THE ECONOMIC SITUATION

A Quarterly Commentary on the Economy

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Mr. Trump and the Forgotten Man

President-elect Donald Trump's unexpected victory—at least for most prognosticators—generated an analysis avalanche, along with thoughtful commentary, on what we might expect in the way of economic policy changes.[1] In his victory, Mr. Trump spoke of the

[1] This section is based on Bruce Yandle, "Why Do We Forget the Forgotten Man?," *Washington Examiner*, November 21, 2016, http://www.washingtonexaminer.com/why-do-we-forget-the-forgotten-man/article/2607803.

importance of making life better for all Americans. He then referred to the Forgotten Man: “Every single American will have the opportunity to realize his or her fullest potential. The forgotten men and women of our country will be forgotten no longer.”

Mr. Trump’s speechwriters knew exactly what they were doing when they suggested the Forgotten Man reference. They undoubtedly knew that the expression came from Franklin Delano Roosevelt’s famous April 7, 1932, Depression-era campaign speech. In his speech, FDR made reference to the horrors of World War I, pointing out that the 1932 depression crisis was far more serious. He then made reference to the policies of the Hoover administration and introduced the Forgotten Man:

> It is said that Napoleon lost the battle of Waterloo because he forgot his infantry—he staked too much upon the more spectacular but less substantial cavalry. The present administration in Washington provides a close parallel. It has either forgotten or it does not want to remember the infantry of our economic army.
>
> These unhappy times call for the building of plans that rest upon the forgotten, the unorganized but the indispensable units of economic power for plans like those of 1917 that build from the bottom up and not from the top down, that put their faith once more in the forgotten man at the bottom of the economic pyramid.

Like Mr. Trump, FDR was a wealthy populist who was swept into office by voters across the land who, disgusted with Washington’s business-as-usual failed policies, were desperate for change. But while the fact of winning is similar for the two of them, it must be remembered that in his campaign against incumbent Herbert Hoover FDR carried 42 of the then 48 states and gained 57 percent of the popular vote. Mr. Trump carried 31 states out of 50 states and the District of Columbia, and he lost the popular vote. Like Mr. Trump, FDR turned on his Wall Street buddies and called for embarking on a huge infrastructure project. He would later attempt to put America first when it came to limiting immigration from war-torn Europe. Mr. Roosevelt, too, remembered the Forgotten Men, those ravished by the depression. But unlike Mr. Trump, Mr. Roosevelt was a dyed-in-the-wool Democrat and a successful politician who had governed the state of New York and rendered service to the nation in Washington. And unlike Mr. Trump, Mr. Roosevelt was one of the greatest orators of his day.

Can public choice economics explain the Forgotten Man?

The question in FDR’s time as well as today is this: How did the Forgotten Man get to be forgotten? A major part of the answer to the question comes to us from public choice economics. By definition, the Forgotten Man is a part of a large but politically unorganized component of society. Otherwise, he would not be called forgotten. Though all such men taken together have common interests, they do not form a politically important interest group. No one seeking national office typically needs to curry their favor. Unlike organized interest groups—the teachers and labor unions, environmentalists, business and financial interests, ethanol producers, corporate

farmers and cattlemen, and some minority groups—each member of the unorganized forgotten ones can be thought of as being interchangeable with others in that same group. Sure, their votes matter, but their support—most of the time—is not essential to a candidate seeking to gain political power, at least until they awaken and rebel. Seen another way, it is very costly to organize the unorganized Forgotten Men, unless technological changes reduce the cost of doing so. Smartphone technology and related social media may have done just that.

Using the Forgotten Man to make a policy change forecast

The forgotten tend to become invisible—until they rise up. And why did they raise their voices this time? What were the all-encompassing issues that motivated rank-and-file lower-income, less-educated Americans to get out and vote this time, but not before? I don't think the answer to these questions involves closing industrial plants, rising immigration, and falling opportunities for less-educated workers. These three forces have been playing through the economy for a long time. I consider them to be background forces. They may have set the conditions for the political action we observed, but I don't think they ignited the action. I suggest that three events triggered the revolution. The triggers form the basis for a forecast of Mr. Trump's post-inaugural actions.

Here are the three triggering events:

1) The suddenly rising cost of the Affordable Care Act's mandate and the timing of the premium announcements.

2) The "clean energy" push by the executive branch, now delayed by a court decision, that sharply accelerated the demise of the natural-gas-threatened, coal-producing economy.

3) The highly visible wealth effects generated by federal policies that slowed community bank lending and brought interest rates almost to zero on the savings of ordinary folks while fueling massive increases in wealth for the Wall Street–savvy elite.

And so what might be the policy changes that result from all this?

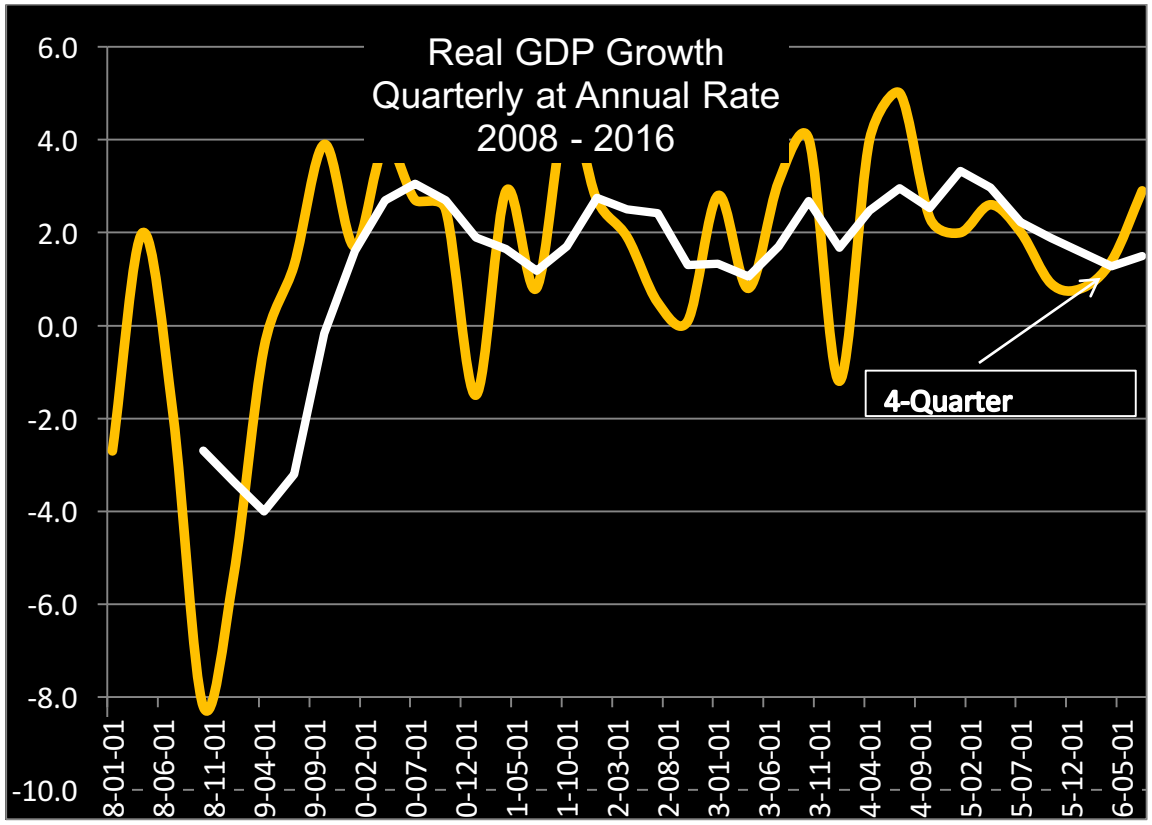
- Sharp revisions that will bring more competitive outcomes to the Affordable Care Act,
- changes in Dodd-Frank that will soften financial institution regulation,
- reductions in taxes and a call for higher interest rates, and
- enhanced emphasis on economic consequences of environmental policy.

