

THE ECONOMIC SITUATION

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- **Has Katrina generated a dramatically different economic outlook?**
- **What about educational attainment in a global economy?**
- **The Great American Manufacturing Machine: It is still there?**
- **Hammering out a forecast for the next six months.**
- **Susette Kelo, a property rights hero.**

The Situation Before Katrina

Just a few weeks ago, the U.S. economy was about to hit its stride. The effects of the manufacturing recession were pretty much worn away, employment was growing handily, and GDP growth was rising above the long-term trend. The August unemployment rate, a number that receives critical attention, fell to 4.9%, a four-year low, and with the exception of crude oil prices—a rather big exception I should add, we were well on our way to a happy Goldilocks economy where everything would be “just right.”

But then, Katrina struck the Gulf Coast, rendering a tragic blow to hundreds of thousands of people and much that they and the rest of us treasure. The force of Katrina and the magnitude of the harm are still being assessed.

To get a handle on Katrina’s economic impact, let’s first consider a baseline. A quick summary of the Pre-Katrina Economy is seen in the next chart that shows my December 2004 forecast for 2005 year-end numbers and the comparable August 2005 numbers. The chart’s first column shows the 2004 year-end data.

Year-end Forecast and August Data

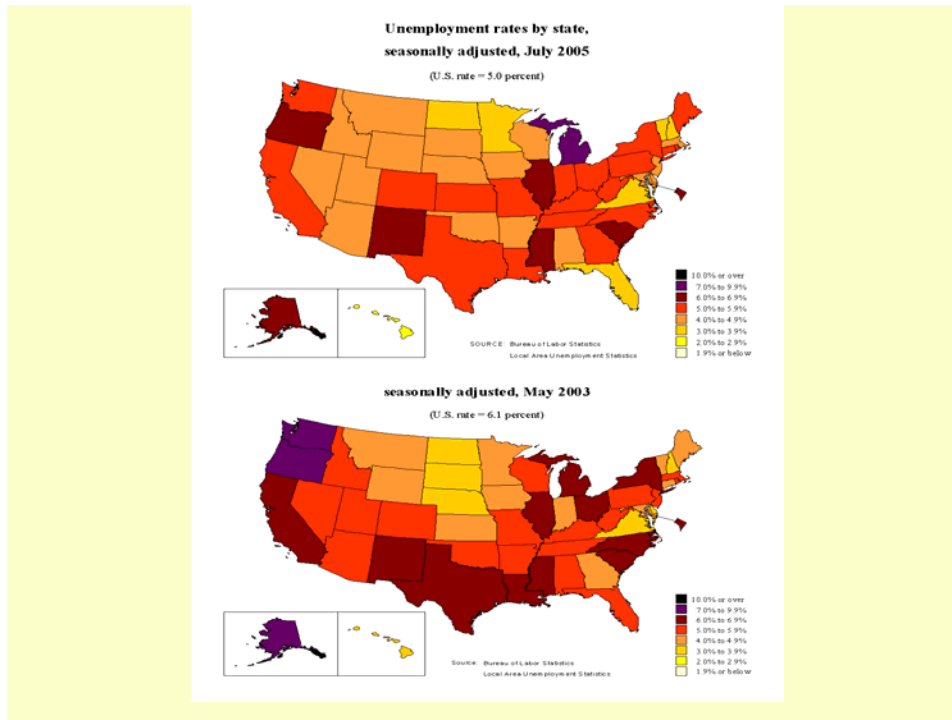
	2004 Actual	2005 Year Ahead	August 2005
GDP Growth	4.4%	3.7%	3.6%
Inflation (Core)	2.2%	2.5%	2.6%
Prime Rate	5.25%	6.00%	6.50%
Unemploy	5.4%	5.0	4.9%
Dow-Jones	10,600	11,200	10,600
Employ Gain	150M/mo.	150M/mo.	200M/mo.
30-yr. Mort.	5.19%	6.25%	5.87%
Oil	\$45	\$40	\$70
Gold	\$422	\$400	\$450

As the chart tells us, GDP growth through August looks pretty good, and it's close to the rate I predicted for the year. Inflation, too, is staying in bounds. But wait a minute, the Prime Rate is getting ahead of my forecast, and it's just August. A quick glance at the rest of the numbers suggests why the Prime may be higher. Employment growth is accelerating, but so is the price of crude oil!

