THE ECONOMIC SITUATION: A QUARTERLY COMMENTARY
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HOPING FOR THREE-LANE PROSPERITY ON A TWO-LANE ROAD

The wet blanket blamed covering our economy might be energy regulation, monetary policy, or healthcare policy, or credit market controls, or environmental policy. But it is not policy per se that chills the economy—it is uncertainty with respect to policy.

Most business people tell me, "Just let us know the rules of the game, and we will figure out a way to play." It is awfully hard to play the game when rules are being changed without a clue as to when they will become final.

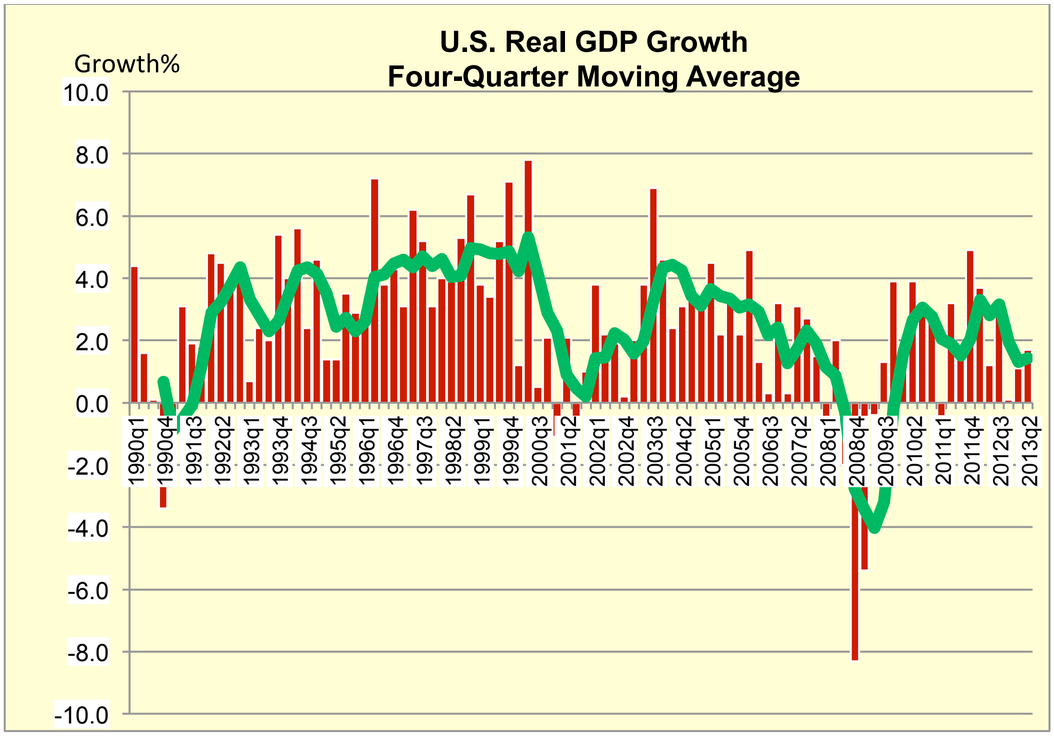
Today's world has enough risk and uncertainty without more being added by Washington.

There's slow traffic on GDP highway.

When policy uncertainty is folded into an economy where consumer balance sheets are still bruised, where state and local budgets are stressed, and employment growth is miserable, we get an economy that struggles to grow at 2 percent annually, instead of hitting the 3 percent real GDP growth that economists consider the norm.

The economy right now is like traveling on a three-lane GDP expressway with one lane closed. Even worse, we are locked in slow moving traffic, and our gas gauge is pointing to empty. Worse than that, we are borrowing gas from other places and people just to keep our engine running. One might say that we are part of a two-lane deficit economy without a filling station in sight.
Have you ever faced this problem? Orange construction barrels everywhere. Little prospect of reaching an exit any time soon. A knot in the pit of your stomach? Worried about running out of gas and wondering if some kind soul will assist you?

If so, you understand the relief that comes when finally you see service station markers ahead.
Believe it or not, there is some relief in sight for our economy . . . maybe. We see the latest GDP growth data in the following chart. The four-quarter moving average points toward 2.0 percent, and there is general agreement that we are headed in that direction. And here's the better news: there are good signs that the third lane will open in 2014, that the economy will again chug along with 3.0 percent real GDP growth.



There's still some catching up to do.

Yes, 3.0 percent real GDP growth is out there waiting for some additional real consumer purchasing power. The next chart describes this piece of the 3.0 percent puzzle.

Here we see total US real disposable personal income for January 1994 through June 2013. The chart's red line shows the start of the recent recession, but it is the white trend line that deserves attention. The gap between "trend" and "actual" forms part of the gap between 2.0 percent and 3.0 percent GDP growth.

We will see solid 3.0 percent real GDP growth when consumers have the purchasing power to make it happen and when employer and worker incentives combine to yield a larger workforce. More on this later.

Lending is up, but there's room for lots more.

When will it happen? There is always more to the story.