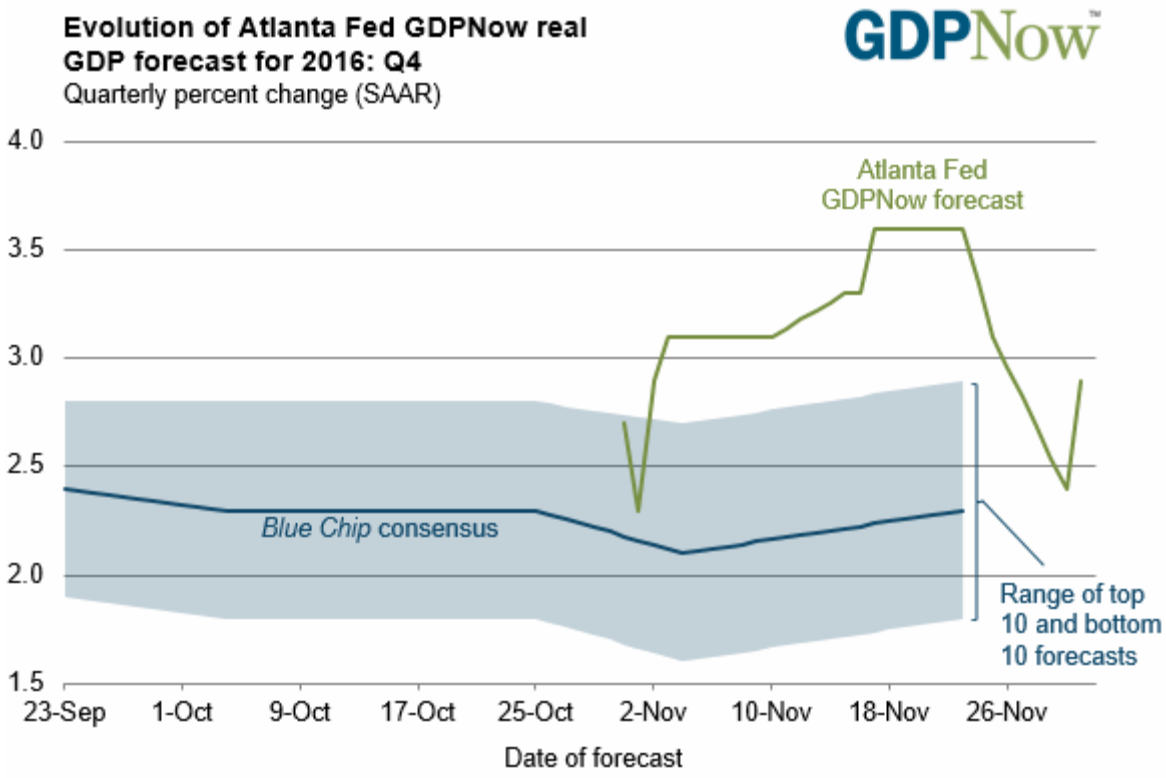
These high-priority changes will be folded into actions that relate to the background issues: trade and immigration policy.

Can the high-priority changes improve productivity and America's GDP growth path, all else the same? Of course, the details matter, but I think that all else equal these policy changes will result in faster-paced economic activity. But the GDP growth effects will not be seen for 18 to 24 months. Before clearing our throats for a muted shout of celebration, we must remember that "all else will not be equal." I will consider some political promises later in the report that may cut the other way, especially trade policy.

Speeding Up in the Slow Lane: Did Someone Say GDP Growth?

October's estimate for third-quarter real GDP growth brought smiles to the faces of slow-growth-weary observers. Indeed, the 3.2 percent final estimate exceeded the consensus by almost 1 percentage point. I provide data on the quarterly growth rate and four-quarter moving average in the next chart. The moving average indicates annual growth has turned toward 3.0 percent, which, once upon a time, was the long-run average rate of growth. But given the very pale first half, heading toward 3.0 percent may be as good as it will get—for a while. When the Federal Reserve Bank of Atlanta's 2.9 percent projection for 4Q2016 growth is considered, shown in the next chart, we may at least approach a 2016 annual growth of 2.0 percent.



