

THE ECONOMIC SITUATION

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- **Using Industrial Production as a lens: The pros and cons.**
- **Taking a closer look at South Carolina**
- **Assessing the end-of-2004 forecast. Yikes!**
- **The dynamics of the U.S. economy: Imprint and change.**
- **Yet with all that change, incomes keep rising.**
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Taking a look at the U.S. economy through the industrial production lens.

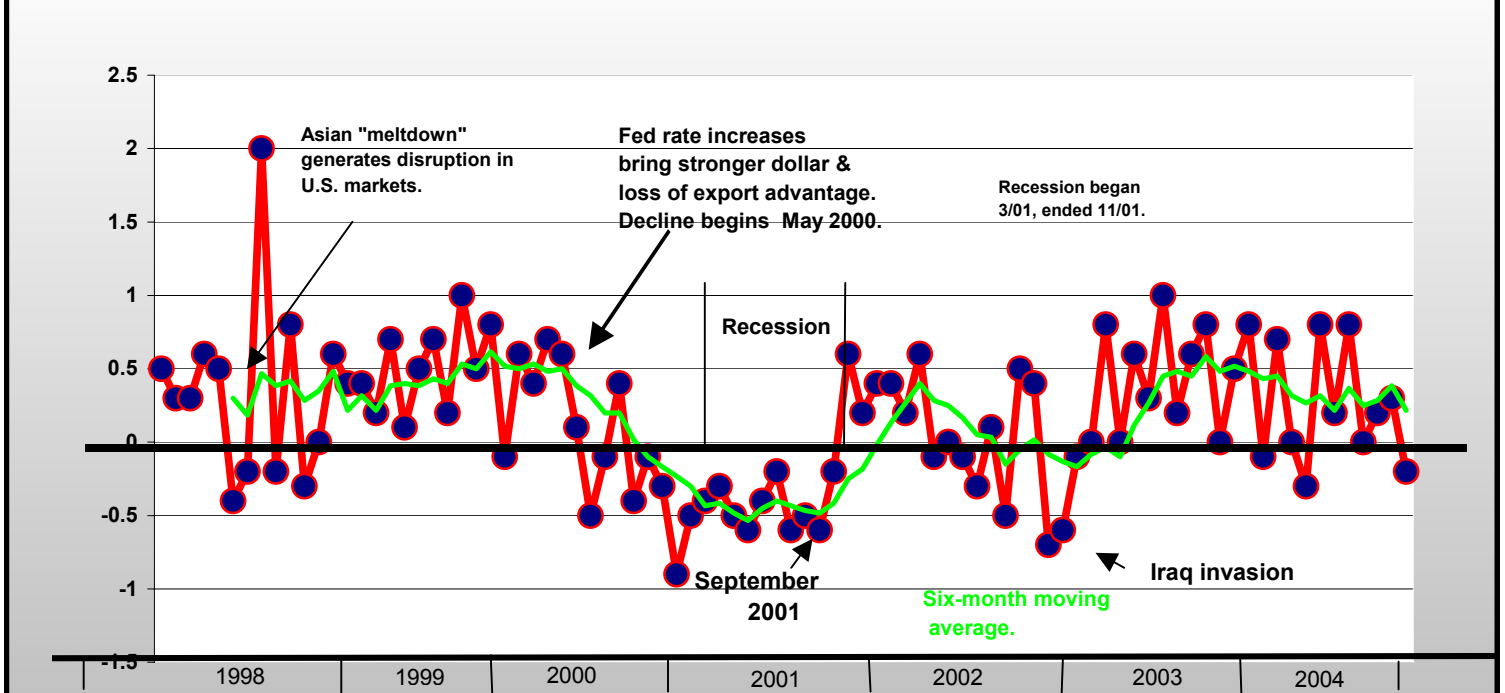
With economic growth now running at about the long-term trend and with jobs being generated big time, the U.S. economy is still not quite to Goldilocks where everything is just right. But the situation is far better than Hokey Pokey, where things just turn around and head the other way. Even so, there are a few bumps in the road.