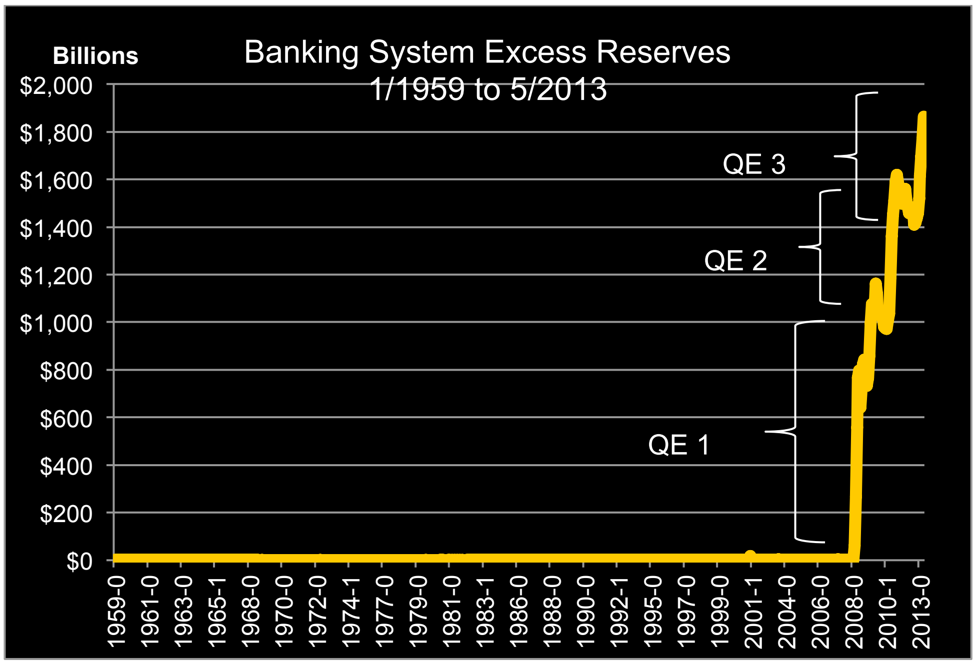
Recent commercial and industrial loan data from the US banking system, shown in the next figure, tell us that the nation's pulse beat is definitely getting stronger. Seen as a measure of core economic activity, the June loan level is just about where it stood when the last recession began. We are operating at 2008 levels in a 2013 economy. This may feel better, but it is surely not progress.

There is immense ability to lend.

While banks are definitely lending in spite of tighter regulatory standards, their ability to lend, as shown by excess reserves, is hardly being tapped.

The next chart shows the level of excess reserve for the banking system. I have marked the three periods of quantitative easing. Each time the Fed has injected more money into the system, reserves have risen by almost as much as the injection itself. And most of that injected money is still on the back shelf, resting in bank reserves while earning a low level of interest from the Fed itself.

One thing is certain, based on reserves, there is ample capacity for funding a three-lane GDP highway.

