

# THE ECONOMIC SITUATION

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## September 2010

- Is the stimulus working, and if so, for whom?
- What about paying off the debt? How and when?
- Double dip? Can a 🐸 become a W?
- More on brains and the economy.
- South Carolina digest.
- Meet a Rational Optimist.

### Is it working? And how will we pay for it?

Conversation about the economy in Washington and across the country contains two elements: Is the stimulus working? And whether working or not, how will we pay for it?<sup>1</sup> Speaking to the first part of the question has pitted economists and others who doubt the power of government spending to have any meaningful long-term effect on the economy against other economists and policy makers who believe just the reverse. No one really doubts that spending \$800 billion additional taxpayer-funded dollars on projects will have short-run impact. That much money just can't be spent without generating real action. What is questioned is whether or not such spending will have a longer-run sustainable impact, and if the resources so diverted might have had an even larger impact if left undisturbed.



<sup>1</sup> The report illustrated in the upper right-hand corner of this page is one that I produced for George Mason University's Mercatus Center. The report can be downloaded at <http://mercatus.org/publication/everyman-s-deficit>.

The doubters have two pieces of evidence on their side of the argument. First, there is the matter of the Keynesian multiplier. The story goes like this. An injection of federal dollars into the economy will have a direct impact when the money is spent in round one. This is followed by the splash-down effect. There will be ripples. Receivers of the spent money will spend, bank deposits will rise, banks will lend, and even more money will enter the economy, generating an overall impact of more than the first effect when the boulder hit the economic waters.

All this sounds lovely until someone asks about where the money comes from, how it will be paid back, and what the money might have done if left in private hands. And there is another pesky question. How much does it cost to raise a public dollar by borrowing and then run the dollar through government channels to get it to a favored interest group? (And why aren't we all favored?) As to the splash-down effect, credible estimates of the multiplier suggest it can have a value of less than one. Instead of increasing overall spending, government injections reduce overall spending. As to what it costs to get a dollar through the government system, which relates to the pale multiplier, estimates on this indicate it costs more than a dollar to move a dollar through government channels to the first recipient.

Darn it! Why is it so hard to produce something out of nothing?

But there is a challenge to this thinking that comes from those who may accept the evidence I have mentioned but still support stimulus programs, if they create jobs..., even short run jobs. Their argument says there are important categories of cost, other than narrow economic ones, that go with long-term unemployment, that when the number of unemployed rises above seven million or more, something has to be done to bring down the number, even if a stimulus program tears up part of the economic engine.

Put another way, winters can be so severe that people living in an old cabin will burn planks off the exterior walls to keep from freezing. Doing so may not make sense for the long run but staying alive now is what matters.

Fortunately, we as a nation are not quite that desperate, and even if we were, we have another option, one that eliminates the costly process of trickle down spending by way of government contracting. We can just cut payroll taxes, across the board—employee and employer, and that can enable everyman generally to save the walls of the cabins. Instead of destroying private wealth to stay warm, we reduce the flow of wealth to government.

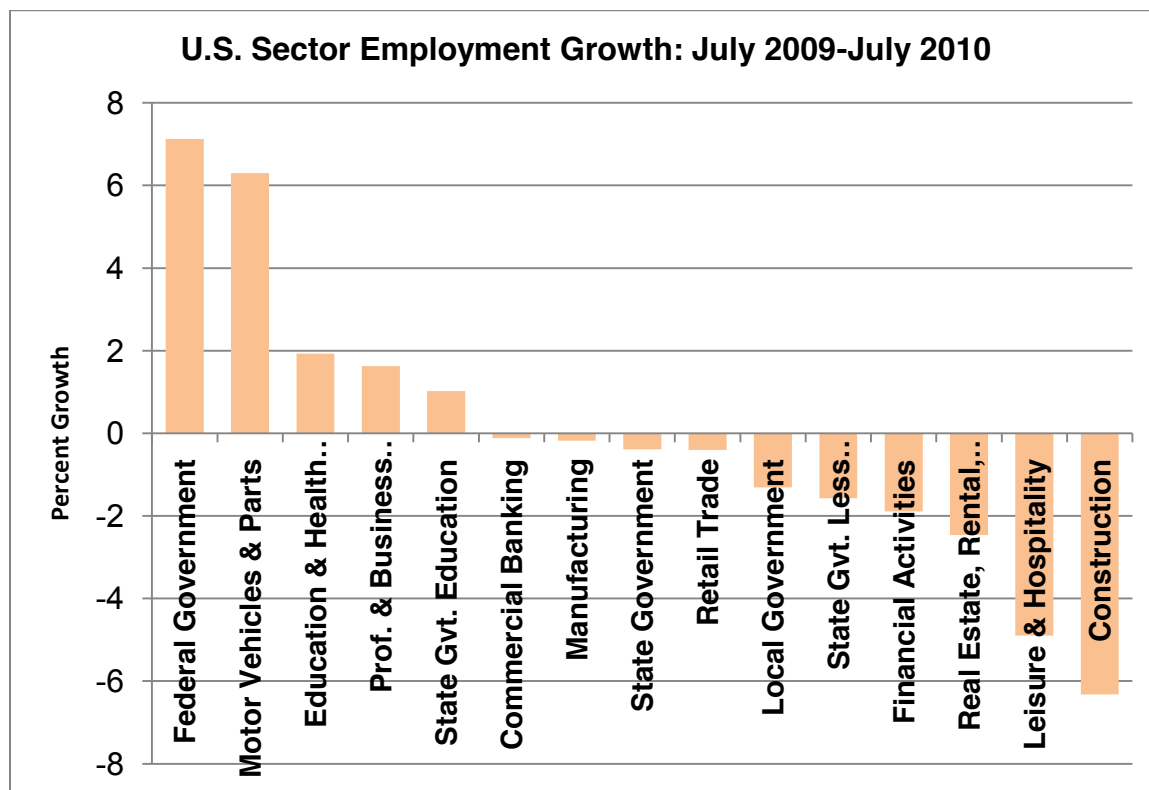
The fact that we as a nation have not cut taxes for everyman suggests there is far more going on with Congress than just trying to overcome the sad forces of the Great Recession.