Little wonder. There is a war raging that uses human and capital resources. We have a high-spending government that uses debt to expand the size of the public sector. And there are uncertainties that spring from the energy sector, an expanding underground drug economy that feeds terrorism, and above ground, a rapidly industrializing world.

With all that, the market economy is moving at a healthy pace. Enough to call it a miracle. Let's just call it what it is: Capitalism.

The Industrial Production chart shown below gives a pretty good reading on bumps in the road. The Industrial Production Index, which is the most comprehensive monthly measure of general economic activity, picks up variations that occur in manufacturing, mining, and public utilities, and does so monthly.

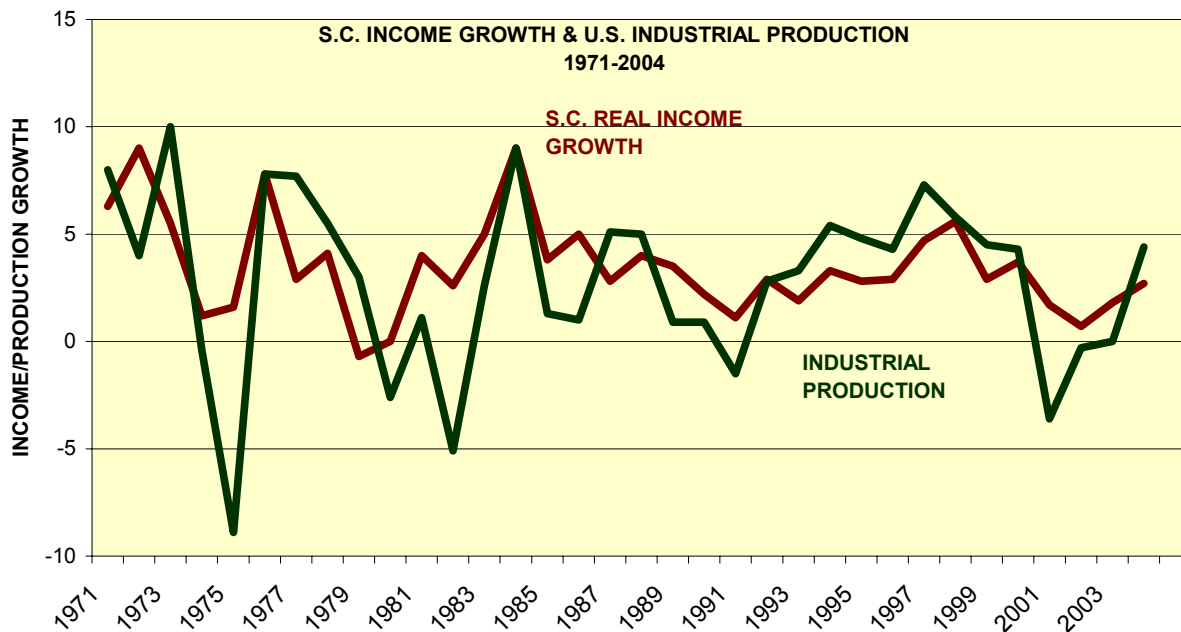
Growth in U.S. Industrial Production: 1998-2005



The most recent May data point places production growth in negative territory, following several stronger months. Fortunately, at least for the country, the manufacturing sector can run rough without creating major tremors for the nation.

But South Carolina is another matter.

We see a different picture when South Carolina, a major manufacturing state, is considered through the lens of Industrial Production changes. The next chart maps annual growth in U.S. Industrial Production into growth in S.C. total personal income. Notice how nicely the two series track when the large variation found in monthly data is removed.



The good news embodied in the chart is seen in the most recent observations. Industrial Production growth lies about state income growth. The 2005 forecast? Look for S.C. income growth to accelerate.

The end-of-year forecast and now.

With about six months activity under the belt, this is a good time to compare my end-of-year forecast with the realities of the situation. (As embarrassing as it may be!)