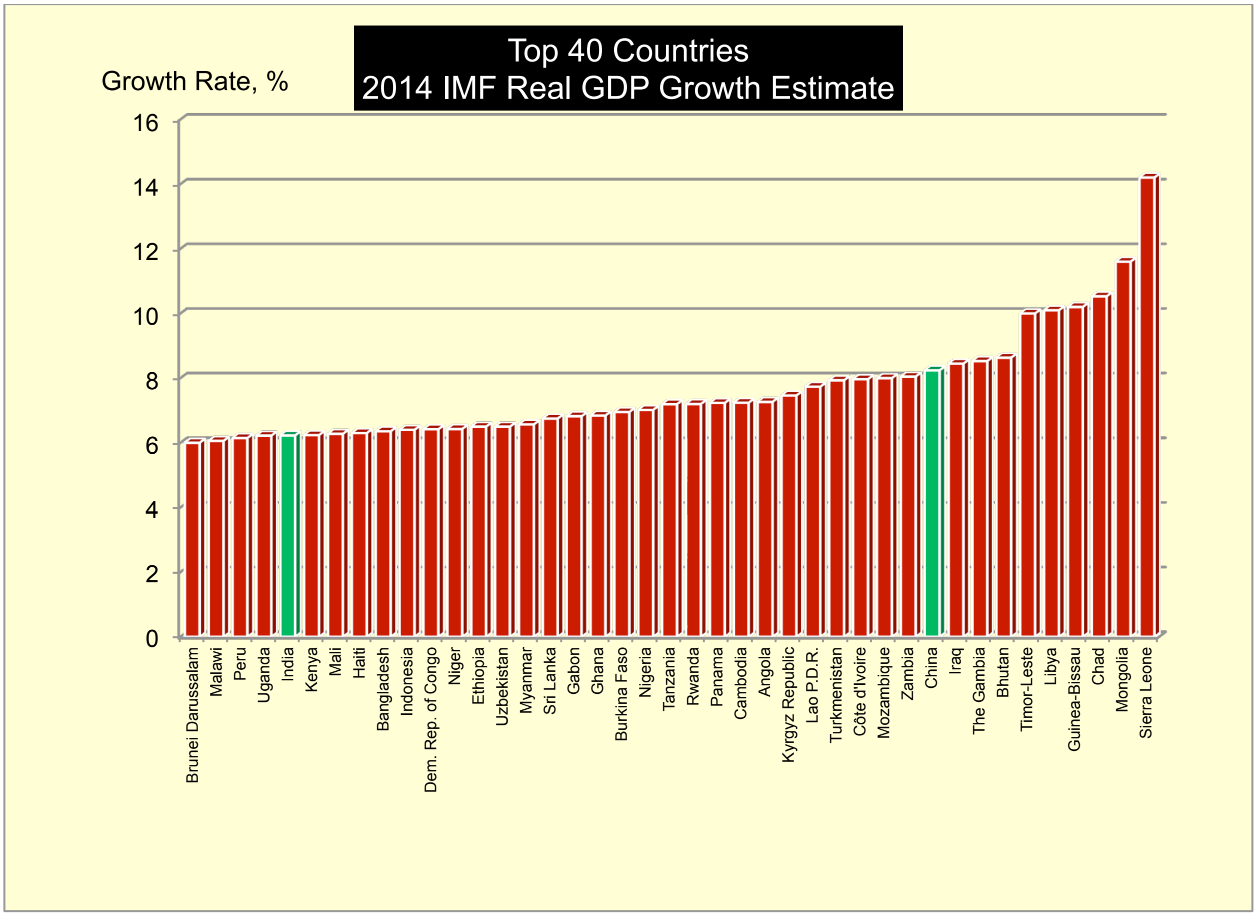


SOME UPS AND DOWNS

When we look for the return of 3.0 percent real GDP growth, there is still more to consider. The developing world, previously the hottest part of the global economy, is another part of the two-lane GDP highway story.

In the next figure, I provide estimates from the International Monetary Fund (IMF) for 2014 real GDP growth for the top-40 countries, minus one. I have omitted the South Sudan from the chart because its 49 percent growth rate would simply wipe out the rest of the chart. I have marked India and China in red, since they are the two large economies in the data set.

Generally speaking, the expected growth rates for the developing world, while still large, have fallen by two percentage points in the past 18 months. This slowdown is obviously a negative factor for the United States. But, while the developing world is slowing, the developed world is picking up. By the way, the IMF predicts US GDP growth will hit 3.0 percent in 2014.



What about Egypt and the Middle East?

Turmoil in Egypt and much of the rest of the Middle East raises a question about impact on the US economy. There are obviously many complex interactions to consider, but the simplest and most direct impact relates to US exports. US exports to the Middle East and North Africa in 2008, the latest data available, amounted to $67 billion or 5.1 percent of total US exports. For comparison, the US exports about $200 billion to Mexico each year.

Of Middle East countries, the UAE is the largest US customer, receiving some $15.7 billion in US goods in 2008. Israel is second, with $14.5 billion, then Saudi Arabia, with $12.5 billion, and finally Egypt, with $6.0 billion. As we used to say in business, "every order counts." Still, the risk of export losses in the Middle East is relatively small.

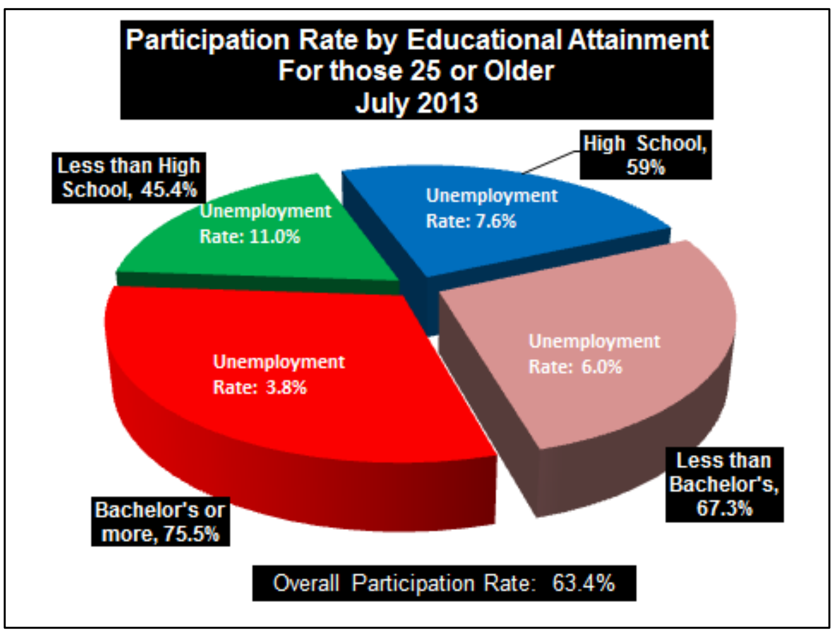
Housing recovery?

Robert Arial's cartoon (shown on next page) hits a sensitive issue. The stock market has recovered and is now—finally—hitting some new highs. Not so for a significant part of the labor market. The recovery of housing construction is critical to the recovery of employment for a population of workers with high skills but low educational attainment.