### **Is the stimulus working?**

To answer this question, I decided to look at some data. I examined Bureau of Labor Statistics seasonally adjusted employment growth data from July 2009 to July 2010 for a few major sectors, some that were targeted directly by stimulus programs, such as autos and banks, and others that were not, such as manufacturing overall and retailing.

The results of my calculations are shown in the accompanying chart where the sectors are ordered from highest to lowest levels of growth. I note that there was zero employment growth for the period in the overall private sector and zero growth in the overall public sector—federal, state and local. But there were vast differences to be found among sectors. First off, federal government employment takes first place in the growth sweepstakes; it grew 7.1%. But a large part of that growth involves lingering census workers. So let's move to the next sector. The auto industry comes in second. Bailouts seem to matter, but there is some real growth taking place too. Employment in the Motor Vehicle and Parts sector grew 6.3%. Privately provided Health and Educational services follows next with almost two percent growth. We all know that a lot of healthcare money was sent to this sector.

I was surprised and heartened to see positive growth in Professional and Business Services. This was a leading growth sector before the Great Recession. I mark this sector's growth as evidence of life in the real economy, not the stimulus economy. Finally, as we might expect, state funded education recorded positive growth. Following a special August congressional session, another dose of funding is headed that way again. The chart also shows that state government employment fell when the education sector is removed. Employment growth for local government was also negative.



Of the sectors I examined, Commercial Banking is the first to go negative, but only by a small amount. Undoubtedly, the FDIC and TARP salvaged some jobs. Manufacturing,

which of course includes Motor Vehicles and Parts, registered a small employment decline, but nothing like the larger losses registered by the Financial Activities and real estate sectors. These two were caught directly in the gears of the housing collapse. They lost ground together.

The weakness shown in Retail Trade and Leisure and Hospitality probably reflects recession-weary consumers, and nothing in the way of direct stimulus benefits. But of the sectors I considered, construction was the largest loser. We know that a popped housing bubble leaves little chance for an early recovery in housing related construction. But we heard a lot of talk about shovel-ready jobs when the large stimulus package was being debated. Was it more talk than jobs? If we probe deeper and look at employment in heavy and civil construction, we see significant positive movement. The stimulus billions did generate some employment in that sector. But trickle over to the broader construction sector didn't work out.