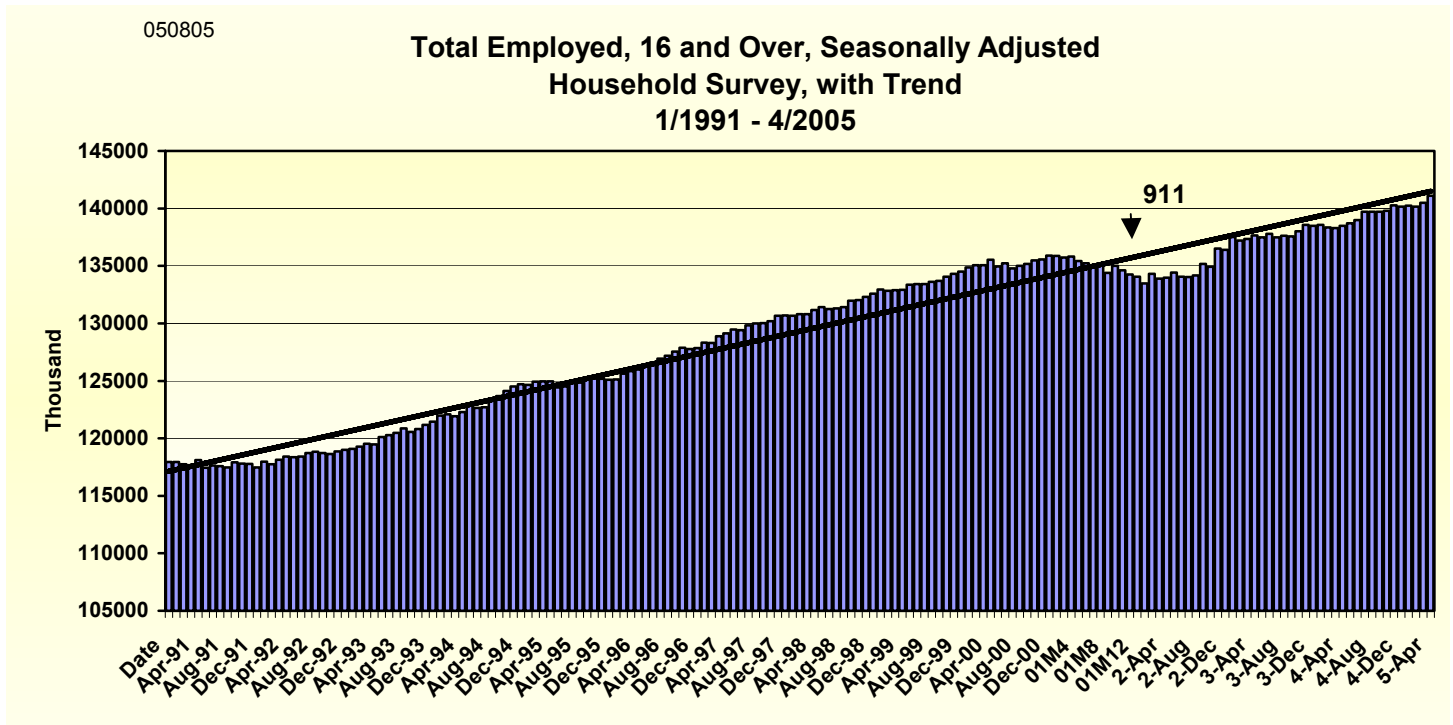
As 2004 was closing out, I ventured forth with an end-of-2005 forecast. The data in my forecast are shown in the chart below along with values for May 22, 2005. As can be seen, GDP growth thus far is a bit weaker than my forecast. There are at least two explanations for the shortfall—growth in net imports and energy prices. Of course, the two are interrelated. Higher priced oil leads to higher valued net imports, while at the same time reducing the vibrancy of the domestic economy.

The Year Past & Ahead

| | 2004 Actual | 2005 Year Ahead | May 22 2005 |
|------------------|----------------|--------------------|----------------|
| GDP Growth | 4.4% | 3.7% | 3.4% |
| Inflation (Core) | 2.2% | 2.5% | 3.3% |
| Prime Rate | 5.25% | 6.00% | 6.00% |
| Unemploy | 5.4% | 5.0 | 5.2% |
| Dow-Jones | 10,600 | 11,200 | 10,400 |
| Employ Gain | 150M/mo. | 150M/mo. | 211M/mo. |
| 30-yr. Mort. | 5.19% | 6.25% | 5.50% |
| Oil | \$45 | \$40 | \$47 |
| Gold | \$422 | \$400 | \$417 |

When it comes to the prime and the unemployment rate, my end-of-year estimates may have been a bit too low for the prime, but on target for the unemployment rate. We will likely see another 50 basis points added to the short-term rate. My optimism for equities, and the disappointing performance so far, is seen in the estimate for the Dow-Jones. There's no doubt about it, the market will really have to liven up to break through 11,000 and accelerate to 11,200 by December. (I am still pulling for it! Continue to read.)