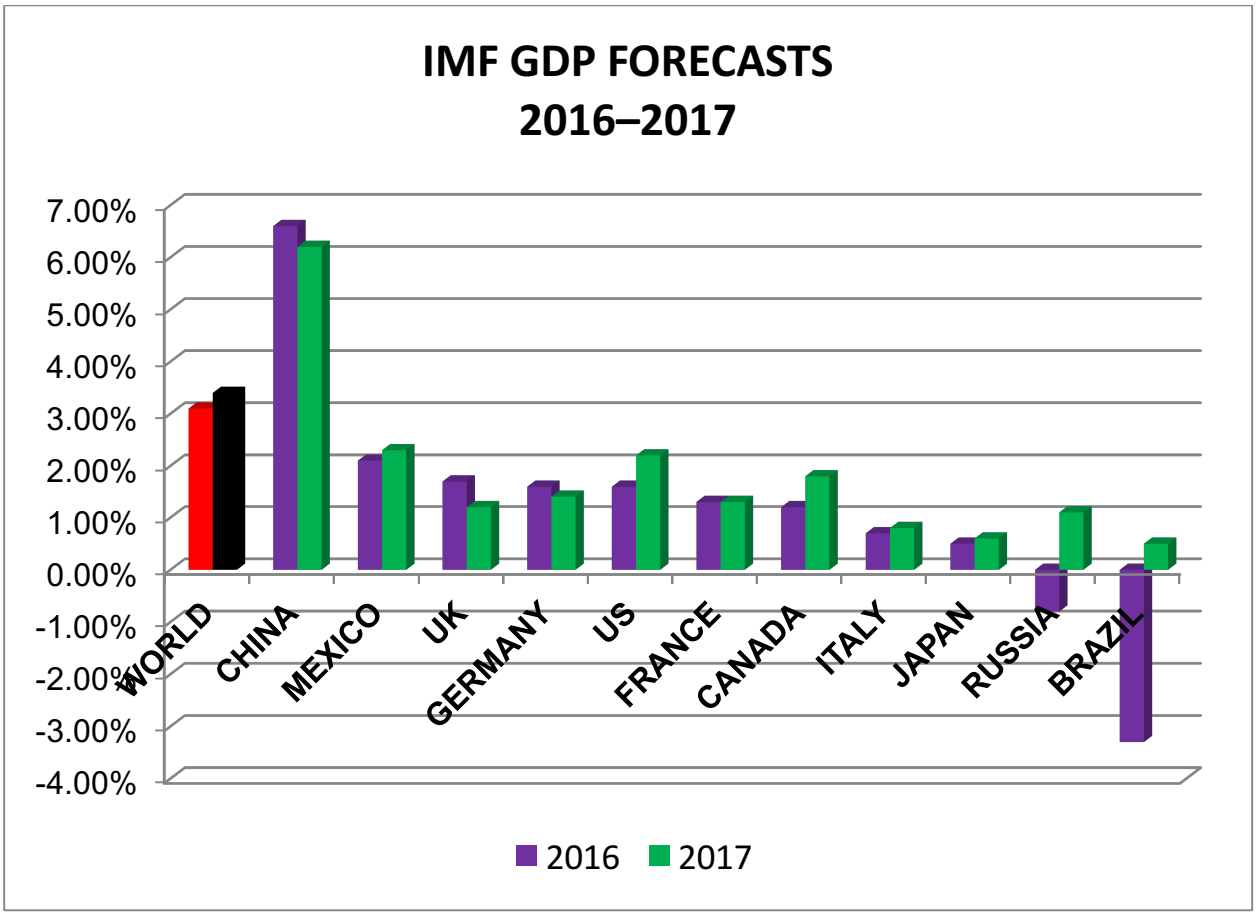


Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*

Note: The top (bottom) 10 forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip* survey.

Will our major trading partners contribute to improved GDP growth?

The United States' likelihood of breaking the 3.0 percent growth barrier will be improved if its trading partners ramp up their purchases of US goods, which will happen if their GDP growth improves. The International Monetary Fund sees better times ahead for the world and for the United States, Mexico, and Canada, our largest trading partner. In the next chart, we see a mixed bag of outcomes for other industrialized countries.



What about Global Trade and Mr. Trump's Promises?

It's good to see an optimistic 2017 forecast, because in late September, the World Trade Organization indicated that growth in global trade for 2016 would fall to the lowest level since 2008. The growth slowdown is explained primarily by the generally slow pace of world economic activity, particularly for commodity-producing countries. But anti-trade sentiments being registered around the world, like those of Mr. Trump, may also keep growth in the cellar.

In the recent campaign, both presidential candidates Clinton and Trump sounded off about the loss of US manufacturing jobs and how trade agreements that promise to make things better could really make things worse, especially for American workers. The campaign rhetoric matched the sentiments of people across the United States and advanced economies, but not of those polled from the developing world.[2] Ironically, in a way, those countries that have flourished because of open markets and trade are the

[2] Pew Research Center, "Americans Unsure of Trade Benefits," September 15, 2014, http://www.pewglobal.org/2014/09/16/faith-and-skepticism-about-trade-foreign-investment/trade-12/.

same countries that are ready, figuratively speaking, to put rocks in harbors—at least for a while.

President-elect Trump has promised to play hardball when it comes to trade deals and foreign access to American markets. In his struggle to be elected, he called for 45 percent tariffs on Chinese goods, renegotiation of NAFTA, and an end to efforts to form multinational trade agreements. Holding true to this campaign rhetoric would lead to trade wars, production shifts away from countries that are being punished to those that are not, and, while these adjustments are underway, the beginning of a significant recession. Put another way, we could forget about the rosy forecast provided earlier in this report.

What about the record? What do data tell us about US trade in manufactured goods? Are we really losing ground?

Let's consider some data

While there are clearly trade-induced employment dislocations that have beset major US manufacturing industries, such as furniture, textiles, and some parts of the automobile industry, it is just as clear that manufacturing exports have not suffered. In fact, US real manufacturing exports have increased sixfold since 1980. Obviously, the composition of exports has changed. Perhaps of greater interest, given the rise of the US knowledge economy, is the fact that it is the service sector's exports that set the higher pace for US trade. Trade in that sector has grown sixfold since 1980. The share of service exports has increased from 18 percent in 1980 to 30 percent in 2014, while manufacturing's share has held its own.

But there is still another part of the story that deserves to be considered. Not only has the composition of traded goods and services changed, for example from furniture to electronic machinery, but also the share accounted for by intermediate components has exploded. According to the *Economist* magazine, 2005 trade in intermediate inputs accounted for 56 percent of goods and 73 percent of services that crossed national borders.[3] Simply put, the days when built-from-scratch automobiles in one country were exported to other countries has long been dead.

Writing about this in his 2016 book, *Door to Door*, Edward Humes explains that at least 24 primary suppliers on three continents provide the content for Apple's iPhone 6 Plus.[4] In some cases, the same component parts are shipped back and forth across countries as they become finished parts for final assembly. Humes estimates iPhone 6 Plus components travel 240,000 miles as they move from country to country and finally to

[3] "The Problematic Proposal," *Free Exchange*, *Economist*, August 13, 2016.
[4] Edward Humes, *Door to Door* (New York: HarperCollins, 2016), 24.

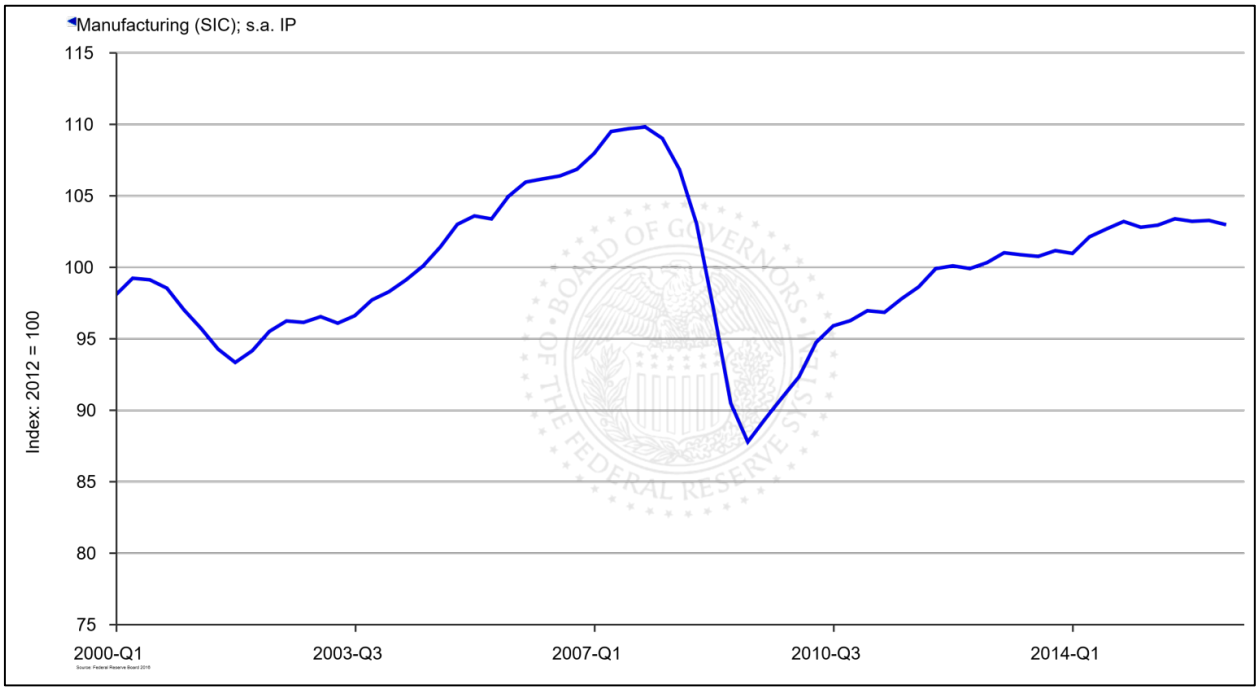
assembly in China, where 128,000 workers are employed making phones. In other words, component manufacturing and processing weaves an economic fabric that encompasses the globe. Specialization expands and employment and incomes grow along the way, but the situation is not so simple as to say “the United States has a problem with China” or “if you elect me, I will bring jobs back to America’s steel-making centers.”