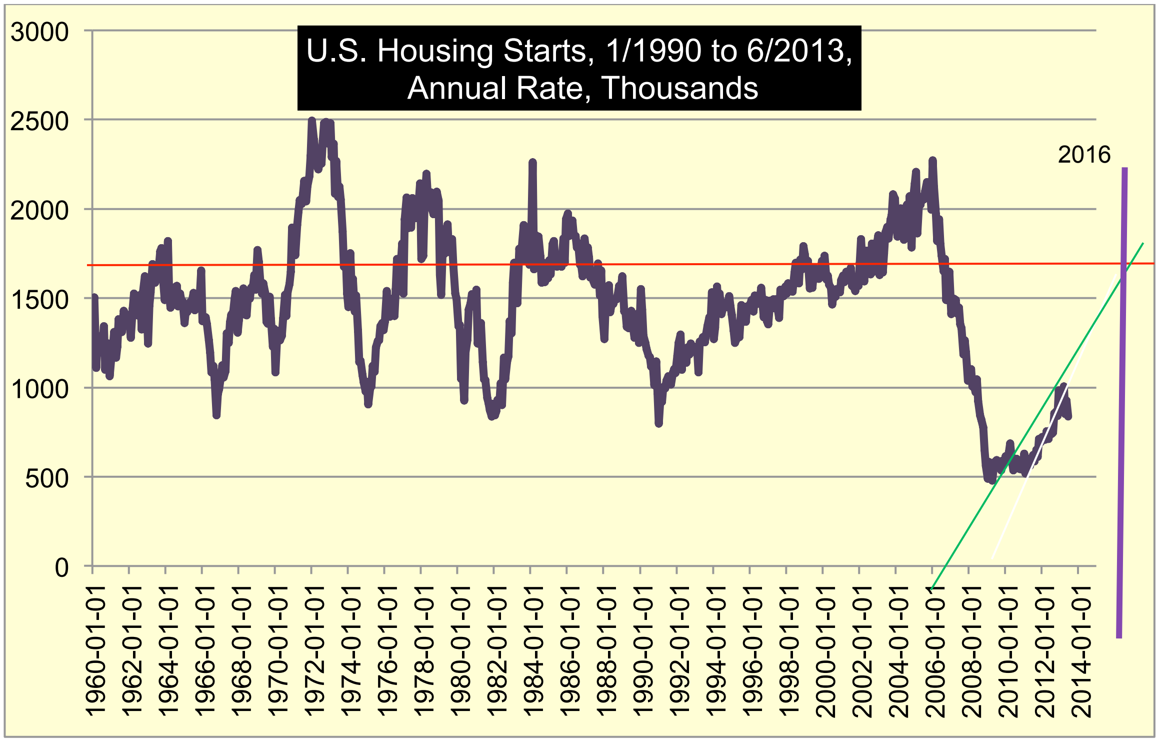
In the pie chart below, we see some July 2013 labor market data. The pie slices reflect the labor market participation rate based on educational attainment. This is the share of the adult work-age population working or looking for work. Labels on the slices give the unemployment rate for each group. Notice the obvious: the higher the level of educational attainment, the larger the participation rate—and the lower the unemployment rate.

The point: there are not many people with bachelor degrees working as roofers, framers, and carpenters, but there are a lot of high-school graduates and people without high-school diplomas who seek those high-skill jobs.

No matter how much stimulus money Washington pumps into the economy, there is just no way to convert highly skilled carpenters and drywall hangers into knowledge-economy workers. But recovery of housing construction can bring them on.



Fortunately, there is significant improvement in the housing start data. As shown in the next chart, based on recent improvements, the US housing sector should hit the red-line construction norm of 1.6 million starts annually in 2016. Meanwhile, things are getting better for lots of construction sector workers.



WHERE IS WALDO AND THE US LABOR FORCE?

At one time or another, we have all been intrigued by graphic puzzles that invite us to find Waldo, the proverbial everyman lost in an illustration packed with people. A creation of Martin Handford, British writer of children's stories, finding Waldo in the crowd can be fun for young and old alike. But Handford offers puzzles that can be solved. Look long enough and Waldo will surface. Would that the search for the US labor force in these times was as simple!