Employment growth for the first four months of the year is the real surprise in the data. April data came in like gangbusters and brought along upward revisions for February and March. By way of this indicator, the economy is once again on solid ground for growth. Consider the next chart, which show total U.S. employment. Notice that the trend line is kissing the last observation. The gap is closed. Sweet!

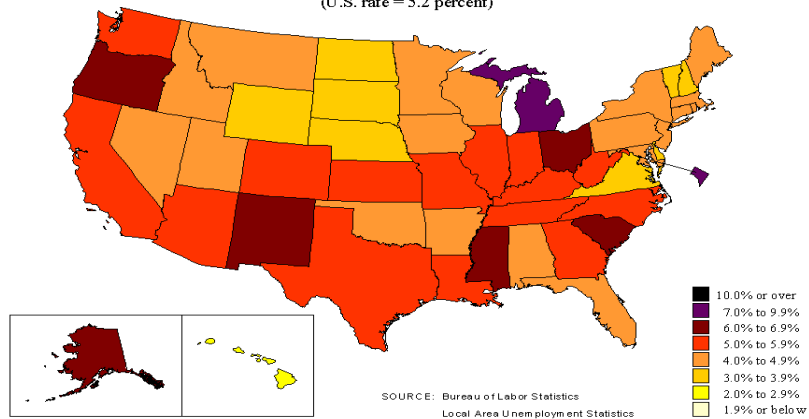


The geographic imprint is uneven.

While the total employment gap appears to be closed, the effects of economic change across the states leaves a very uneven imprint. The two maps that follow show unemployment rates by state for the periods April 2005 and May 2003. A comparison of the two helps to identify those places where employment growth has been slower. The comparison also shows how the outlook has generally brightened across the nation. The Pacific Northwest, which was hardest hit by the recession and dot.com bubble pop has recovered. Michigan, which suffers with the weakening of Ford and GM, relative to the Japanese and Korean brand American producers, has lost even more ground.

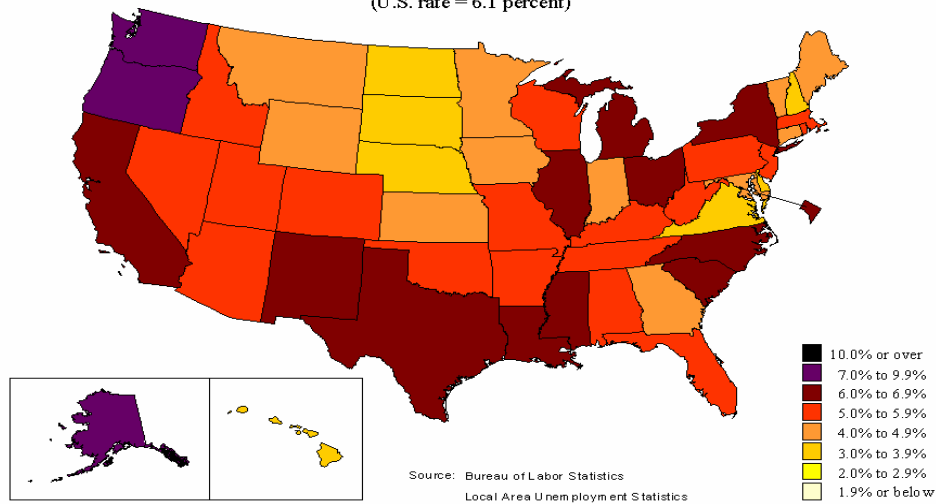
**Unemployment rates by state,
seasonally adjusted, April 2005**

(U.S. rate = 5.2 percent)