Has America Lost Manufacturing Muscle?

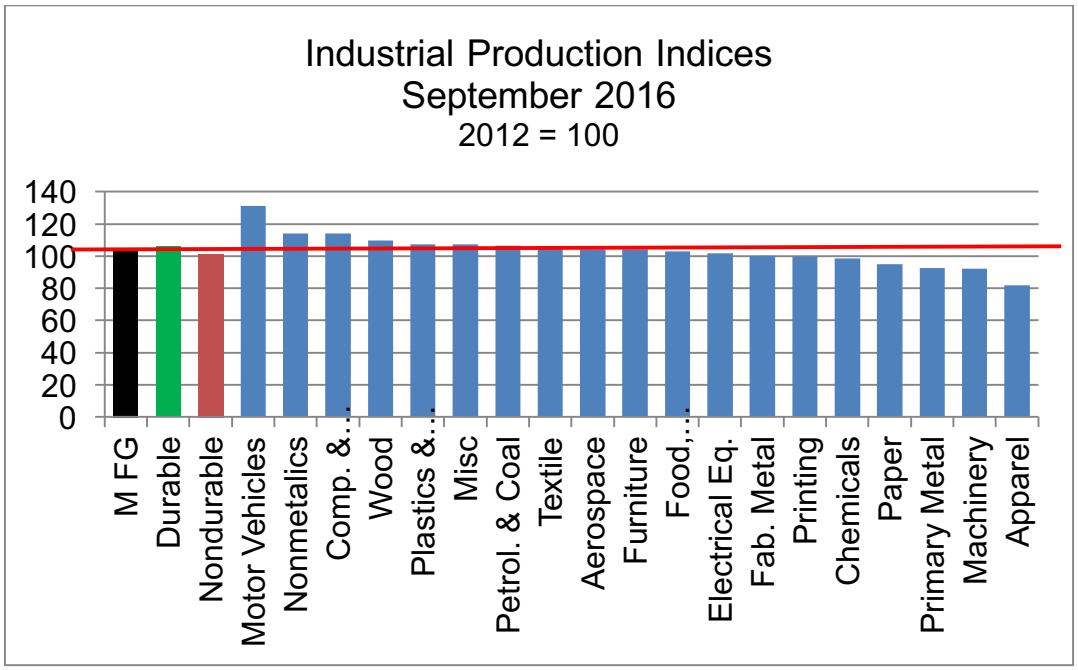
Each morning we awake to a new economy, one that is a wee bit different from the one we put to bed the evening before. The differences are small, so small that they cannot be detected, but change is there nonetheless. To detect the change, we must observe it at a distance, perhaps a few quarters at a time—better yet, with the perspective of a few years. Consider manufacturing. We know that the service sector has become the dominant economic sector. But have we lost our manufacturing muscle?

One answer to the question is found in Federal Reserve production data in the form of an index for manufacturing, where 2012 = 100. The accompanying chart shows the index from 1990 forward. As can be readily observed, the index is a bit lower now (103) than it was just before the start of the 2008 recession (110). A glance further back tells us that even though it is a bit lower, the index is still ranging above the level of previous decades. Yes, declining exports are part of the story. There is not as much manufacturing muscle as there was in 2008, but there is still a lot of muscle.

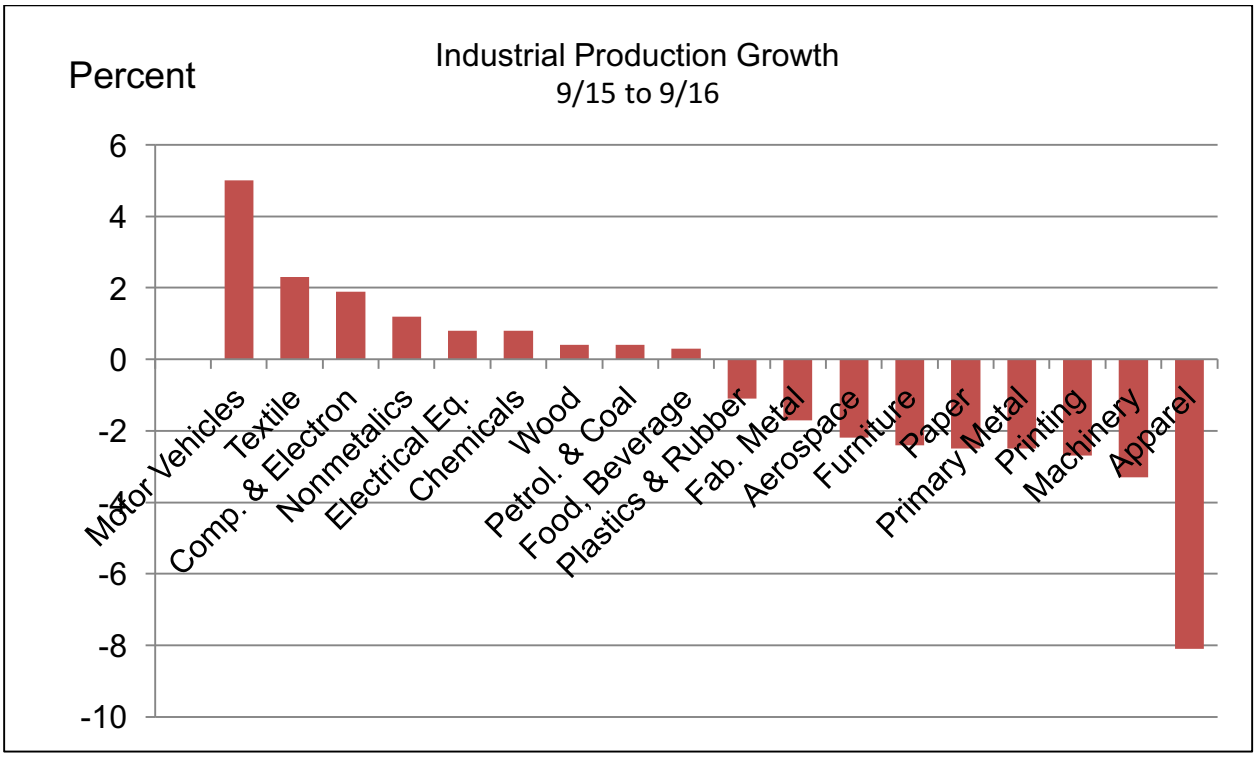
US Manufacturing Production, 2000–2016



Some other Federal Reserve data, shown next, tell us which manufacturing sectors are strongest. I have inserted a red line where the index is equal to 100. Any bars above the line indicate levels of production higher than those in 2012.