The price of energy plays an important role in decisions made throughout the economy. Indeed, the Council of Economic Advisers indicates that "one rule of thumb is that a \$10 increase in the price of oil reduces the real level of GDP growth by 0.4 percent after four quarters." Fortunately, the \$70 crude we saw in the crunch of Katrina does not represent an equilibrium number. We are already seeing \$63 oil, and will likely see further price softening later in the year. But that is still \$20 or so above the level observed at the end of 2004. The CEA rule of thumb translates the increase into an 0.8 percent reduction in GDP growth, by year end. Looking back at my report card, we can see that 2004 GDP growth was 4.4 percent. Subtract 0.8 percent for oil price effects and we get 3.6 percent, which is where we are now.

The Exceptions

Those places that have not recovered from the manufacturing recession of 2001-2002 are rather important to us. South Carolina is one of the six states that is still languishing. We see this in the next two charts that compare state unemployment rates across the U.S. for May 2002 and July 2005. The darker the color, the higher the unemployment rate.



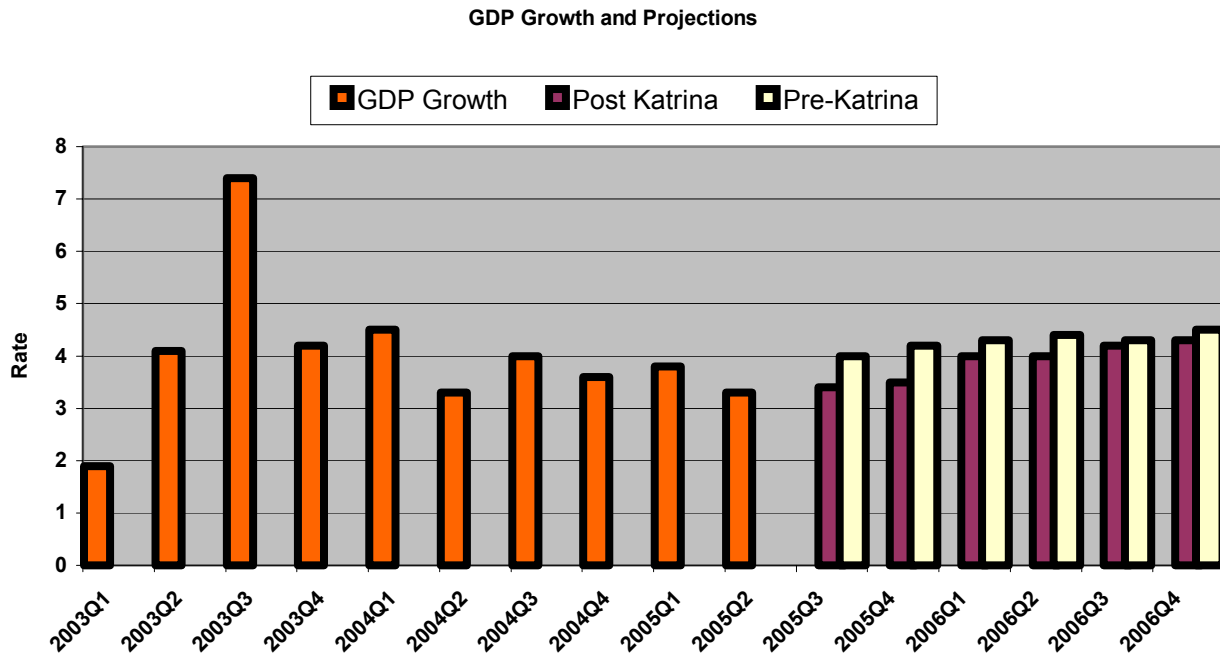
Notice the slightly darker color of the Gulf region, and how hard those states were hit earlier on. Hurricane Katrina hit an area that had not fully recovered from the earlier recession.