**Unemployment rates by state,
seasonally adjusted, May 2003**

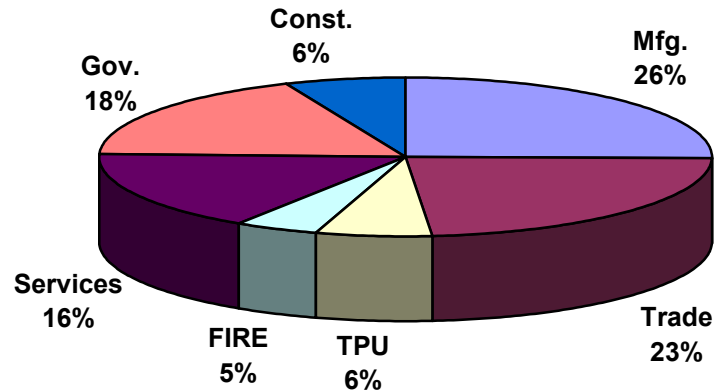
(U.S. rate = 6.1 percent)



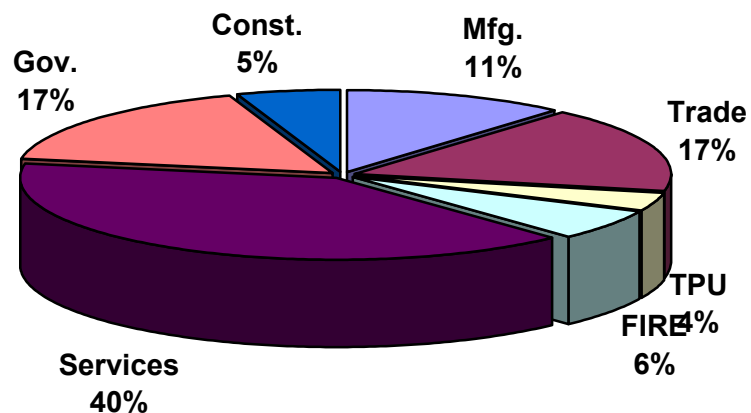
What people do for a living has changed a lot, too.

While considering the nation's employment situation, let's examine how workplace choices have changed. Because of past habit, we still tend to think that manufacturing is the economy's employment engine. This has not been the case for years, maybe even decades. Consider the next two pie charts that compare employment by sector for two years 1972 and 2004. Notice especially the slices labeled Services and Manufacturing. In a simplistic sense, manufacturing employment is being transformed to services employment, and the trend will continue.

U.S. Employment Sectors: 1972



U.S. Employment Sectors: 2004



The changing face of U.S. manufacturing

While the sizes of the pie slices have been changing, major changes have also occurred within the slices themselves. Consider the list of leading U.S. industries based on Industrial Production Indexes shown below.

In 1972, Iron and Steel was America's leading industry, followed by Apparel. These two industries fell to the bottom of the list or disappeared from the list in later time periods. Notice also that Computer and Electronics just didn't amount to anything in the early periods, but became the leading industries in the last two periods.

But take a look at Iron and Steel again. An industry that practically fell off the charts has become a leader. All because of China's demand.

A lesson? The market economy accommodates powerful adjustments across sectors and within industries.