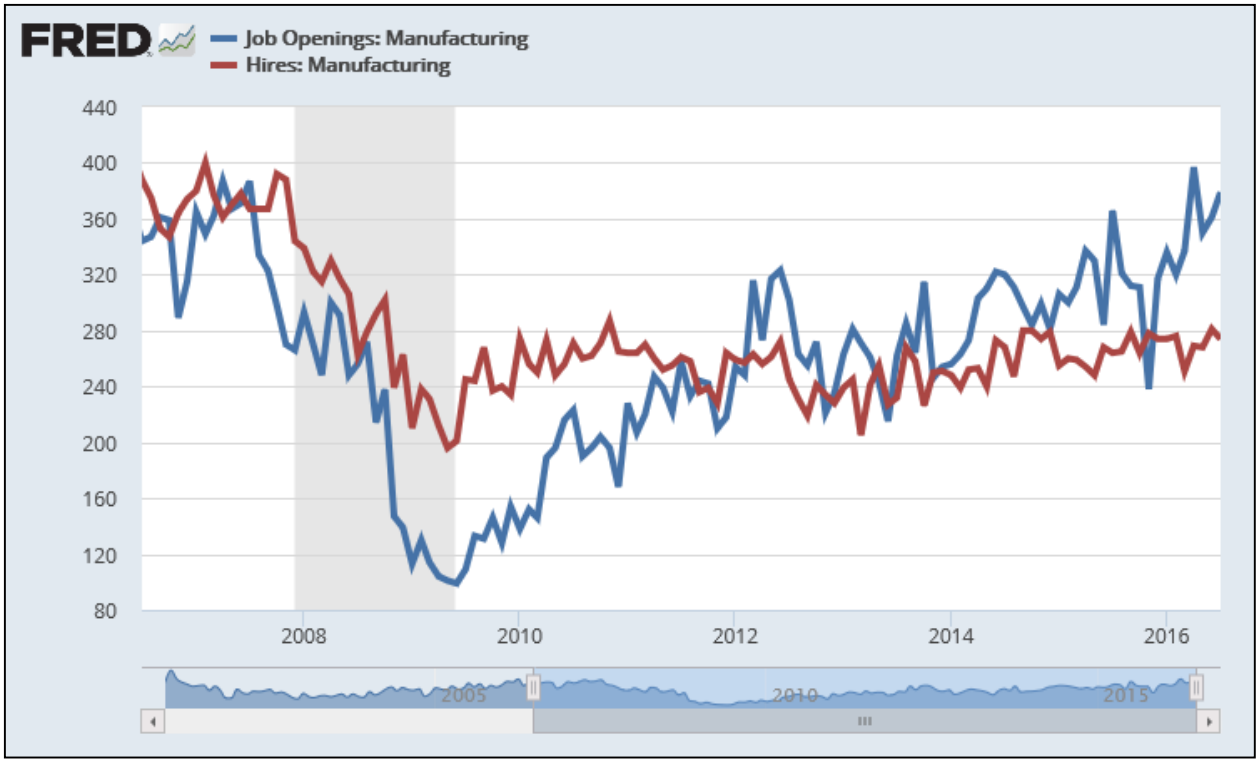


As we can see, the automotive sector, glass (nonmetallic), computers & electronics, plastics & rubber, petroleum & coal, textiles, aerospace, furniture, and food have index values greater than 100. I also show the indices for durables and nondurables. The durables sector is the stronger. Finally, the last manufacturing chart reports growth in production for the recent period. A quick glance here tells us what's hot and what's not. Sometimes there are surprises. Note that the textile sector is one of America's surging sectors.



What about manufacturing employment?

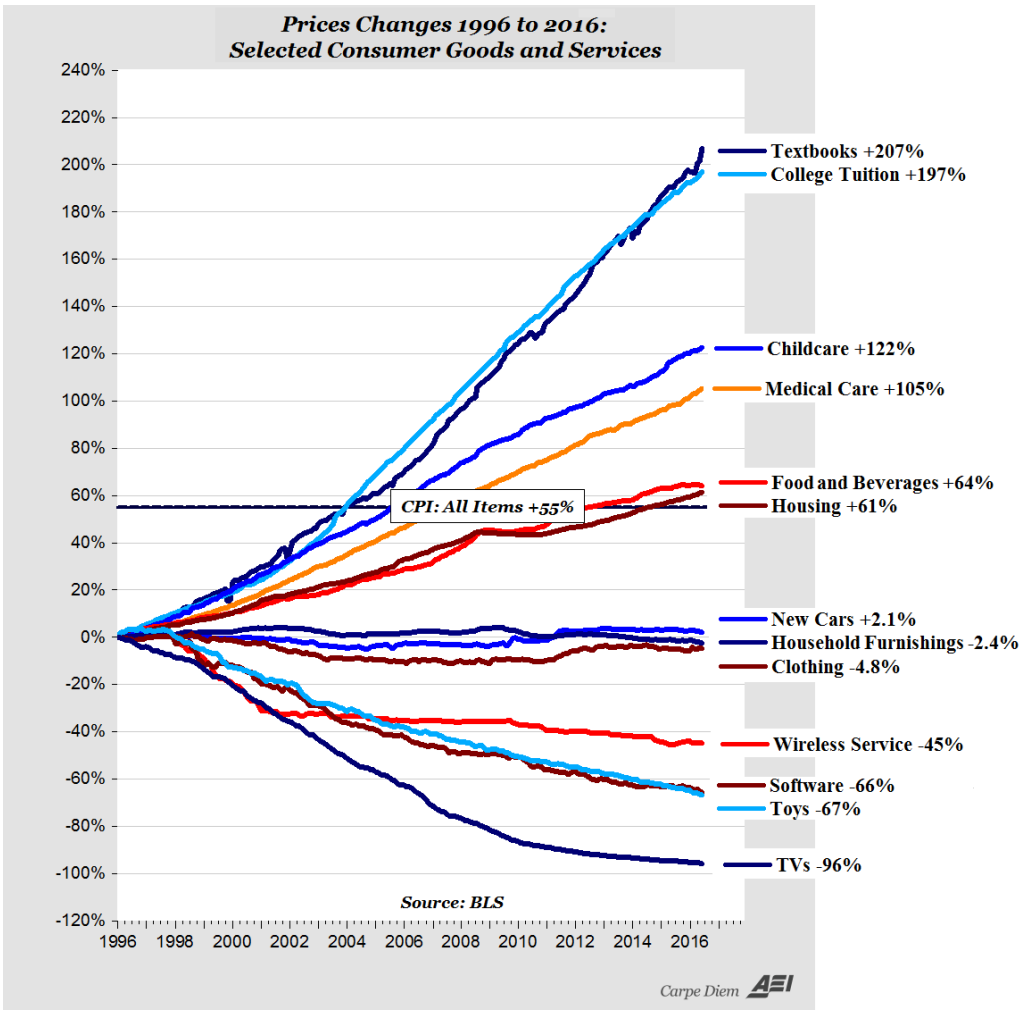
Interestingly enough, America, right now, has a manufacturing jobs crisis. No, it is not about job losses. It is about more job openings and lack of workers to fill them. Consider the accompanying St. Louis Federal Reserve Bank chart. I've mapped Bureau of Labor Statistics job opening data with job hires. Since 2014, the gap has widened. The current gap is 100,000 unfilled jobs. There are not enough qualified workers to fill the openings. So what happens if, by some magic, a newly elected political leader does bring back more job openings? The gap would get larger, unless the happy leader also brought workers to fill the jobs. In the current environment, the US challenge is not about jobs, generally speaking, it is about job dislocations in particular locations. Of course, this is part of the Forgotten Man issue. There are lots of people in rust belt states who would love to see nearby closed factories reopened. They would love to respond to the work whistle once more. Targeting a return of jobs is a tall order, indeed.