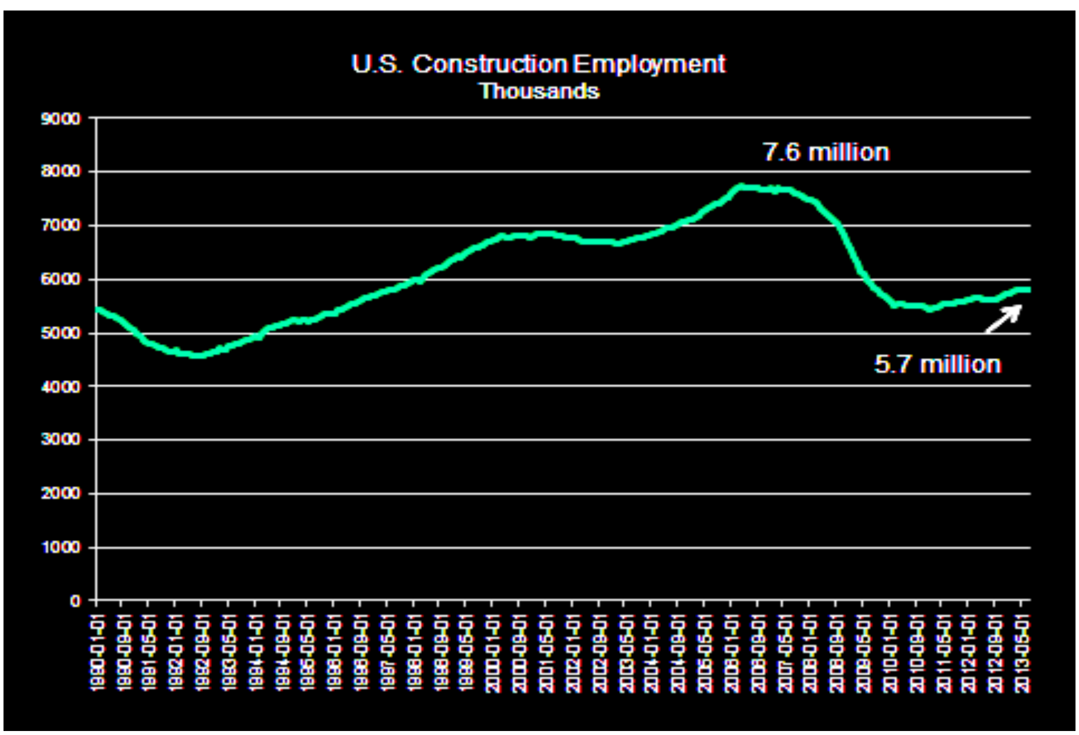
We all know the rhetoric. When looking for economic progress in monthly data, instead of focusing on the unemployment rate, which can fall when discouraged job seekers bail out of the market, we should zero in on the employment rate, the share of the work-age population that seeks to participate in the workforce. When we look, what we observe will be the result of millions of individual decisions based on incentives, opportunities, and personal forecasts as to what is best for the individual person.

The result of all this is provided monthly by the Bureau of Labor Statistics Civilian Labor Force Participation Rate, a number that has fallen sharply since the Great Recession began in January 2008. In fact, as shown in the accompanying chart, the number was falling before the recession began at the point marked with a red upright. The July 2013 number stood at 63.4 percent. In January 2008, when the economy hit the sliding board, the number was 66.4 percent. The difference in those two numbers accounts for a labor force loss of 6.3 million workers. Even more troubling to some, the July number is the lowest since May 1979.

Where are those 6.3 million working-age Americans? Are they out-of-work carpenters, brick masons, and drywall installers hoping for housing to boom again? Are they in college? Disabled? Have they started businesses at home and somehow don't get counted as employed?

Let's see if we can find the missing part of the US labor force. Where is Waldo?

A quick glance at the next chart suggests that about 2 million of the missing workers may be associated with lost jobs in the construction industry. Yes, it is possible for employment losses in one sector to be offset by gains in other sectors for the same workers, but perfect substitution just doesn't work so well for specialized construction workers.