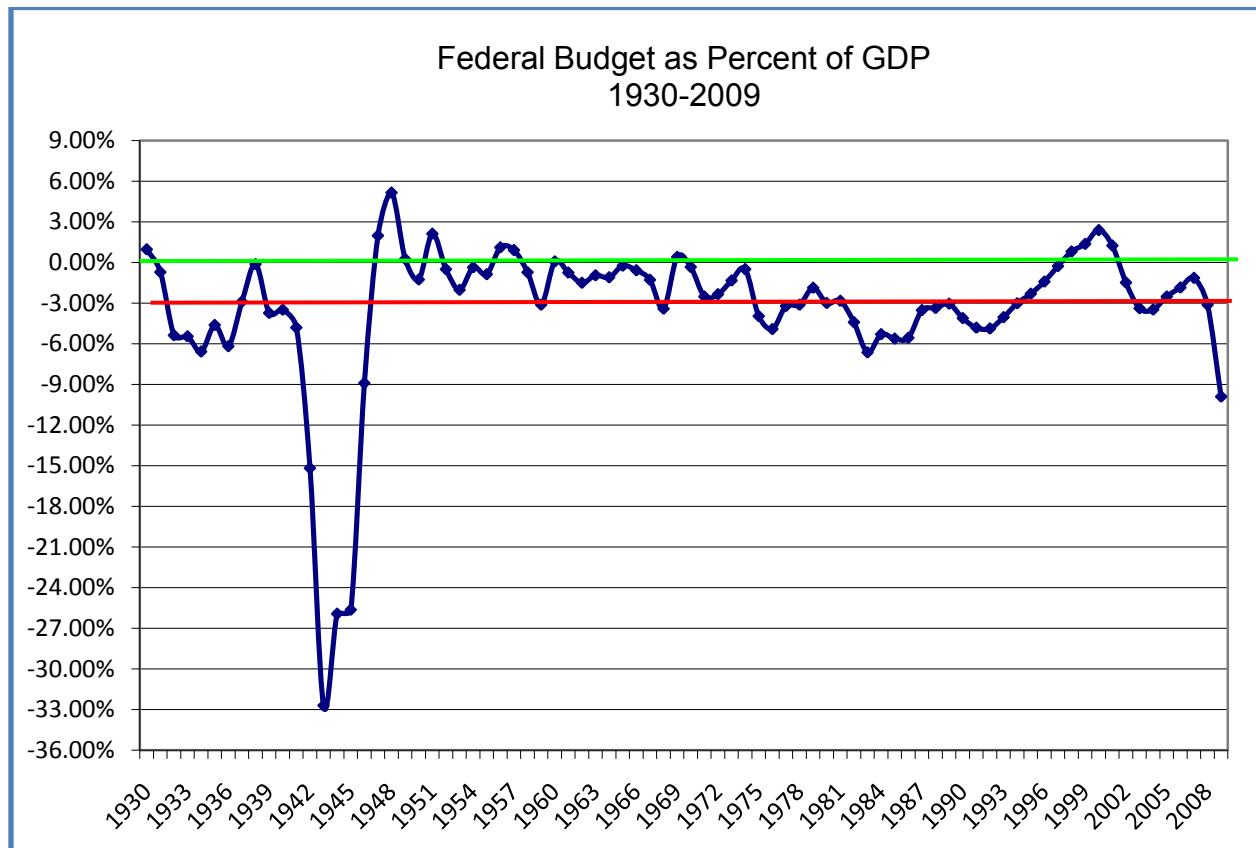
When we think about it, the stimulus legislation was never intended to stimulate the entire economy, directly. Had that been the case, we would have seen something like overall tax cuts for all employers and employees, actions that would have hit all the sectors I examined. Instead, the various packages favored particular sectors such as autos, banks, teachers, and hospitals over the general economy. As a result, there was little in the stimulus package for the unidentified, unorganized smaller businesses where most employment growth always occurs. Everyman was left to make it on his own, perhaps hoping that some of the splashdown spending would trickle his way. Meanwhile, the overall unemployment rate stays hung at 9.5%.

### **Should we worry about paying for it?**

The combination of recession, war, and bailouts has taken a toll on the nation's fiscal purse. We have heard the litany: a \$1.4 trillion 2010 deficit, which is 10% of GDP, an amount equal to \$40,000 per capita; and a total federal debt that is approaching 100% of GDP, up from 80% three years ago. The deficit rule of thumb says a nation should not exceed deficits over 3% of GDP, and that total debt should not go beyond 60% of GDP. These rules are based on experience. Most mature economies on average grow a bit more than 3% annually. This means today's deficit can be funded with future income, if the 3% constraint is maintained. And most countries get into serious trouble in producing new wealth when government grows so fast that debt exceeds 60% of GDP. But to do something about the rivers of red ink, we should recognize that the deficit has two distinct parts. There is the emergency component that was generated by the current explosion of spending. And there is a structural deficit that reflects a growing government habit that reaches back at least to 1970. We should not necessarily seek to cure both deficit illnesses with the same medicine.

The two dimensions are seen clearly in the accompanying chart that shows deficits as a share of GDP from 1930 to 2009. I have marked the zero point in green and the 3% point in red. The chart shows that our nation generated deficits in excess of 3% of GDP during the Great Depression, World War II, and then in some of the 1980s, 1990s, and now. It is

disturbing to see that our deficit/GDP share is larger now than in the Great Depression. Little wonder that we call it the Great Recession.



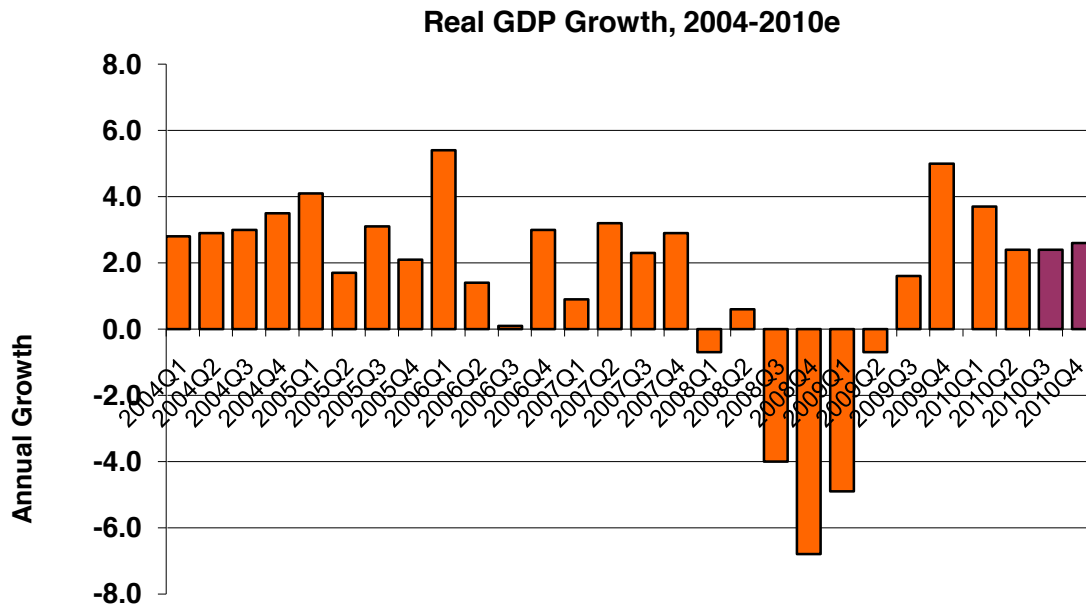
Focusing on the space between the green and red lines, we see that since 1970, the nation has generated a surplus for only four years. For 36 out of 40 years our government habit has fed the red ink river. This is the structural problem. The structural problem must ultimately be addressed by making major cuts in the programs that feed it, which means Medicare, Medicaid, and Social Security. The emergency part of the deficit must be dealt with by encouraging the real economy to become energized. This means keeping taxes low, reducing regulatory burdens, and offering encouragement to everyman, not just to special interest groups that matter so much politically.

