncertainty notches up when strongmen can clamp down.

As the next chart shows, even with data for January and February, the prices of oil and gold continue apace, with about the same distance between them. A quick scan of the chart easily reveals the oil price collapse that occurred in early 2008 with the start of the Great Recession. Industrial output fell to the cellar. Meanwhile the price of gold continued to reflect inflation expectations and real market forces.



We get a bit more information when we examine the gold price of oil. Readers may recall this chart. It is based on an old tale that oil traders reckon their product in ounces of gold, that an ounce has historically fetched 20 barrels of oil. The chart has a dark line at 20 barrels. Theoretically, the price of oil in gold will cycle around the dark line. In viewing the chart, remember that oil is cheap when observations lie above the red 20 barrel line. Oil is dear for points below the 20

barrel line. As indicated, the number of barrels that can be bought with an ounce of gold rose above 20 at the outset of the recession. Since then, Middle East disturbances have raised the price and lowered the number of barrels fetched with an ounce of gold.



Looking ahead

With oil prices forming an ugly cloud on an otherwise brighter sky, the 2011 outlook has brightened considerably since Congress and Mr. Obama agreed to keep income tax rates reined in and to reduce the employment tax. In fact, the two tax actions caused most forecasters to nudge their numbers in a positive direction, sometimes as much as a half percentage point. I provide next a summary of forecasts. The initials are for the Federal Reserve Board, National Association of Business Economists, Bank of America, and Congressional Budget Office. The repeating names show how forecasts have changed in a relatively short time. The old saw in forecasting, "If you can't forecast well, you must forecast often," doesn't apply here. When major new information arises a good forecaster will take the information into account and revise the numbers.

All in all, it seems we are about to move to higher ground. Indeed, if oil prices do not get the best of us, there is a good chance that we will see some meaningful acceleration in GDP growth before the year is out. Meaningful? Numbers like 3.75% to 4.00%.

The risks are downright scary at times.

- The ticking inflation time bomb being controlled by the Fed.
- Oil price explosions.

- Crazy dealing with the deficit that could include raising taxes. Explosions of regulations with cap-and-trade hitting the energy economy.

GDP Forecast, 2011

| Organization | Date | 2011 |
|-----------------|---------|---------|
| FRB | 11/2010 | 3.0-3.6 |
| NBE | 11/2010 | 3.2 |
| Wachovia | 12/2010 | 2.5 |
| Bank of America | 12/2010 | 2.0-2.5 |
| Economy.com | 12/2010 | 3.8 |
| Kiplinger | 12/2010 | 3.5 |
| CBO | 1/2011 | 3.1 |
| Bank of America | 1/2011 | 3.1 |
| Wachovia | 2/2011 | 3.2 |
| Economist Mag. | 3/2011 | 3.3 |

Final Thoughts

At a recent Washington conference on regulation in the 21st century sponsored by George Mason University's Mercatus Center, I had the opportunity to reflect on what has happened with federal regulation since 1970 when what I term the U.S. regulatory saga began. That was the year when the *Federal Register* printing press moved to high gear. It was also the year when a bevy of newly formed regulatory agencies came on stream. Driven by new regulators, such as EPA, OSHA, CPSC, and NHTSA, the flood of new *Federal Register* pages that came between 1970 and 2010 totalled 2.5 million. And that's a lot of rules.

During those years, regulatory agencies were fed with deficit dollars. Across the years 1970-2009, agency budgets increased by 5.3% annually, in real terms, while federal revenues rose by 3%. As a nation, we were borrowing money to write more regulations. Unfortunately, nothing in the federal establishment provides that someone keep score on the effect of all federal regulations on particular industries or organizations. And for the most part, there are no requirements that agencies systematically check to see if their rules really make a difference.

Sadly enough, it is as if no one really cares about outcomes. It all seems to be about regulation.

In the early years of the saga, commentators often referred to the huge Depression era statues that sit at the front of the Federal Trade Commission headquarters building. The statuary shows a powerful free market horse being reined in by a benevolent plowman. Many thought regulation could be designed beneficially to improve the behavior of firms and industries. But long before there were 2.5 million pages of new rules, a new kind of capitalism emerged. With what I call regulatory capitalism, success requires that firms find ways to form profitable linkages with government.



Instead of plowmen seeking to control wild free market horses, we have horses looking for plowmen.

President Obama has issued a new Executive Order that renews and extends the orders of previous presidents requiring White House review of major regulations. The Order also calls for agencies to consider industry effects and to conduct retrospective analyses of the effects of older rules. But there is nothing in the new Order or older ones that calls for an examination of the anticompetitive effects of regulation on affected industries.

Major regulations often serve to cartelize industries. A rule that sets stricter standards on new than on existing firms in an industry is an example. It also the case, that a firm with a newly patented technology will lobby the plowman to impose the technology on everyone else in the industry. This can cause costs to rise for the competition while royalties rise for the firm with the patent.

As a part of new regulatory review, I argue that all agencies be required to conduct an antitrust review of major regulations in which the agencies identifies winners, losers, and the anticompetitive effects of the rules.

Somehow, the U.S. must find ways to renew the competitive juices in the economy. After 2.5 million pages of rules, regulatory capitalism needs to be deregulated.