PRODUCTION-BASED INDUSTRY RANKINGS

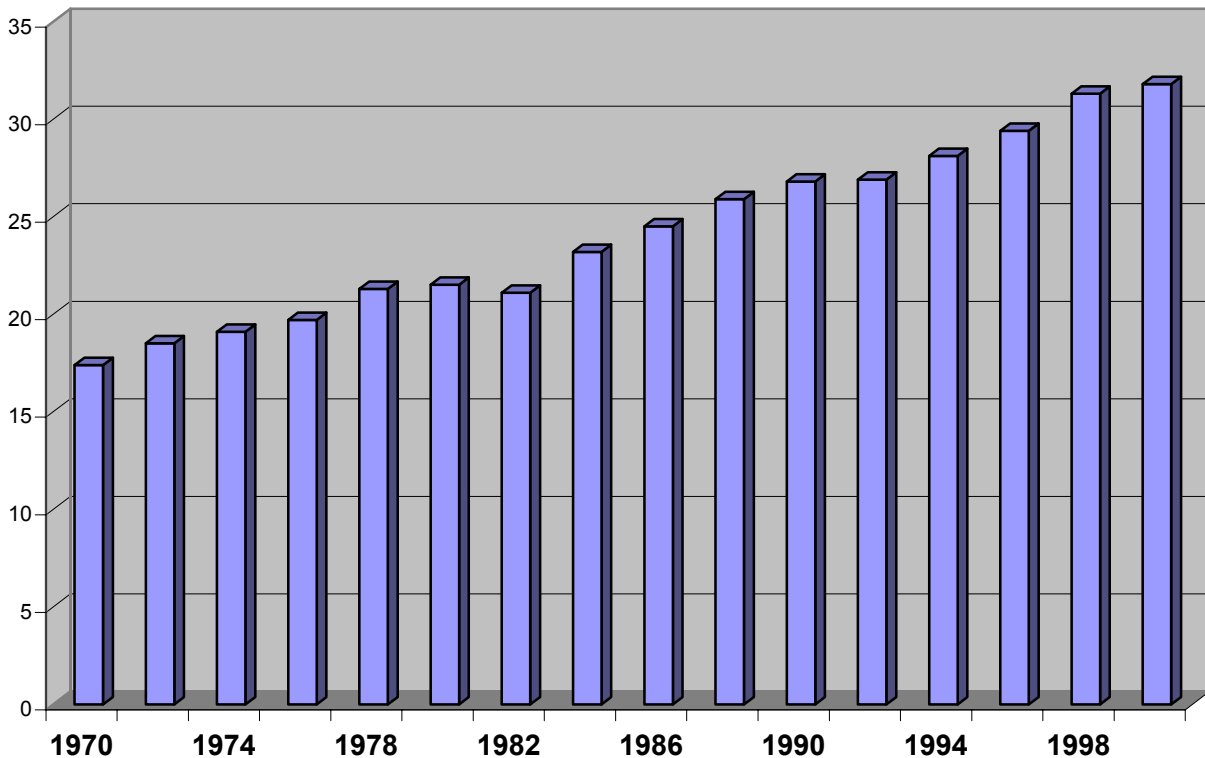
| 1972 | 1980 | 1990 | 2000 | 2004 |
|--------------|--------------|--------------|--------------|--------------|
| Iron/Steel | Iron/Steel | Printing | Comp/EI | Comp/EI |
| Apparel | Apparel | Apparel | Autos | Autos |
| Fab. Metal | Machinery | Paper | Plast/Rubber | Food |
| Food | Fab. Metal | Food | Fab. Metal | Chemicals |
| Paper | Paper | Chemicals | Machinery | Iron/Steel |
| Machinery | Food | Iron/Steel | Food | Plast/Rubber |
| Chemicals | Chemicals | Fab. Metal | Chemicals | Machinery |
| Autos | Printing | Machinery | Printing | Fab. Metal |
| Printing | Autos | Plast/Rubber | Paper | Paper |
| Plast/Rubber | Plast/Rubber | Autos | Iron/Steel | Printing |

Source: Economic Report of the President, 2005.

With all that change, real per capita income still rises!

The next chart tells a powerful story about the last 30 years. The U.S. economy has been transformed from one characterized by high manufacturing employment to one dominated by services. Total population has increased by some 75 million. And in that population increase, one finds more than 30 million legal immigrants. All that and higher per capita income. Let's hear a cheer for capitalism!