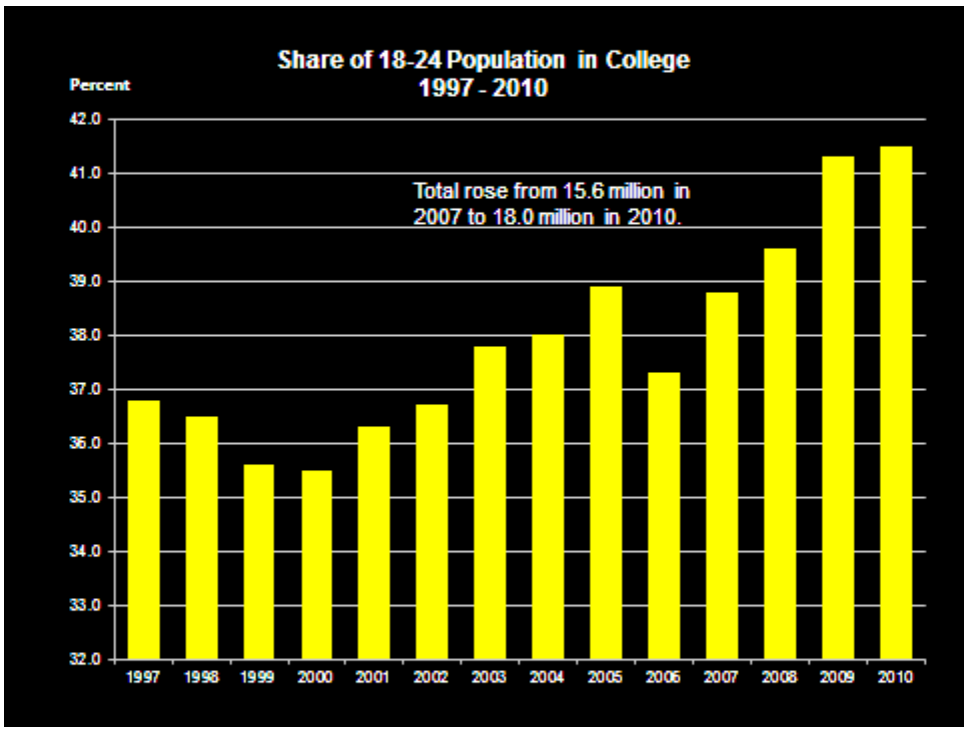


Call this 2 million part of the missing group, and we are left to find 4.3 million more.

The next chart shows the share of the population age 18 to 24 who are enrolled in post-secondary education. Notice how enrollment skyrocketed after 2007. When translated into people count, about 2.4 million more have enrolled in school since 2007. Keep in mind that this is just the younger part of the enrolled population. There are also a lot of the over-24 group going to classes.

It only makes sense. Wages foregone is the largest part of the cost of going to college. And if there is no work available, that part falls to zero. Add to this the availability of generous student loans subsidized by dear old Uncle Sam, and the industry booms. In academic year 2007–2008, total loans and federal grants to college students stood at $105.8 million in 2011 dollars. By 2011–2012, the total was $173.7 million, and rising. This looks a lot like a growth industry to me . . . at least until the day of reckoning arrives.

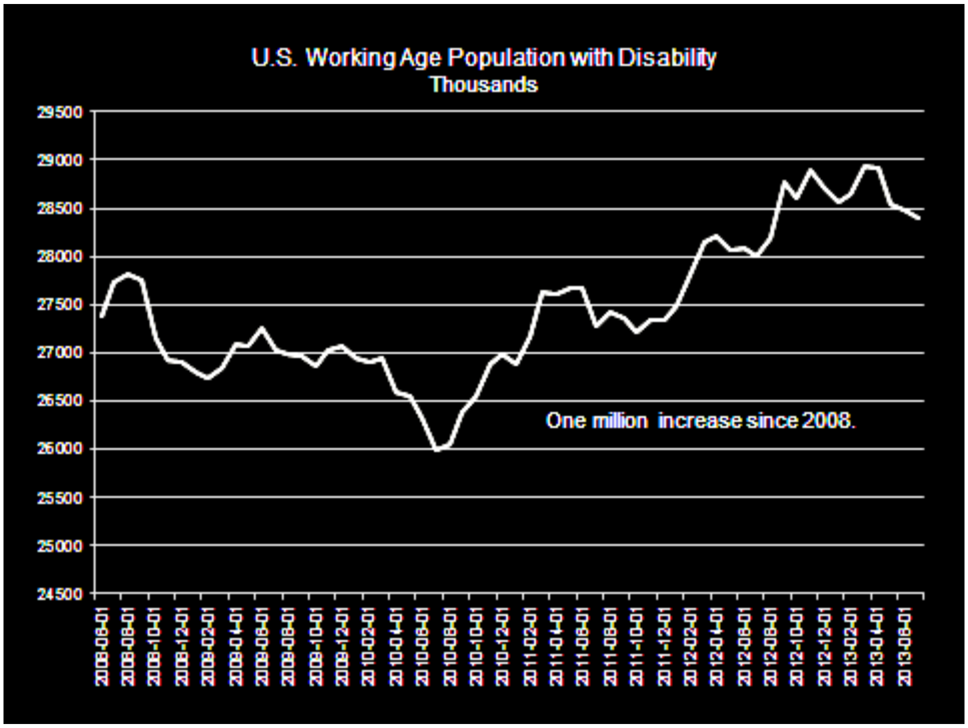
If we take this 2.4 million into account, that leaves about 2 million more displaced job seekers to account for.



Let's look at the count of people on disability. Since 2008, there has been a 1 million increase in the number of working-age Americans receiving disability payments from the Social Security fund. These are individuals who previously participated in the labor force but because of some physical or mental difficulty are no longer participating and who are unlikely to return to work.