Are there benefits to consider?

But what about globalization's benefits? What has happened to the prices of consumer goods over the last few decades as US exports and imports have increased? Do we see improvements in the prices of commonly purchased consumer goods? How do those price changes compare with the prices of consumer services where international competition hardly makes a dent? Consider the next chart for some answers.[5] A picture is worth a thousand words.

[5] Mark J. Perry, "Do You Hear That? It Might Be the Growing Sounds of Pocketbooks Snapping Shut and the Chickens Coming Home…..," *Carpe Diem*, American Enterprise Institute, August 13, 2016, https://www.aei.org/publication/do-you-hear-that-it-might-be-the-growing-sounds-of-pocketbooks-snapping-shut-and-the-chickens-coming-home/.



Putting it all in a nutshell

Having discussed possible policy changes, GDP growth projections, and trade possibilities, it is time to offer a nutshell summary of what I think lies ahead for 2017.

Here's the picture that I see for the U.S. for 2017:

- 2017 GDP growth will be 2.2%.
- Inflation will rise a bit. Look for 2.0%.
- Interest rates will nudge up. 10-yr. bond: 2.50%-3.00%. Mortgage rate: 4.00%- 4.50%.
- Housing will be strong; autos down.
- The pace of manufacturing activity will accelerate from hardly moving to slow, led by machinery.

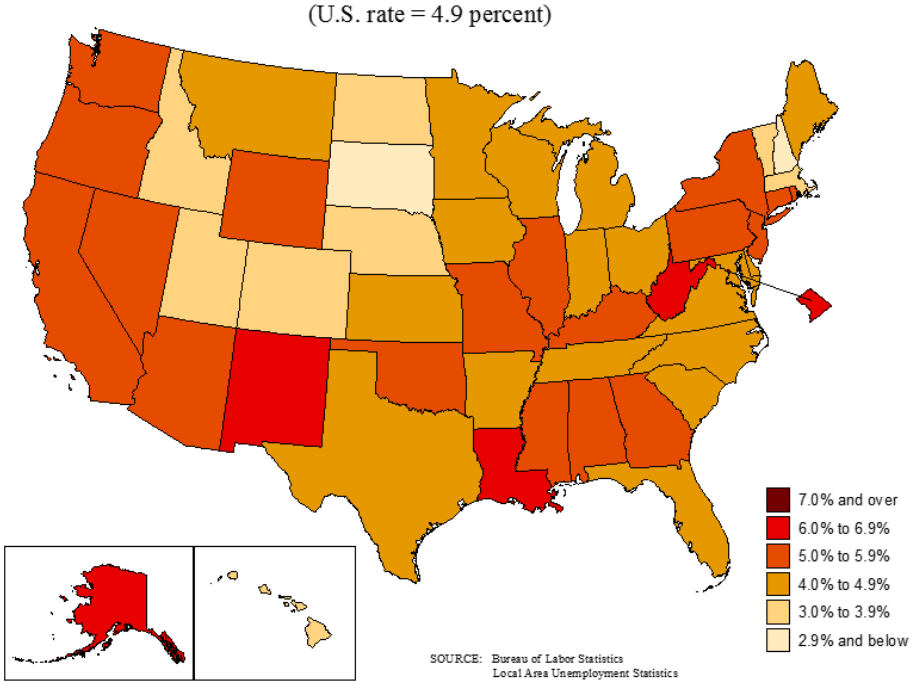
When the records are in 2016 will be a ho-hum year. 2017 will look better.

The Geographic Imprint

When giving presentations on the economy, I often say that when one asks about the economic outlook, I respond by asking, "Which zip code do you wish to hear about?" The point is a simple one. Economic activity varies a lot across cities, counties, and states. I begin this section by providing two state outline maps showing state unemployment rates. The most recent one, for October 2016, shows relatively little variation across states. The strong employment markets are seen at the center of the map. Energy, hard grains, and educational attainment still matter. In contrast, the accompanying 2011 map shows higher unemployment rates, greater variation across states, and when compared with 2016, how unemployment rates have fallen. A lot has happened since 2011. Lest we forget.

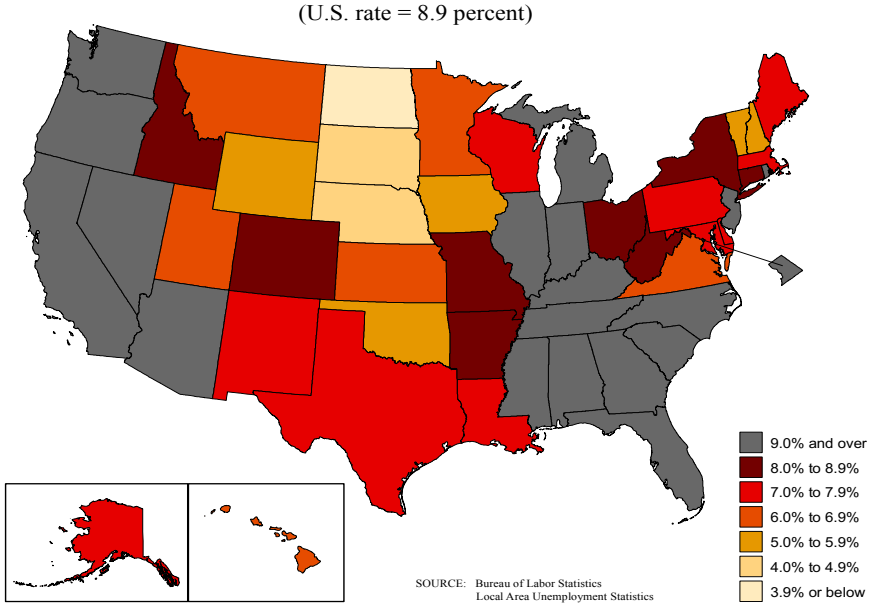
Unemployment rates by state, seasonally adjusted, October 2016

(U.S. rate = 4.9 percent)