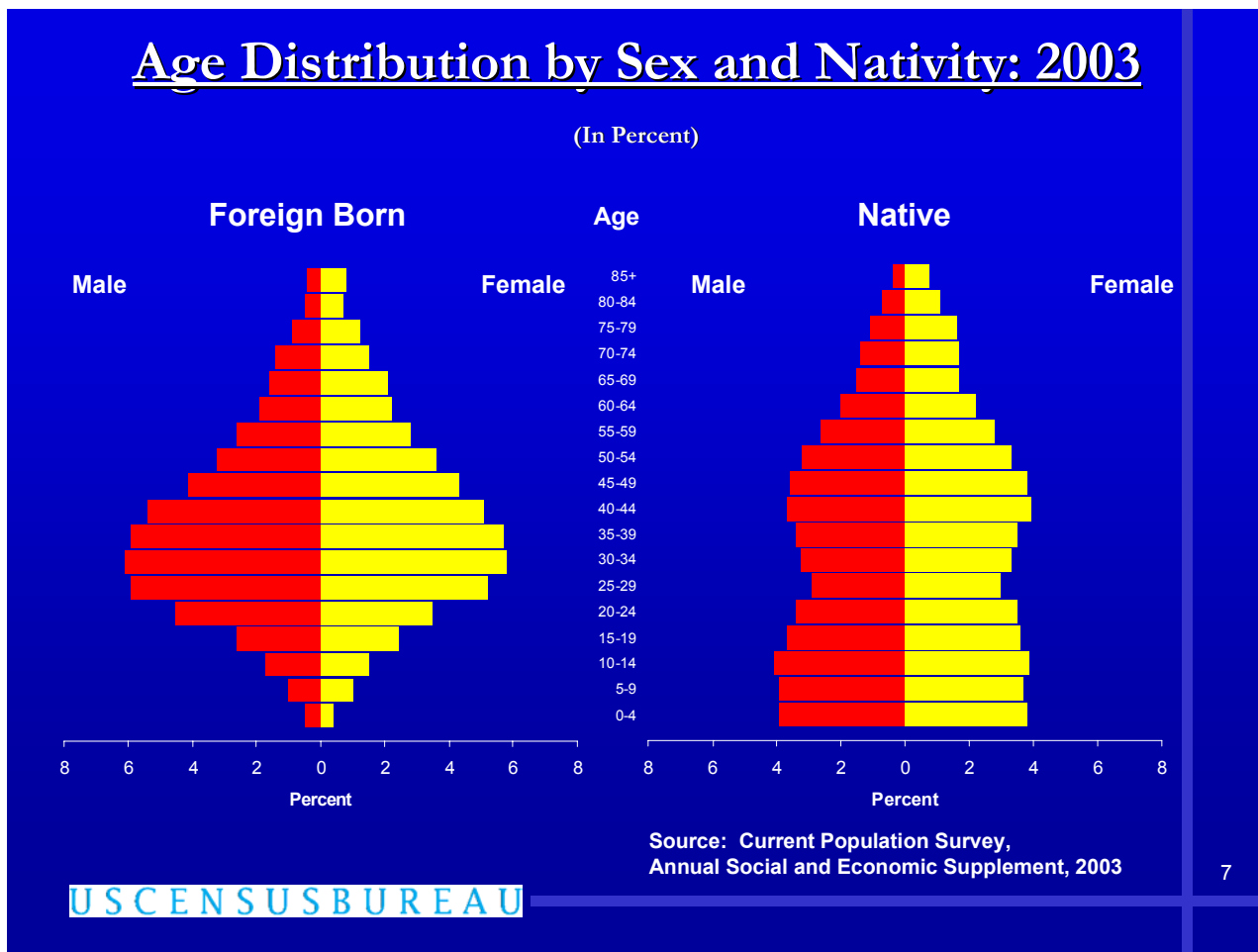
**Per Capita GDP
(Thousands, 2000 Dollars)**



What about the immigrant population?

Consider the age characteristics of the immigrant population relative to the native population. As shown in the next figure, most of the immigrant population is work age, indeed work age with experience. For example, notice the 20-50 age bracket bulge. Then compare this with the native population. One bulges at the middle. The other looks like an hourglass.

A glance at the immigrant population characteristics quickly explains why Mr. Bush and others want to grant amnesty to illegal aliens. Generally speaking, the immigrant population has a low dependency ratio (number working for each one retired), as well as a smaller population of children. Social Security would get a shot in the arm, and welfare requirements would be relatively mild.