The Katrina Effect on Economic Forecasts

In the tragic aftermath of Katrina's destruction, economic forecasters nationwide were recalibrating their models. Revised forecasts were developed quickly by the Congressional Budget Office, OMB, and of course by the major financial institutions and economic forecasting groups. The revisions seem to focus on two things. First, the Katrina region contains roughly 1.3 percent of the nation's employed and produces approximately 1.1 percent of national GDP. In simple terms, if the region ceased to produce anything for the remaining three months of 2005, GDP would be reduced by about 0.3 percent. But of course, the region will not shut down totally. The concentration of energy production and the role played by the Port of New Orleans are two other important factors considered when attempting to estimate Katrina's economic disturbance. For example, applying the earlier energy price rule of thumb gives a GDP

reduction of 0.4 percent at the beginning of 2006, a reduction that would gradually disappear. Layered on top of the negative effects are the effects of a reconstruction boom that will emerge in 2006. Taken together, the negative GDP effects may take about 0.5 percent off the pre-Katrina quarterly GDP estimates over the next six to nine months. The positive effects will replace part of that.

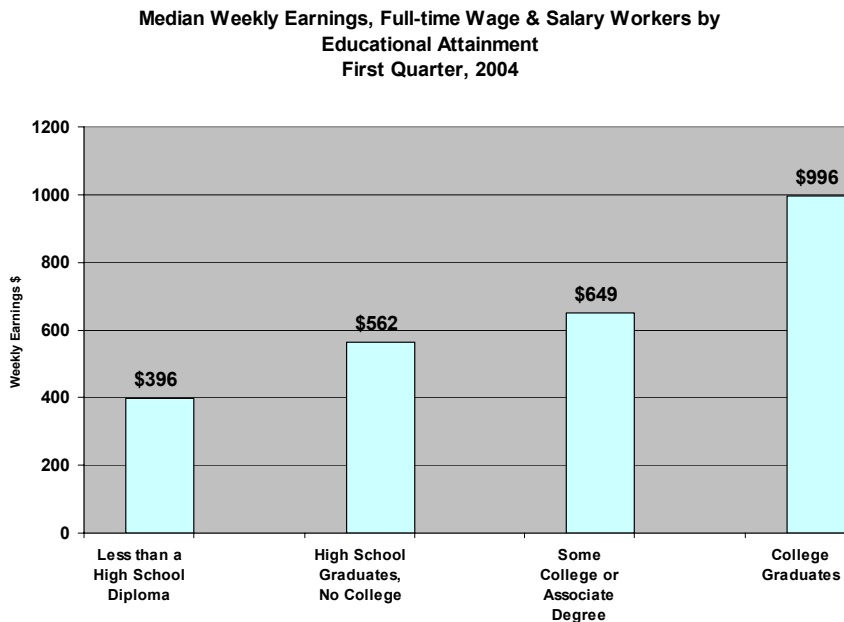
The next chart gives the profile of the pre- and post-Katrina GDP estimates.



More Education, More Pay

The employment recovery is bringing some improved earnings for some individuals and first-time earnings for new entrants to the labor market. How are folks faring with respect to levels of educational attainment?

The next chart shows the differentials in median levels of pay that relate to different educational levels. The message is clear. If one starts college, one should surely finish. The difference in pay is massive.



But the data from which this chart was formed contained an interesting message. For the first time, perhaps since the data were maintained, the growth in earnings associated with a bachelor's degree is negative. Earnings associated with graduate degrees are still rising at a positive rate, as are those associated with a high school diploma. It is not possible to know what is going on in the world market place that is generating negative returns to bachelor degrees, but this doesn't stop some policy analysts from guessing.