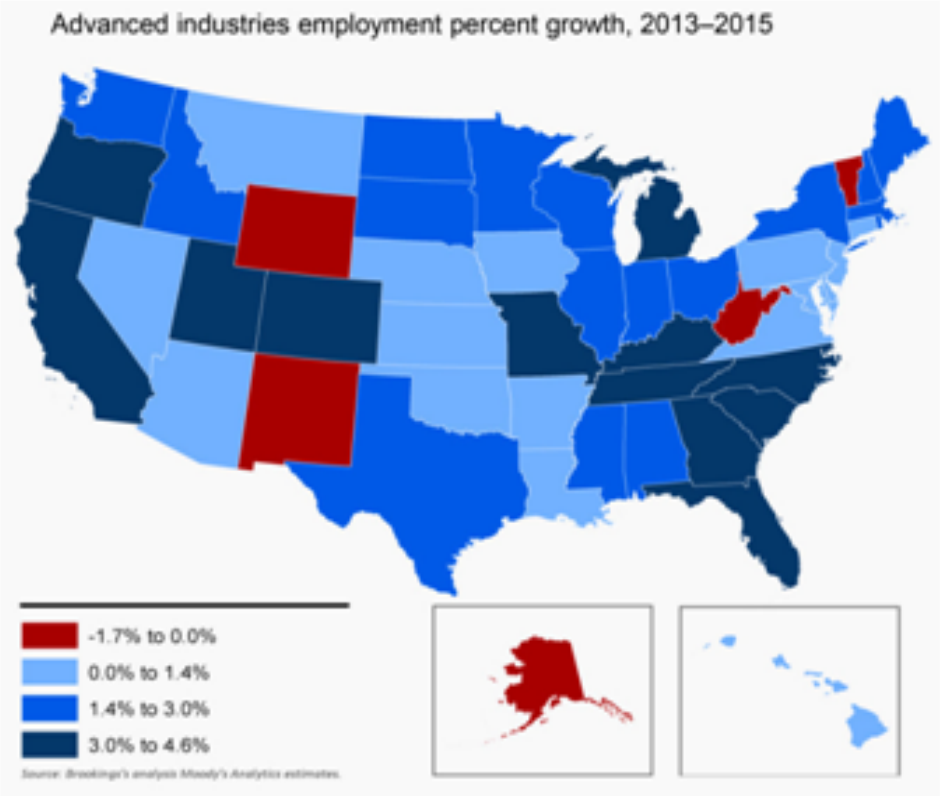


Unemployment rates by state, 2011 annual averages

(U.S. rate = 8.9 percent)

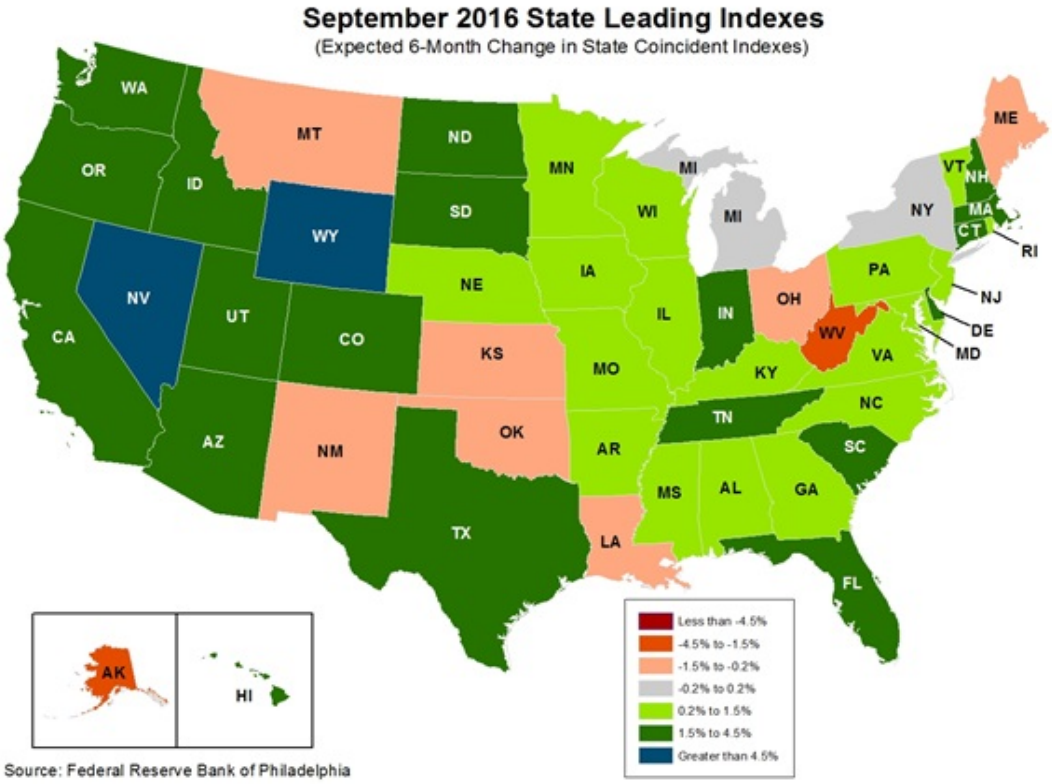


We get another 50-state employment picture in the next map.[6] This one shows employment growth in advanced industries. These are 50 industries that spend disproportionately on R&D and employ a high percentage of workers in science, engineering, and mathematics. The darkest blue states can be thought of as the locations for America's cutting-edge manufacturing activity.



Finally, I provide a chart produced by the Philadelphia Federal Reserve Bank, which shows leading indicators for the next six months. The chart is based on September 2016 estimates, which means that it is forecasting what the picture will be in March 2017. Nevada and Wyoming are the highest-growth states, followed by a large number colored dark green.

[6] Mark Muro, Siddharth Kulkarni, and David M. Hart, "America's Advanced Industries: New Trends" (Brookings Institution, Washington, DC, August 4, 2016), https://www.brookings.edu/research/americas-advanced-industries-new-trends/.



Aspiring Presidential Candidates and Stationary Bandits

Candidate promises that proliferated this year in a seemingly interminable presidential campaign brought to mind the late Mancur Olson, a major contributor to the formation of the field of public choice and one of 20th century's most creative social scientists.[7] In his book *Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships* (New York: Basic Books, 2000), Olson uses the metaphor of roving and stationary bandits to explain the rise of democracies and to offer insights into political behavior generally. His notion about bandits sheds a bit of light on competing campaign promises. But before looking at the matter, we must build a little background.

Consider for a moment the two bandit categories. Olson reminds us that when a roving bandit breaks into a home, he takes all the valuables he can cart off. The bandit has no interest in the victim's long-run prosperity; the bandit is interested in his own prosperity,

[7] This section is based on Bruce Yandle, "Donald Trump and Hillary Clinton Campaign Promises Are About Power," *U.S. News & World Report*, October 31, 2016, http://www.usnews.com/opinion/economic-intelligence/articles/2016-10-31/donald-trump-and-hillary-clinton-campaign-promises-are-about-power.

which of course may be short lived. In contrast, a stationary bandit, who may be a power lord who has somehow seized political control, seeks to maximize tribute that can be taken on an ongoing basis. Like a mafia territorial boss in the business of selling protection, he worries about his victim's economic productivity, and he knows that excessive tribute payments can be debilitating to his victim and therefore to his own prosperity. Put another way, the stationary bandit knows one can fleece a sheep many times, but can skin it only once. More to the point, he knows that incentives matter. If marginal income tax rates are set too high, then higher incomes may disappear along with the bandit's much-beloved revenue.