### **Enough on deficits, what about the real economy?**

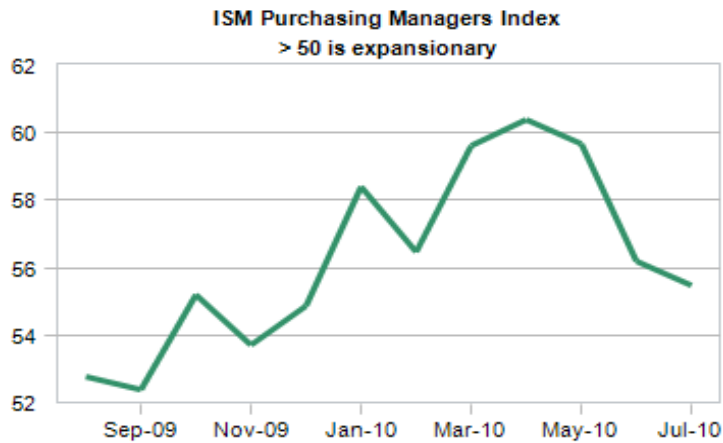
The road to recovery is filled with potholes. Some of these are the result of the housing bubble collapse and huge amounts of debt that must be paid off or worn out. Others are holes we dug with stimulus policies that temporarily inspired activity but then pulled to the sideline and left the targeted sectors searching for a solid basis for growth. How are we doing? The two monthly indexes I follow closely, as well as monthly reports on Industrial

Production, and quarterly reports on GDP all show economic growth. Yes, the data indicate growth may have stalled, but it is growth nonetheless. Be thankful.

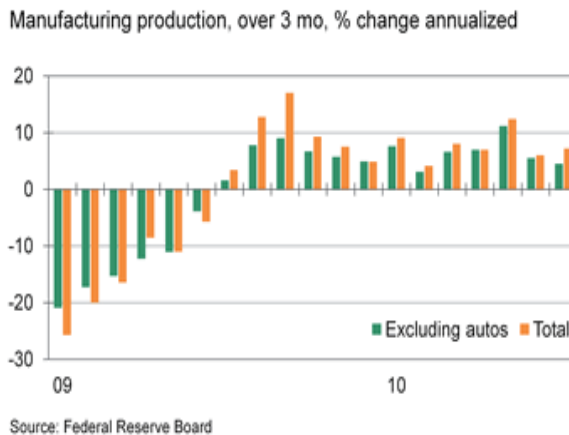
Let's take a look at GDP growth shown in the next chart. There were some major data revisions in the most recent report from Commerce, and these made 2009 look a lot worse. But that was then. We are interested in now. The same revisions showed improvement in the 2010 data. The chart shows the published data along with some estimates for the rest of the year. As things stand, we should see 2.5% to 3.0% growth in the year ahead.



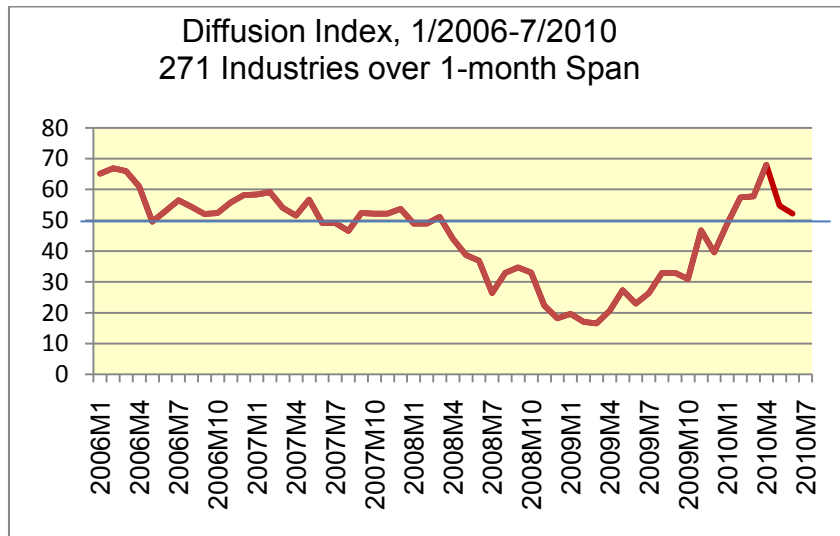
The next chart shows the Institute for Supply Management's Manufacturing Economy Index. Recall that 50 is the growth/no growth dividing line. This index has been in growth territory since June 2009. And while the index has stalled and gone south, it is still above 50. The companion chart for the services economy, not shown, shows a similar configuration. Both parts of the economy are growing, albeit at a weak level.




