

THE ECONOMIC SITUATION

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- 1997: The platform for the 1998 economy. •
 - The Asian tremors: sorting out some effects. •
 - 1998's prospects: Below average but positive. •
 - Will Wall Street see bulls or bears? •
 - South Carolina and the southeast: Better than the nation, but not much better. •
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1997 and Asian Tremors: Building a Platform for the 1998 Economy

1997: Looking Better All the Time

While the final 1997 tally is yet to be made, the record is clear enough to pause and celebrate. GDP growth for the year will likely exceed 3.5%, making it one of the best years, if not the best, since 1988. Along with good GDP growth came extraordinary employment gains, improvements in wages and salaries, and the practical disappearance of inflationary pressures. Thinking back to the NAFTA debate of a few years ago and the continuing effort by some to close the doors to foreign competition, we can marvel at the silent "sucking sound" that seems to have pushed jobs and incomes to the U.S. instead of the reverse.

As inflationary forces subsided, long-term interest rates responded predictably, giving the lowest yield on the government's 30-year bond since the first year of its being. The January yields of 5.70%, which offer yet one more opportunity for consumers to refinance mortgages, delivered a lighter interest payment cost to American taxpayers who bear the burden of government debt. Rising incomes coupled with higher taxes and lower interest costs brought the promise of balance to the federal budget, which conveniently counts

the Social Security surplus when tallying income and expenses. Politicians, always expert at satisfying our hunger for benefits paid for by others, are now debating what to do with the promised surplus. Visions of government-provided sugar plums dance in our heads.

Along with all this good news about the fundamental working of the 1997 economy came yet one more welcomed leg to the three-year bull market. Even amateur investors were able to make some good hits, whether in mutual funds or with dart boards. Balance sheets improved, for governments, corporations, and families. All things considered, 1997 was an excellent year for the economy and for many American families. What can we say about 1998's prospects?

As 1997 was winding down, the Asian economy, that most exciting part of world markets, began to fall apart. The Asian miracle suddenly became the Asian malady. One by one, major growth economies became caught as financial dominos tumbled. News of currency devaluations, corporate and financial institution bankruptcies, and IMF bailouts left little room for talking heads to celebrate 1997's bright side.

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More on Asian Tremors

Last quarter's newsletter gave a preliminary assessment of some of the expected effects of the financial collapse in the high-octane Asian community. At the time, back-of-envelope estimates suggested that U.S. 1998 GDP growth would be reduced by as much as a half a percentage point, which is roughly a 15% reduction in the rate of growth. With more data now available, let's take a closer look at the problem.

At a gross level, the problem for the U.S. has four components:

- 1) A reduction in the demand for U.S. exports,
- 2) The ripple effects across the economy that result from (1),
- 3) Price level effects that come from lower-priced Asian goods, and
- 4) Interest rate effects generated as global money managers search for safe-haven investments.

Annual exports to Hong Kong, Indonesia, Japan, Malaysia, Singapore, South Korea, and Thailand sum to about \$120 billion, with Japan accounting for about half the total. To give some perspective, this total is about equal to U.S. exports to Canada, our largest trading partner. Taken together, annual shipments to these troubled countries account for about 1.5% of U.S. GDP. If these exports fall by as much as 20%, which is more than most analysts expect, the direct effects would cut 30 percentage points from GDP growth. Instead of being 3.0%, for example, the number would be 2.7%. The ripple effects generated as U.S. producers cut back would add another equal loss, making the total effect a loss of 60 percentage points. In the example just given, GDP growth would fall to 2.4%. Viewed in yet another way, a 20% decline in Asian export sales would yield a loss of 300,000 export and export-related jobs, which is about the number added to the labor force in the month of December.

Each of the affected Asian countries has its own peculiar problems, but to some extent they can be summarized as being caused by over-extended government-sponsored

credit that has generated a huge amount of debt that cannot be paid off. Much like the 1980s U.S. S&L crisis, if the extended financial institutions are left hanging in the wind, populations there would lose their bank accounts and savings; lenders worldwide would have large write-offs, and barring significant action by Asian governments, Asian currency values would fall even more against the dollar. Deflation and recession would strike at the heart of the Asian world. This will not likely happen.

Loans provided by the International Monetary Fund, by the various Asian governments, and rescheduling of debt by global lenders can ease the pain. But a complete bailout fails to penalize some of the foolishness that generated the problem. Each of the countries and their creditors will have to determine just how much penalty and reward they will handle. Meanwhile, the countries with the most severe problems, with South Korea leading that damaged pack, will be dealing with excess productive capacity that yields an increased supply of highly competitive goods in world markets. Investment there will languish. Lower priced goods from the Asian world will further blunt the edge of CPI inflation. While adjustments take place, investors will shun the troubled countries, seeking safer havens for their footloose capital. The resulting deflationary pressures and movement of funds will keep U.S. interest rates lower than they would be otherwise.

What then are the threats?

- 1) Asian recession that significantly reduces the growth of the global economy.
- 2) Deflationary forces that cause a reordering of global financial assets and economic decisions.
- 3) Moves toward protectionism that close borders to increased penetration by lower priced foreign goods and reduced global economic activity.

