

THE ECONOMIC SITUATION

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A quarterly report on economic trends.

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- Recession still lurking? Depends on where you look.
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- Deflecting the recession.
- What's the bottom line for the economy?
- Will Mr. Greenspan cut again?
- Gail Borden, another American hero.

Looking for a recession: The economy's two faces

When this year's first quarter GDP growth was to be announced in April, many pessimistic economy watchers thought the number would be close to zero. After all, the nation's factory face looked pretty battered. The press was filled with announcements of factory shutdowns, shift layoffs, and tough times in manufacturing. But then, there was another face. Construction was still moving along nicely. New home sales were hitting high marks, and those never-say-die consumers were still out there shopping. Would the manufacturing recession be dominant? Or would consumer spending keep the top turning? Which was the economy's prevalent face?

The answers came in the numbers. GDP growth came in 2.0%, a notch above the previous quarter's 1.4% growth, and well above Mr. Greenspan's casual suggestion that we might see zero. But before getting carried away with irrational exuberance, we should remember that GDP numbers have a way of being sharply revised. It could happen again. But a bevy of other data tell us there are two worlds out there—the factory economy and the rest. The first of those worlds—manufacturing—is not doing very well.

For seven consecutive months now, Industrial Production—that one available monthly measure of national output from factories, utilities, and mines—has been falling. After the weakness first appeared in October 2000, the slows came rather quickly, with

the decline accelerating until this January when the month-over-month change fell by a whopping 0.9%.

Since January, the slowdown has continued, but at a milder pace. April showed a 0.3% decline, which followed a smaller decline of 0.1% for March. Things are looking better. But when the books were closed for this year's first quarter, the industrial economy had experienced the weakest quarter since the 1990-91 recession. Some called it a manufacturing recession, and for good reason.

Which is smarter? The OLD or the NEW economy?

To a large extent, this factory recession followed a sudden inventory buildup that came at yearend. And interestingly enough, the old economy seems to have done a better job in adjusting than the new, high tech economy. This may be another case of the cobbler's children having wornout shoes.

Starting last fall, producers of computers, servers, and other information technology continued to build inventory, even though sales were falling. According to *Business Week*, inventories in the new economy rose 8.3% from September through February. Shipments for the same period declined 7.5%. As a result, the new economy's inventory to sales ratio hit 1.21 in February, after recording a record low of 1.03 in September. Meanwhile, the auto sector and other old economy firms had already made the inventory

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adjustment and were ramping up production again. The auto sector seems to have been one of the most agile in making the adjustment.

Of course, when an industry sector is growing rapidly, it is more difficult to stop on a dime. In mid-2000, the new high technology sector, which accounts for 10% of all manufacturing, was growing at an annual rate of 50%. That's right. 50%. Fast-paced expansion coupled with sharply falling demand leads to excess capacity.

The excess capacity problem is most severe in the telecommunications sector. Lots of fiber has been buried to expand long-distance capacity. At present this part of the industry has a utilization rate of 2.5%. Yes, 2.5%. Cut-price competition among long distance providers promises to continue.

The rapid rate of technology change in the new economy also complicates things when slowdowns occur. Take the microchip industry. The time needed to move from dream to chip has fallen 50%. A few years ago this took 36 months. Now, the average is 18 months. Now the picture is clearer. An industry is expanding capacity at an annual rate of 50%. Within the industry the time required to produce some components has fallen by 50%, which itself yields a doubling of capacity. Fold in a sudden decline in sales and shipments. Bingo. Lots of excess capacity.

Deflecting the Recession

Declining demand. Excess capacity. Will the factory recession spread to the larger economy?

A slowing economy transmits signals to the factory sector in very clear terms. Sales fall. Orders and shipments are rescheduled. Inventories build. Manufacturers cut back on temporary workers, then on permanent workers, and finally close plants. As the cycle produces excess capacity, plans for expansion and even replacement capital are shelved.

A glance at the composition of GDP growth offers some insights. The first quarter GDP growth data show nonresidential investment growing at the annual rate of 1.1%. In the fourth quarter that investment was declining at the rate of 0.1%. For 2000's first three quarters, capital investment was rising at the rate of 14.4%. No doubt about it, plant managers and operators hit the brakes. At least in the old economy. Hitting the brakes in the old economy

meant trouble in the new economy, the source of much of the new capital.

What about labor? The use of temporary workers in the U.S. economy cushions some of the adjustment for permanent workers and adds speed to the adjustment process. Temporary workers suffer disproportionately along the way. In the last four months, 234,000 temporary workers have been cut from payrolls nationwide, while total payrolls have fallen 54,000. In other words, the number of permanent workers employed in the economy has actually risen. The economy is adjusting and expanding at the same time.