The next chart, produced by Economy.com, gives a reading on manufacturing production through July 2010. The chart helpfully shows growth for autos in orange, which received significant stimulus, and total manufacturing production in green. Both bars are above the zero line, but clearly, auto production adds extra push to the data.



We see another indication of potholes in the next chart. This one shows how employment growth is spreading, or not spreading, each month across 271 industries. Again, 50 is the magic number. As can be seen, the index has moved south and rests at 52. The chart confirms the data reported in the ISM manufacturing index.

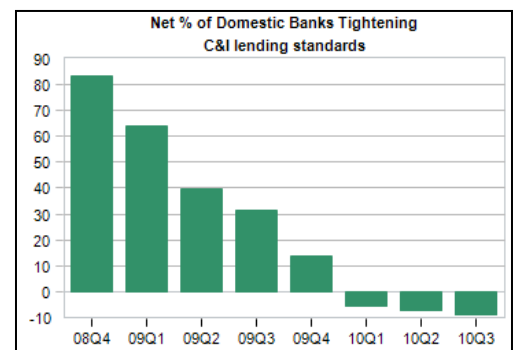


### Does this say we can expect a double-dip?

The data showing stalled manufacturing growth and a reversal in the share of industries with employment growth understandably begs the question: Is this the beginning of a W-shaped recession. We might put the question another way, since I have supported the configuration of a caterpillar as the best descriptor of this bumpy recovery. We might ask can a  become a **W**. Of course it is possible for the economy to slip into negative growth territory. We might say that anything is possible. But I argue it is not likely, unless Washington decides to let any of the Bush tax cuts expire or in other ways places a heavier burden on any part of the U.S. economy. This is not the time to raise taxes, add new taxes, or impose more burdensome regulation.

### Are the banks opening the money spigots?

For a bit more optimistic data, consider the results of the most recent Fed survey of commercial bank senior loan officers. Part of the survey asks about lending standards for commercial and industrial loans. This next chart, also produced by Economy.com, gives the results. The valves are opening again. Reserve positions are improved and there are better lending prospects, especially with mid-sized firms. The real economy, as compared to the stimulus economy, is breathing deeper.

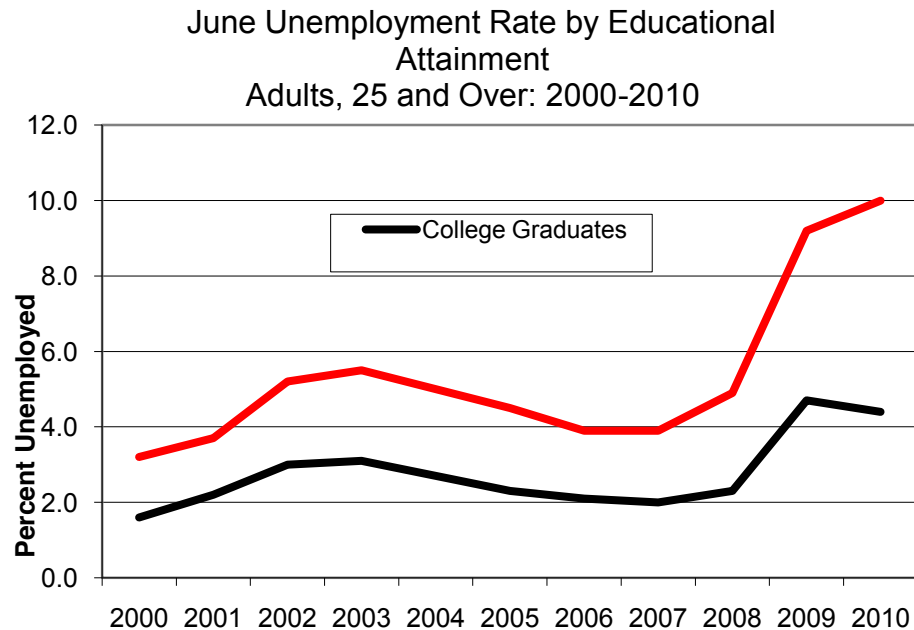




## Brains matter more than ever

August's report on U.S. employment growth brought no cheer to job-seekers with just a high school education. In June 2010, the unemployment rate for adults 25 or older with a high school diploma was 10.1%. By comparison, unemployment among college educated adults was 4.5%. And the overall unemployment rate was 9.5%. A lack of educational attainment is obviously pulling the numbers in the wrong direction.

The U.S. economy is calling for a more educated workforce in every sector, even in the midst of the Great Recession. The data in the next chart show June unemployment rates for the years 2000 through 2010 for Americans with high school diplomas and those with college degrees. The gap between the two series was relatively constant until 2007. After that, the gap exploded; it became far more difficult for those without a college degree to find a job. The apparent ability of better educated people to hold jobs also underlines the recent gains in worker productivity. Of course, recovery will lead to more jobs for all, including the less educated, but the signal is nonetheless clear. With unemployment high, which means low opportunity cost for going to school, as tough as it may seem, this is the time to head to a community college and get some human capital.