Olson suggests that stationary bandits, who he sees as examples of evolving crude governments, protect their territories from invaders; they provide defense and offer other government services that help to enhance their harvest. Unlike the rovers, the sitting bandits have an all-encompassing interest in prosperity. Territories operated by enlightened stationary bandits then have an advantage over others that are controlled by more temporary roving bandits, which is to say, those whose grip on power is apt to be short but not sweet. The seasoned stationary bandit will more readily raise an army to defeat rovers when doing so will earn the allegiance of his subjects. The sitting ruler will also more likely honor contracts and enforce property rights, since it is in his interest to do so. But what may seem like a successful stationary bandit's happy hunting ground takes on an even healthier complexion for his subjects when other stationary bandits operate in competing locations. Though it may be difficult to do so, unhappy subjects may vote with their feet and take their tools with them.

But how does a stationary bandit determine how much take is too much? How does he build his "taxation" agenda? After all, an effective bandit will not want to leave untapped revenue on the table. The question itself gives a hint as to why stationary bandits cannot be solo operators. After all, revolution is a dictator's greatest fear. Successful stationary bandits must have a strong group of supporters and protectors who help keep the crown on the ruler's head and his head on his shoulders. In order to keep power, the bandit or ruler must share power. Sharing power brings knowledge and awareness of limitations of power. Sharing power also means formation of aspiring stationary bandits. Sometimes forestalling revolution means sharing the voice when decisions are made. The stationary bandit extends the vote.

If we apply Olson's model to American politics, we can think of presidential candidates as being hopeful stationary bandits. Though not the kindest moniker we might affix to them, the metaphor immediately raises the challenge just mentioned. How to determine how much wool can be sheared and shared with the stationary bandit's supporters and protectors? In the American case, this severe knowledge problem is addressed historically by political parties, primaries, caucuses, conventions, debates, and ultimately elections. But now microtargeting, through Facebook and other means, can

substantially reduce the cost of matching voter and candidate preferences. With lower information costs, we should expect to see better government performance, at least as seen in the eyes of the interest groups that help elect new leadership.

And this brings us finally to campaign promises. When candidate Donald Trump promised to cut taxes on high-income earners as well as on corporate earnings, he bet that the result will lead to faster economic growth and more wool to shear for expanding some Trump-preferred government functions, like building walls and expanding childcare. But if electorate feedback suggests childcare matters more to voters than walls do, Mr. Trump can modulate and recalculate. And when candidate Hillary Clinton responded that she would cut middle-income taxes and raise taxes on the rich, she argued that the adjustment would help empower people whose wool has been cut too close to the skin. She also argued that lower-middle-income taxes would produce more future wool for her to shear and use for her party's favorite causes, such as making college education "free" and expanding the production of clean energy.

Political competition helps to determine the resulting action agenda and which aspiring politician will gain power. But both major party candidates in this year's election were singing Mancur Olson's stationary bandit's song. They both wanted power, and they both wanted more revenue to use for their political purposes.

For the Reading Table

With all that is being said about labor force participation, various measures of unemployment, and whether or not labor markets are tight enough for the Fed to justify raising rates, books like Nicholas Eberstadt's *Men Without Work* (West Conshohocken, PA: Templeton Press, 2016) need to come around more often. Eberstadt has one overriding motivation for writing his book. He seeks to answer this question: Why does the United States have more than 50 million working-age adults not participating in the economy? They are not working or looking. They are not counted as unemployed, they are simply nonworkers. Perhaps they are a part of Mr. Trump's Forgotten Men and Women.

Eberstadt's focus is on the male component of that number, which is some 20 million tall. Why? Because the number has been rising systematically for decades. The female counterpart has been rather stable. Eberstadt probes into lots of data. He shows that many of the nonworking men are able to consume at a fairly good level; consumption expenditure data show a more positive picture than do income data. So where does the money come from? There are overlapping disability income programs. Multiple family members can play the game and pool the proceeds. There is also the shadow economy where work for cash takes place.

Eberstadt seems most frustrated when discussing ex-offender data on the estimated 23 million people who have served time but are not participating fully in the market economy. His frustration comes from two sources. First, a large part of this population is not working, and cannot easily find work. Second, there is no systematic counting of or reporting on this huge population by any government agency. We are accustomed to hearing people bemoan the low and falling labor force participation rate, but we hear nothing about how sentencing guidelines and prison policies laid the foundation that explains a large part of the problem. I hope Eberstadt's book will be read widely.

For those who love good barbecue and want a change of pace from reading relatively flavorless economics tomes, Rien Fertel's *The One True Barbecue* (New York: Touchstone, 2016) could be just the ticket. In this remarkable read, Fertel traces the rise and decline of whole hog cooking. Along the way, he takes the reader to 15 locations, following a mostly southern swath that goes from Mississippi to parts of Tennessee but is concentrated primarily in coastal North Carolina and the lower part of South Carolina. Somehow, he also manages to visit one somewhat misplaced whole hog cookery in New York City.

While he provides tasty details on the prepping and cooking, Rien focuses mainly on the people, the slowly disappearing master cooks who learned their art as young people and practiced it carefully to old age. Consider how he introduces Ricky Parker on the book's opening page: "Whole hogs. Prodigious beasts, 180 to 200 pounds apiece. Fed and fattened to his specifications, slaughtered at the local abattoir, head and offal removed and ready for roasting and smoking in his cinder-block pits. This is what Ricky called barbecue. Whole-hog barbecue. The only barbecue that he and all of Lexington, Tennessee, ever knew. The one true barbecue: a hog, slow simmered over hickory coals and ash, its flesh and fat and skin primed for the cleaver and chopping block after twenty-plus hours. Bathed in smoke and massaged by fire."

Along with discussions of the relative merits of tomato- and mustard-based sauce to no sauce at all, the book is filled with stories about dedicated, almost loveable, pitmasters who prided themselves in the quality and quantity of whole hogs they convert to sumptuous, juicy barbecue. And the name? Where does the word come from? The reader will learn that barbecue is derived from a French term associated with the apparatus, the framework, used for cooking. And that explains why there is a Barbecue Creek in coastal North Carolina, named so by a Scottish Highlander who upon seeing early morning mist rising from the creek was reminded of his sailor days in the Caribbean watching native islanders roasting meat using the French apparatus. Located nearby is Barbecue Presbyterian Church, founded in 1758.

I hope you will read and enjoy the book. Better yet, I hope you find some delicious barbecue.

Finally, I must shamelessly offer a review of Kathryn Smith's book, *The Gatekeeper: Missy LeHand, FDR, and the Untold Story of the Partnership that Defined a Presidency* (New York: Simon & Schuster, 2016). Kathryn, my much-admired daughter, devoted almost three years to the research and writing that produced this first biography of Missy LeHand, the first woman to become a president's chief of staff. LeHand worked with FDR from 1920 when he ran for vice president until 1941 when she suffered a massive stroke. The adept and polished LeHand managed the White House flow of people and activities during one of the nation's most challenging periods. As FDR's gatekeeper, she also often served as White House hostess in place of First Lady Eleanor, a tireless globetrotter who was constantly engaged in other social and political enterprises. Kathryn gained access to as-yet-unpublished letters and film from LeHand's nieces and used that material to supplement other research to provide a memorable account of FDR's personal and political struggles. Gaining an appreciation of Mr. Roosevelt's polio struggle is key to understanding the man himself. Missy LeHand played a critical role as booster, companion, and partner in FDR's successful battle to struggle to his feet and lead the nation through the Great Depression and World War II. FDR fans and foes alike—and their numbers are legion—will appreciate this heavily documented biography of Missy LeHand's extraordinary professional life.