And what might be the opportunities? With cooperative reordering of financial assets, reductions of government intervention and tax cuts in the Asian world, a freshening of economic activity in the more secure countries enhanced by low inflation and accompanying lower interest rates.

Looking Ahead to 1998

1998: What are the U.S. Prospects, Given the Background?

Having laid a foundation, let's focus on the 1998 outlook. The fundamental changes that emerged in 1997's fourth quarter led forecasters to revise their 1998 estimates by more than a half a percentage point, and more importantly, to change basic assumptions about underlying forces that support and create the economy about us. In December almost half the Blue Chip Forecast panel reduced GDP estimates for 1Q1998. Their composite 1998 forecast now stands at roughly 2.2% growth for the year. The WSJ composite GDP forecast is about the same as the Blue Chip number. It calls for 2.4% growth in the first half and 2.1% in this year's last six months. The University of Alabama forecasting unit calls for 2.6% GDP growth; the University of South Carolina, 2.4%; Barnett Bank, 2.5%, First Union, 2.2%; and Wake Forest, 2.8%. All of these estimates lie well below 1997's 3.7% estimated GDP growth. However, we must recognize that the 1997 economy began to slow down in the last half of the year.

Along with significantly slower GDP growth and reduced inflation, 1998 promises to bring stable, if not lower, interest rates. In recent weeks, rates have fallen across the yield curve, giving a flat profile from five years out. In short, the spread between 90-day interest rates and yield on the 5-year note and 30-year bond are much smaller. The general consensus sees the 30-year bond ending the year with a 6.0% yield and the 90-day bill standing at 5.2%, which is close to the current picture.

Will We See More Bull Market Action on Wall Street?

Investors have felt the Midas touch for the last three years. The current picture offers little hope of yet another golden year. Think about the main drivers: Profit growth, productivity increases, interest rate declines. Not much promise here. Interest rates may fall a bit more, but not by enough to spur the market. Investment in pursuit of productivity gains will still be present, but slower projected world activity implies less investment

in new capital. Finally, global market competition promises to be even more severe, leaving little room for substantial profit improvements.

1997's bull market leaders included brokerage firms, advertising agencies, petroleum services, S&Ls, banks, airlines, and home construction. Reduced equity market activity takes the bloom off brokerage houses. Declining petroleum prices darkens the short-run picture for petroleum services. S&Ls and banks will face reduced interest rate margins, although merger actions will still be present. Airlines will gain from lower priced fuel; advertising firms should continue to glimmer, and home construction should be stimulated by lower interest rates. Last year's list of winners doesn't seem to fit this year's picture. The Asian shakeout will reduce the likely gains from computers and related equipment as well as autos. The conclusion: 1998 should be an interest rate play, with insurance and mortgage lenders showing some gains. But all things considered, we will have lots to celebrate if the Dow-Jones Industrials end the year at 8400; it and other broad market indexes will likely swoon a bit before recovering.

The South Carolina Economy

The accompanying table shows six forecasts of state product growth for South Carolina, regional product growth for the Southeast, and GDP growth for the nation. In general, the state's economy will grow less than the region's but better than the national economy. Adjustments in textiles and apparel to global competition have reached a stable point. Major hits from the declining federal sector are also behind us. We are left with a strong economy that continues to be driven by industrial and tourism activities.

1998 Growth Forecasts

	S.C.	Southeast	U.S.
University of Alabama	2.6%	2.8%	2.6%
University of South Carolina	2.7	2.8	2.4
University of Tennessee	3.3	3.2	2.5
Wake Forest University	2.7	2.8	2.8
Barnett Bank	2.5	2.7	2.3
First Union	2.9	3.0	2.2

Source: *Wall Street Journal*, 1/7/98.

(continued on back page)

(continued from page 3)

The amount of Asian investment in the state poses a concern. Firms such as Fuji, Bridgestone, and Hitachi are major state investors. Asian tremors could affect plans for future expansion. At the same time, South Carolina is a major exporter to world markets, with Asia representing a significant destination for S.C. goods and services. While these factors are considered in the accompanying forecast data, we should be aware that the state economy is far from immune to world economic forces.

Final Thoughts on 1998 and Beyond

Prophets of doom and gloom always seem to attract more attention than those who forecast better days. This leads us to magnify trouble while discounting underlying strength. The U.S. economy could not be better posi-

tioned to shake off trouble from Asia and elsewhere. The economy is strong. Indeed, the Asian tremors will limit actions by the Fed to cause its own kind of tremors. 1998 will see the Asian economies restabilized, and the global economy will continue to expand, but on a new footing.

South Carolina and the region will form some of the brighter spots in the days that lie ahead. As always, we face fundamental challenges for improving and protecting life. The gains experienced in the last few years have provided a basis for making life better. While we mark time in 1998 and move forward at a slower pace, we will have the opportunity to repair, rebuild, and renew. Our free market economy has shown once again that the uncoordinated actions taken by free individuals and firms are far better for all than the coordinated action taken by governments, politicians, and related cartels. We can learn from the Asian tremors.

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