## Summarizing the situation

The U.S. economy is a mixture of stimulus and real forces. One set of forces—stimulus, bailouts, Fed action—seeks to address the roughly 10% unemployment rate. The other set of forces comes from the 90% economy. The stimulus has targeted particular sectors and left the broader economy scratching on its own. It is the 90% economy that will ultimately pull us away from recessionary undertows that can take us into deeper, troubled water. We see the interaction of these forces in the data, and we can also see the prospects for better growth and calmer economic waters.

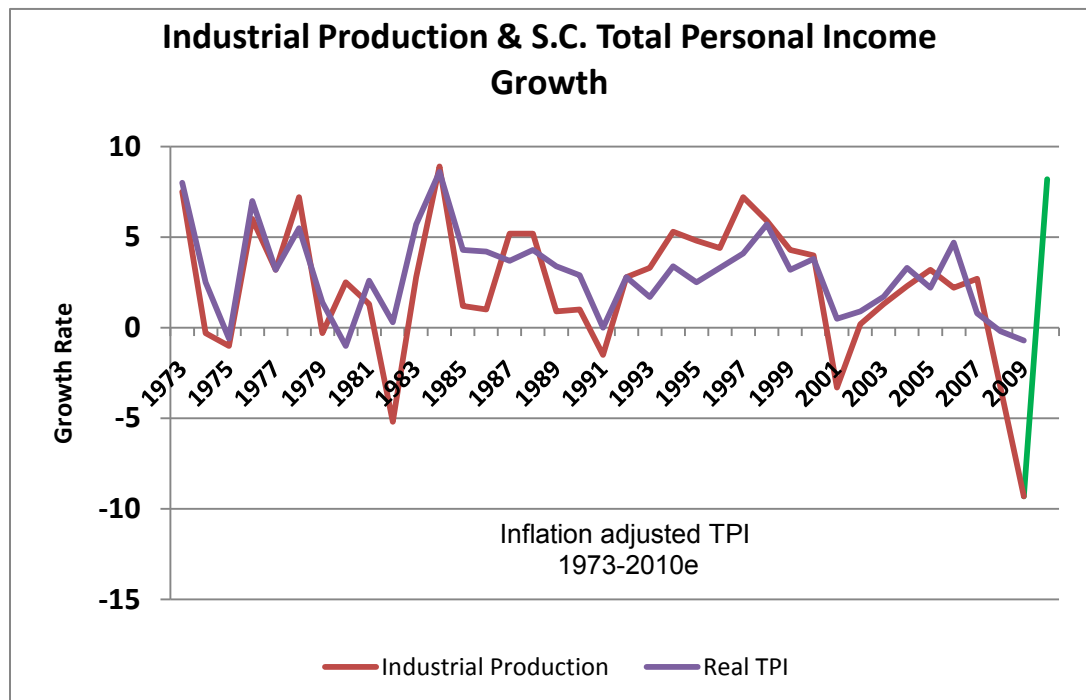
- Overall economic growth is positive but weaker than in the first half of the year. Still, the prospects are good for continued positive GDP growth on into 2011 and beyond.
- The manufacturing economy that gave muscle to the nation's recovery is still pumping iron, but at a less energetic level. The auto industry is the leader, but other industries, such as machinery, are coming to fore.
- Commercial banks with tidier balance sheets are opening the money valves a bit, and bank outstandings indicate a rebirth of lending. This adds to a sense of optimism about the year ahead, and removes some concern about swooning into a double-dip recession.
- Employment growth is weak and will remain so until the 90% economy regains confidence. That day will come sooner if Washington takes a time for policy silence, lets tax cuts remain permanent and takes real actions are to deal with the nation's deficit habit.

## South Carolina Digest

South Carolina's economy is tightly linked to the nation's manufacturing engine. This is a curse when there is a manufacturing recession, but a real blessing with the big factory starts running again. Let's take a look at how the nation's factory drives South Carolina.

I have mapped Industrial Production growth for the nation into growth in real S.C. Total Personal Income. For 2010, I simply used the record for the first six months as an annual growth rate for Industrial Production. This shows up in green. Doing this allows us to make a forecast for the state.

The data are in the next chart.