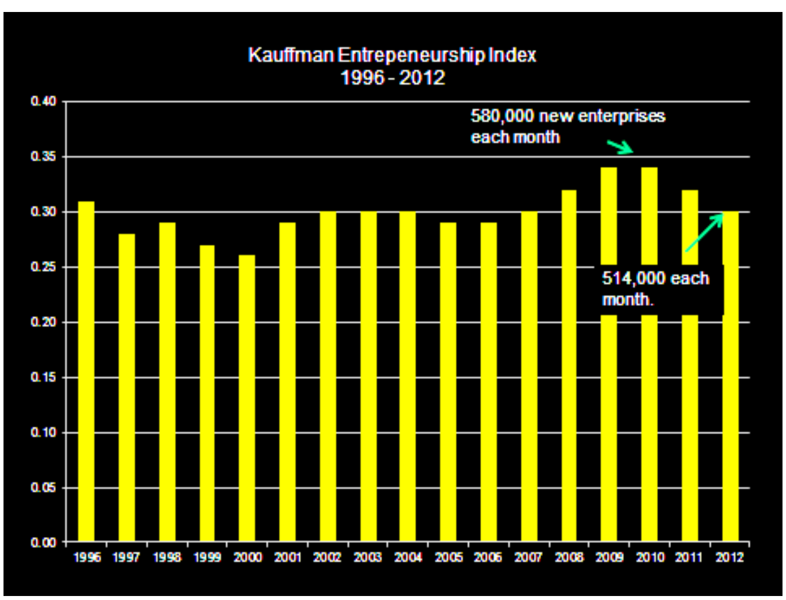
On average, a disabled worker receives about $1,200 tax-free dollars each month, perhaps for life, along with "free" Medicare hospital coverage for two years. Returning to work ends all this, and that's a pretty hefty "tax" to pay for the privilege of working.

This leaves 1 million nonworking Waldos unaccounted for. Finding that group may not be as easy as the first few million.



There is another important group to consider. These are folks who started small businesses after losing their regular jobs. While they are technically still participating in the labor force, I am guessing that when labor market surveys are taken the data become rather blurred for this group. Why would I say that?

Consider the Kauffman Entrepreneurship Index. This number is generated based on a large-sample survey that estimates the number of people out of 100,000 who started a business in the year of the survey. The next chart gives the results. First, notice how the number shot skyward as the recession became more severe. And notice how the number recedes as the recession goes away. The data indicate clearly the old adage: when the going gets tough, the tough get going.



According to the Kauffman data, there were more than 580,000 new businesses started each month in 2010. The monthly increase fell to 514,000 in 2012. The difference? About 70,000 new businesses each month. If there is one person involved in each business that yields roughly 840,000 individuals who may have been previously employed in what I will call the traditional workforce.

Keep in mind that some, if not all, of these will be accounted for the monthly employment survey that seeks to determine who is working, wishing to work, or no longer looking. But it is my guess that a lot of these entrepreneurs are missed in the count.

With the calculations provided above, we have gotten close to the 8.3 million workers who are no longer participating in the labor force. But what will happen when the three-lane economy opens up and real annual GDP growth rises from 2.0 percent to 3.0 percent?

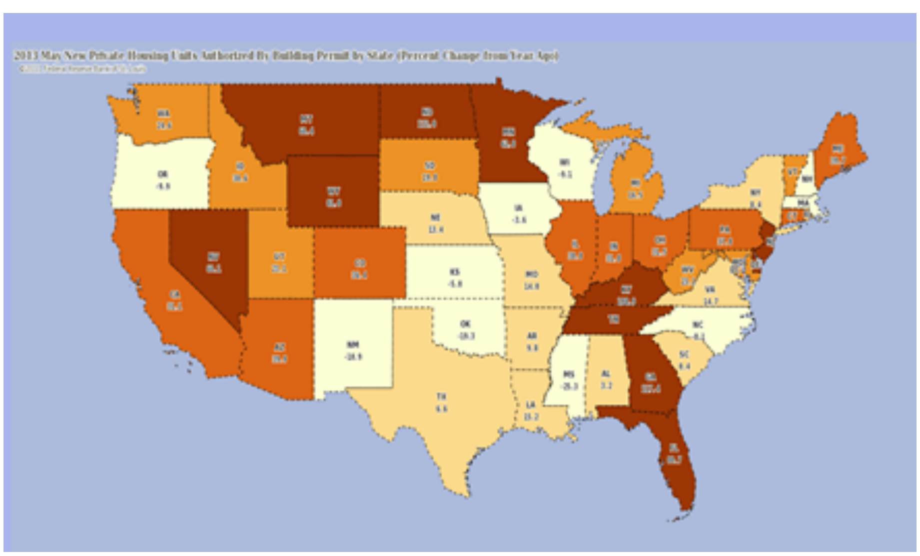
Some of the entrepreneurs will decide they are better off being on someone else's payroll and will return to the traditional labor force; others will not. Some of the disabled will decide their fortunes are better served by getting back to work; many will not. A large number of students will sense the higher opportunity cost of being in school and will head to work. And a lot of construction workers will gladly get back to work, after having given up looking.

The longer the duration of the slow job market, the more likely the participation rate will not return fully to the pre-recession level. But that, too, is determined by incentives and how they may change.