Now we get a clearer picture, I hope. The national economy is being buffeted by two distinct sets of forces. The old economy has sustained a significant inventory adjustment and is recovering. The old economy's adjustment has sent tremors through the new economy. It is still swaying. Layoffs in one part of the economy—the old—are mostly behind us. Layoffs in the new are still occurring.

What's the bottom line on a recession?

I know of no forecasting group that sees a recession lurking ahead. For example, the Blue Chip Consensus calls for GDP to accelerate from a growth rate of 1.2% in this year's second quarter to 3.0% in the fourth quarter. The group predicts 2002 GDP growth will hit 4.2%. Recall, GDP growth in 2000 was 5%. The 1999 growth rate was 4.2%. Wake Forest University's Gary Shoemith is not nearly so optimistic. His latest forecast calls for 2.2% for this year, followed by 2.6% in 2002. Still, there are no recession images in these reports.

Shoemith's analysis of the region and state provide another example of multiple faces in the economy. In 2000, the Southeast expanded employment at 2.6%, roughly 0.6 percentage points more than the nation. South Carolina had the same growth as the region that year. Georgia and Virginia led the region with growth rates of 2.8%. The forecast for this year calls for South Carolina to register 1.9% employment growth, just below Florida and Georgia, the region's two strong states.

Interestingly enough, employment growth in the Palmetto State has not suffered as much as the nation,

this in spite of the South Carolina's heavy manufacturing concentration. On a March 2000 to March 2001 comparison, national manufacturing employment has fallen 2.3%. Factory employment in South Carolina has fallen by 0.6%. Are we lucky or what? Part is luck. Auto shipments nationwide weakened. BMW's accelerated. Firestone/Bridgestone suffered a set back. Michelin North America expanded. The coastal economy is still flourishing, and the Upstate high-tech manufacturing and services economy continues apace.

Will Mr. Greenspan cut again?

The Federal Reserve has now whittled short-term interest rates 2.5 points in 4.5 months, one of the boldest moves on record. On the other hand, the Fed had just increased interest rates at rapid pace too.

The Fed now indicates three concerns: 1) The reverse wealth effect generated by declining stock prices, 2) Weak corporate profits and declining capital spending, and 3) Declining economic growth in the rest of the world. Export shipments have been falling for six months now, after a long series of expanding quarters, and declining corporate profits will be with us until the inventory adjustment is completed.

The reverse wealth effect is another matter. At this point, the 20% decline in equity values as the year 2000 was closing has not generated a meaningful effect on consumer demand. This is in spite of the fact that household wealth was 2% lower in 4Q2000 than in 4Q1999, the first drop in 20 years. So why no wealth effect?

Two considerations come to mind. First, the run-up in equity values was large and rapid. Consumers may have discounted some of the paper wealth so generated. Then, the value of real estate holdings of consumers exceeds equities. For the nation, the value of real estate holdings increased 10% last year, the largest increase in 15 years. Finally, when it comes, the wealth effect doesn't come immediately. Empirical work suggests there is a lag of two years. That being so, we can look out for weaker consumer spending in 2002.

So what's the bottom line? Will the Greenspan fed cut rates again in late June. The betting line says yes. Data from interest rate futures provided by

Dismal.com indicate a 96% chance that rates will be cut by 25 basis points by the end of August. So far, the futures market has been incredibly accurate. Right now the federal funds target rate is 4.0%. We should look for 3.75% by early July.

Looking for heroes: Gail Borden

Gail Borden, a surveyor, land agent and tinker from Galveston, Texas is a hero. He did well by doing good. In 1846 Borden learned about a catastrophe that befell a starving group of settlers trying to make a winter passage to California through frozen Donner's Pass. Had there been preserved food, starvation and cannibalism would have been avoided.

Borden set out to remedy the situation. In the process he became fixated on condensing things. He wanted to condense everything. He urged preachers to condense their sermons and lovers to condense their thoughts to a kiss. He would have probably been screaming for me to cut to the chase and finish this report.

After many experiments, he found a way to dehydrate beef and invented the condensed meat biscuit. Hard enough to use as a baseball, the meat biscuit could survive all forms of exposure and temperature.

Borden's invention was so revolutionary that the meat biscuit was selected to be displayed at the 1851 London Exposition. There in the great crystal palace, the humble biscuit sat next to the Colt revolver and McCormick's reaper. This trinity was considered to be America's great technology wonders.

Returning from London, Borden and the other ship passengers encountered stormy weather. At the time, cows were carried on board ship to provide milk for infants. Guess who got sick at sea? Not Borden. The cows. No milk. Unhappy babies. Unhappy passengers.

Gail Borden vowed to find a way to condense milk. If he had been a scientist, he would have known that it couldn't be done. No scientist, Borden was a Texan. He didn't give up until he found the way to condense and can wholesome milk. Along the way, he made a fortune.

Borden did well by doing good. A real hero.

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