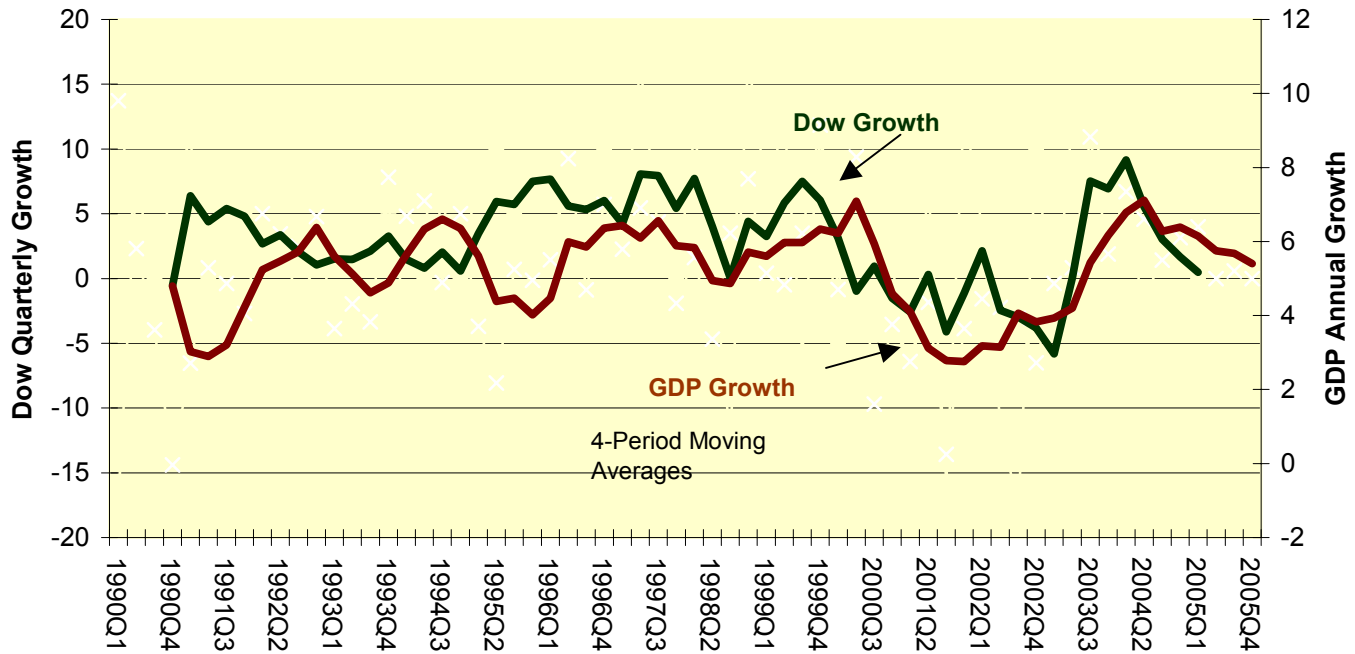
Oh yes. What about the Dow?

Please hark back to my end-of-year forecast and the lousy shot at the Dow. One might think I would adjust that estimate. But, then on the other hand, has the basis for my estimate changed?

It hasn't. I still focus on GDP growth, and what is expected for it, and the growth in the Dow-Jones Industrial Average.

Here's the chart.

Dow Industrials & GDP Growth



As indicated in the chart, GDP growth, recorded and expected, lies about the current growth of the Dow. The forecast? The Dow will engage. When? I hope before the end of the year!

Stay tuned.

Some Final Thoughts

Shaking hands with 600 hundred heroes.

As Interim Dean of Clemson's College of Business & Behavioral Science, I have the high honor of participating in the various graduations. Doing so affords me the privilege of shaking hands with the graduates from our college. On May 13, I shook hands with some 600 degree recipients. In the moment of the handshake, I offered the graduates a good luck wish and asked that they stay in touch with us. These young people are entering a vibrant economy, but one that holds a heavy dose of uncertainty, at least as seen through the older eyes of their teachers. But the new entrants have a better understanding of this expanding global economy than most of us. They more often than not see few limits to where they might travel and what they might do in a lifetime.

They have an entrepreneurial bent to them, and many of them have been helped along the way by readers of this newsletter who have offered internships and employment opportunities. For that I am deeply grateful.

Always looking, I realized as I shook those hands that I had found 600 budding heroes.