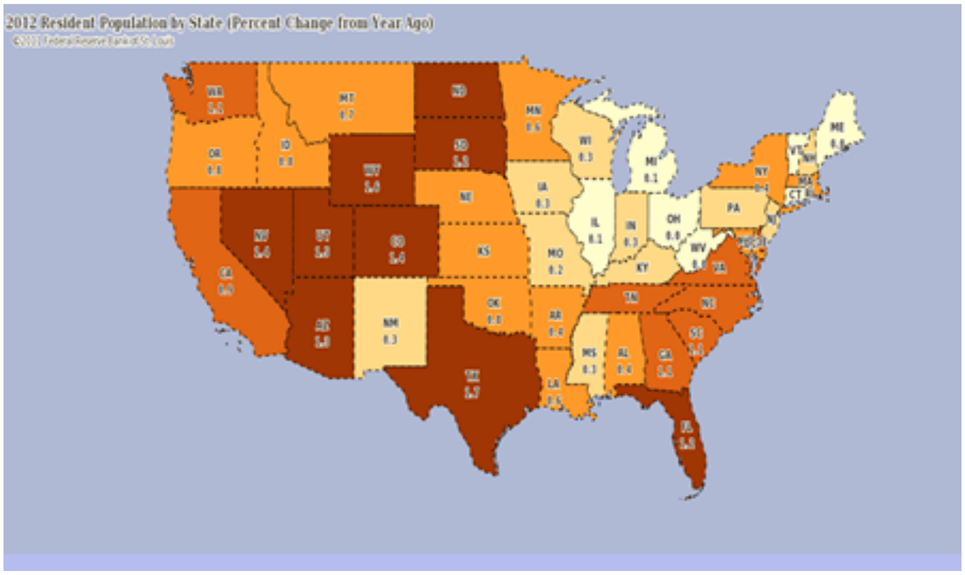
SOME GEOGRAPHIC CONSIDERATIONS

Line graphs and pie charts may convey useful information about overall economic performance, but most of us really want to know about the outlook in our home territories. After all, things may look a lot better on average, but still seem awfully bleak in our particular town, county, or state. The outline maps that follow offer some geographic insights for housing construction, tax revenues flows, and the ultimate economic test—whether more people are leaving a state or heading to it.

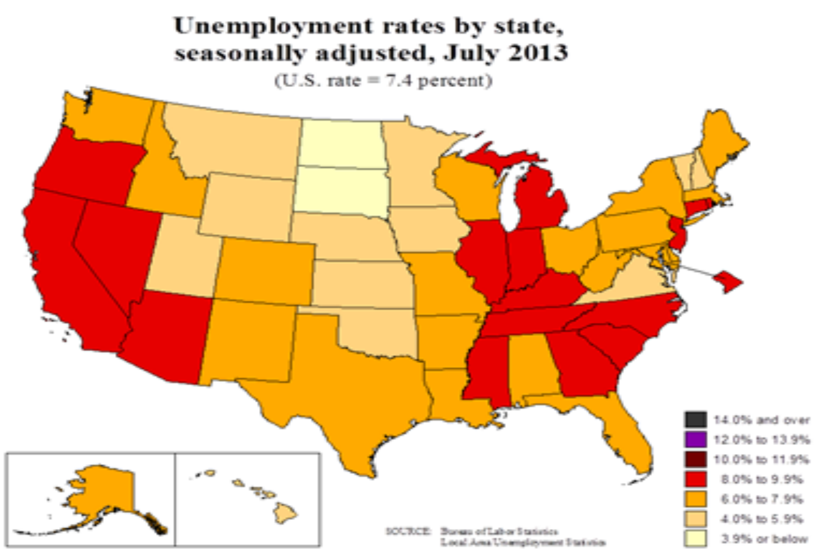
Housing start growth reflected in May 2012 data is shown in the next map. Darker brown corresponds with higher growth. The lightest tan marks negative growth, as seen in New Mexico, Oklahoma, Kansas, Iowa, Wisconsin, and Oregon, for example.



Population growth, 2011–2012, is shown in the next chart. Again, darker brown means higher growth. People voting with their feet tell us that they prefer what is going on west of the Mississippi River, showing particular affection for Texas and the Dakotas. Could it be about employment opportunities?



We get an answer to this question in the next chart, which shows the July unemployment rate by state. In this map, the lighter hues indicate lower unemployment rates. Once again, west of the Mississippi seems preferred, with the exception of the Pacific states.



A SUMMARY STATEMENT

So how do we sum up? What is the September 2013 economic situation? The developing world is slowing down, but the older developed world is chugging ahead. Economic risks in the Middle East, which reflect horrible human tragedy, are manageable. Major parts of the economy are showing strength. We see this in manufacturing, wholesale shipments, auto sales, and retail sales, and we are beginning to see major improvement in the housing sector. Unemployment rates for the college educated are very low. But the unemployment rate for the lesser educated is pretty dismal. There are good prospects for improvement that will come as the construction sector builds a full head of steam.

Even when that happens, we will still not see solid 3.0 percent real GDP growth on a regular basis, unless a good many who are now out of the labor force decide to go back to work. Many will do just that when incentives change. When sitting in school comes at the cost of a good salary that can be earned, many college students will decide to put their improved human capital to work. When markets get tighter, and payrolls begin to grow, many of those who started their own small firms will decide they would prefer the security and regular pay that comes with working for somebody else. As things improve even more, some who are now on disability, upon seeing real opportunities to secure a good job, will move into the labor market.

Along the way, it is even possible, though not very likely, that the federal government will reduce some policy uncertainty instead of adding more.

Then we will be back on the three-lane highway again.