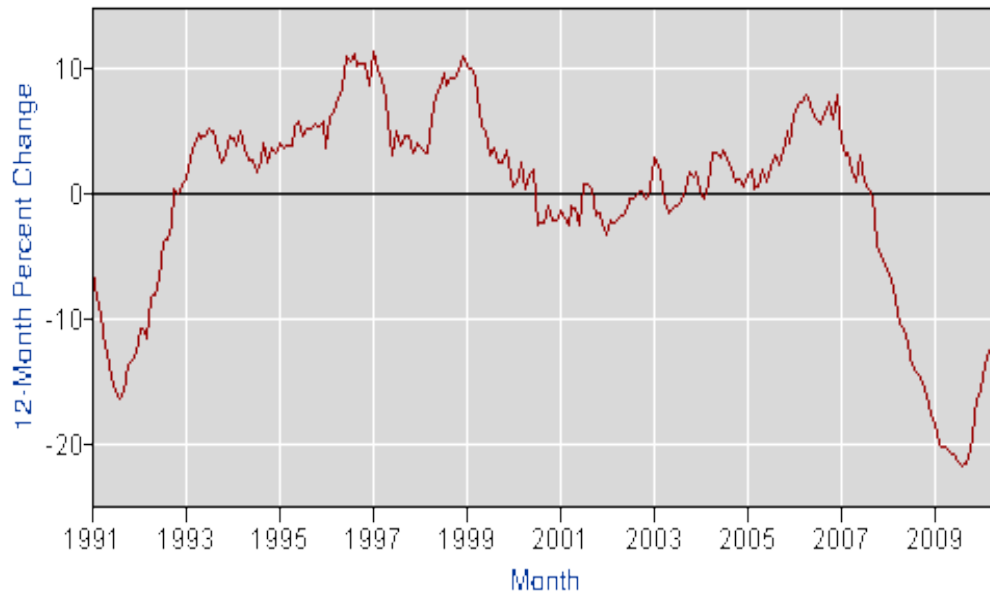
The chart's message is clear. We should see a sharp recovery in the growth of S.C. Total Personal income in the year ahead. But notice, the growth is for real income, not nominal. This means, inflation adjusted income, which, after all, is the real stuff.

While real stuff is what matters to most of us, growth in the state's general fund is measured in nominal terms. When inflation goes up, the state has "more money" to spend. And when inflation sinks to the floor, as at the present time, the state has "less money" to spend.

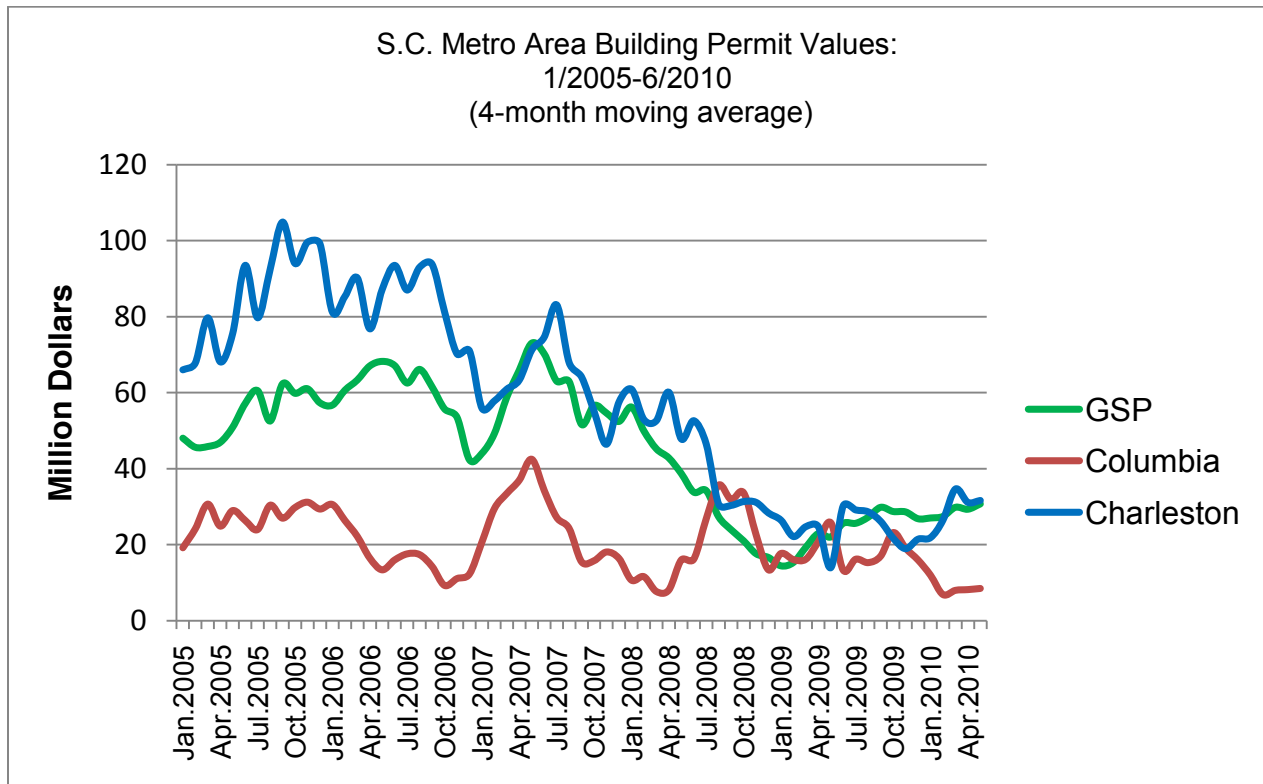
My chart says that the state money counters may see a surplus in this fiscal year, which is to say a bit more money than the low-growth currently predicts.

### **What about housing and construction?**

Construction activity across the state is in the pits, to put it in plain English, and it will be a long time before employment in the sector stops losing jobs. Close inspection of the next chart, which shows construction employment growth from 1991 through June, 2010, tells us about how long it will be before growth hits the zero point on the way to positive ground. Assuming the path going up looks like the one going down, we should see construction employment stabilizing near the end of 2011.

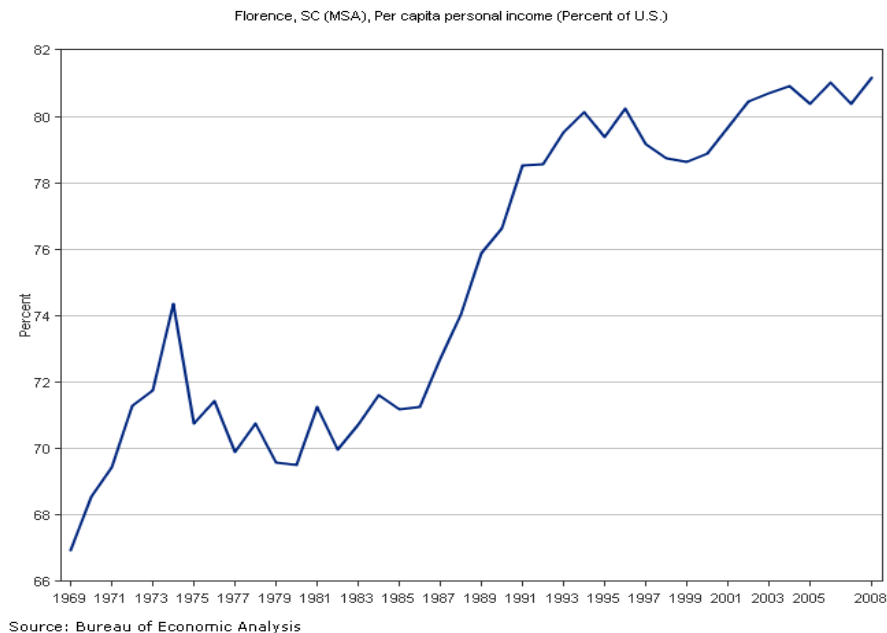


Of course, a lack of housing activity is the big sinker on the data. But there is some life in that sector. And where is life, there is hope..., someone has said. Data on the value of new housing permits for the state's three major metro areas, shown next, tell us that things have picked up in the Charleston and Greenville regions, but are still sort of pacing along in Columbia. But before getting too excited, notice the level of activity. Yes, things are turning, but from a very low level of activity.



### Metro area health

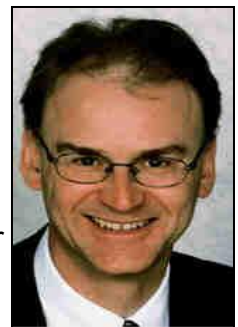
I recently examined all S.C. metropolitan areas to see how they are doing relative to the nation. The data in my review were for the ratio of a metro area's per capita income to the U.S. per capita income for the years 1969 through 2008. Several S.C. metros have performed strongly; they are gaining on the nation. These include Charleston, Florence, and Sumter. Others were gaining but lost considerable ground after 1995. These are Anderson, Charlotte-Rock Hill, Greenville, Myrtle Beach and Spartanburg. And then there are a few where the ratio topped out, turned down, and then bounced up a bit. These are Augusta-Aiken and Columbia. Just to give a feel for what I am describing, I provide the chart for Florence, which, by this measure, is one of South Carolina's healthiest metro areas.



The state's outlook partly reflects the national prospects, but with a good bit of drag generated by the state's manufacturing concentration. The drag is heavier from older, high labor using industries and lighter where newer industries bring higher labor productivity. As indicated, national industrial production is improving. South Carolina's performance will improve also. The year 2011 will be better than 2010. And 2012 should be better still.

### The Rational Optimist

Some readers know zoologist Matt Ridley, pictured on the right, as the former editor of *The Economist* magazine and author of *The Origins of Virtue: Human Instincts and the Evolution of Cooperation*, a marvelous 1996 book that offers an explanation of how moral behavior may have evolved as result of the prehistoric development of markets. Ridley is now being celebrated for *The Rational Optimist*, a book that covers a long, long sweep of human progress that explains 1) why he, a scientist, is optimistic about the outlook for mankind and the environment and 2) why other rational people may wish to join his optimistic band. The economist J.M. Clark once said that economists generally have an irrational passion for dispassionate rationality. Well, apparently some zoologists do as well. Here's a sample from the first part of the book (pp. 4-5):



Clearly, human beings are very good at social learning, indeed compared with even chimpanzees humans are almost obsessively interested in faithful imitation. But big brains and imitation and language are not themselves the explanation of prosperity and progress and poverty. They do not themselves deliver a changing standard of living. Neanderthals had all of these..., but they never burst out of their niche. It is my contention that in looking inside our heads, we would be looking in the wrong place to explain this extraordinary capacity for change in the species. It was not something that happened within a brain. It was a

collective phenomenon. Look again at the hand axe and the mouse. They are both “man-made,” but one was made by a single person, the other by hundreds of people, maybe even millions... No single person knows how to make a computer mouse. The person who assembled it in the factory did not know how to drill the oil well from which the plastic came, or vice versa. At some point, human intelligence became collective and cumulative in a way that happened to no other animal.

You may want to read more. I recommend Ridley’s book, and believe you will enjoy it.