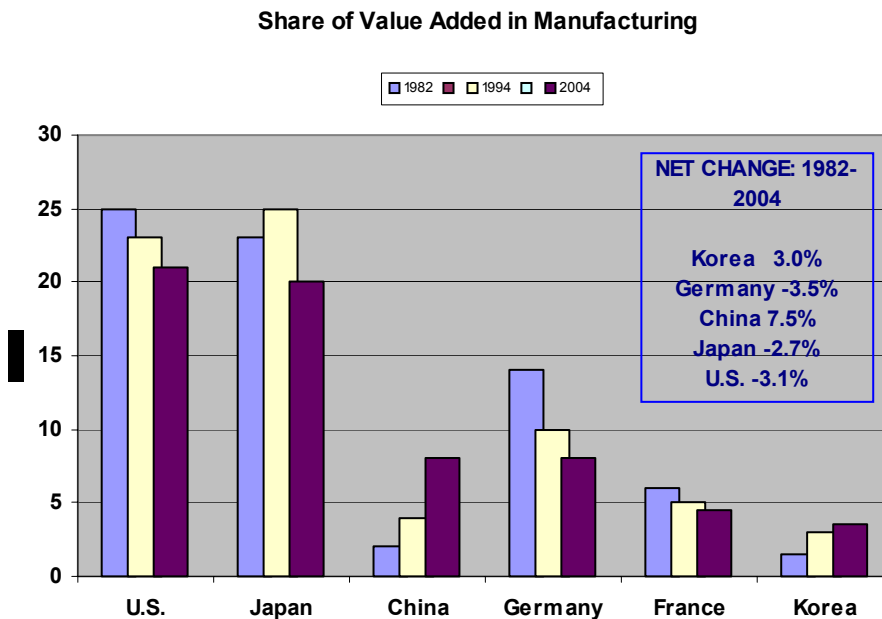
One explanation suggests that when more and more people obtain a bachelor's degree the day has to come when growth in earnings ceases and then falls. Another idea suggests that the globalization of work associated with people who have bachelor degrees has led to more intense competition in global labor markets, again leading to a decline in the earnings growth rate.

The Great American Manufacturing Machine

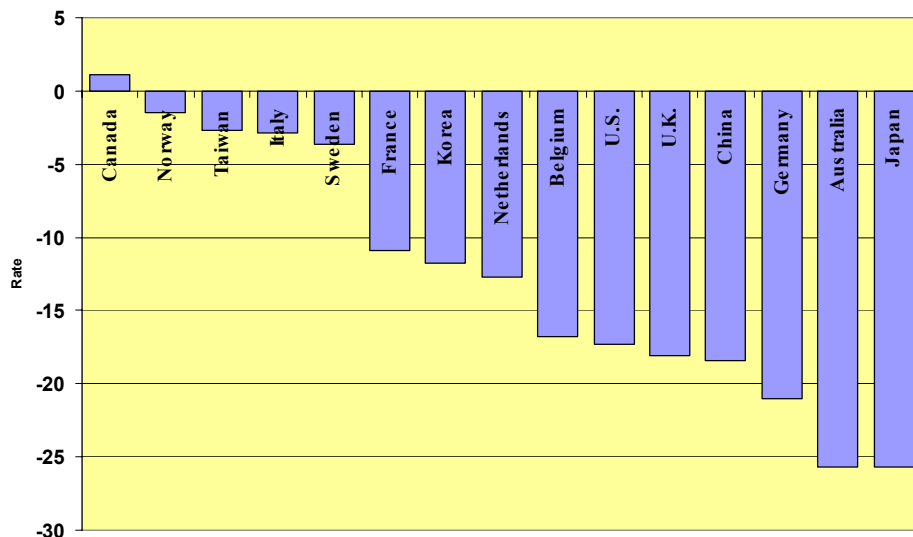
From time to time, it is easy to get the impression that the United States has lost its manufacturing muscle. The confusion, to the extent that it prevails, relates to employment in manufacturing, not to output from manufacturing. Yes, manufacturing employment is falling rapidly, following the pattern set by employment in production agriculture. Productivity gains are huge. Employment gains are gone.

The next chart, which compares data for value added in manufacturing for major manufacturing countries, shows the United States as the world leader. Yes, the share has fallen somewhat because other nations are entering the picture, but the absolute level is still highest.

The chart that follows shows the most recent data on manufacturing employment growth for countries that account for 90 percent or more of world manufacturing employment. Of the countries shown, the U.S. shows a significant decline, but not as much as China.



Percentage Change in Manufacturing Employment 1992-2003



Data for The Netherlands and China are for 1990-2002.
Source: W.A. Ward, Manufacturing Productivity and the Shifting U.S.,
China, and Global Job Scenes, 1990-2005. Center for International Trade,
Clemson University, Clemson, SC

What about a Forecast?

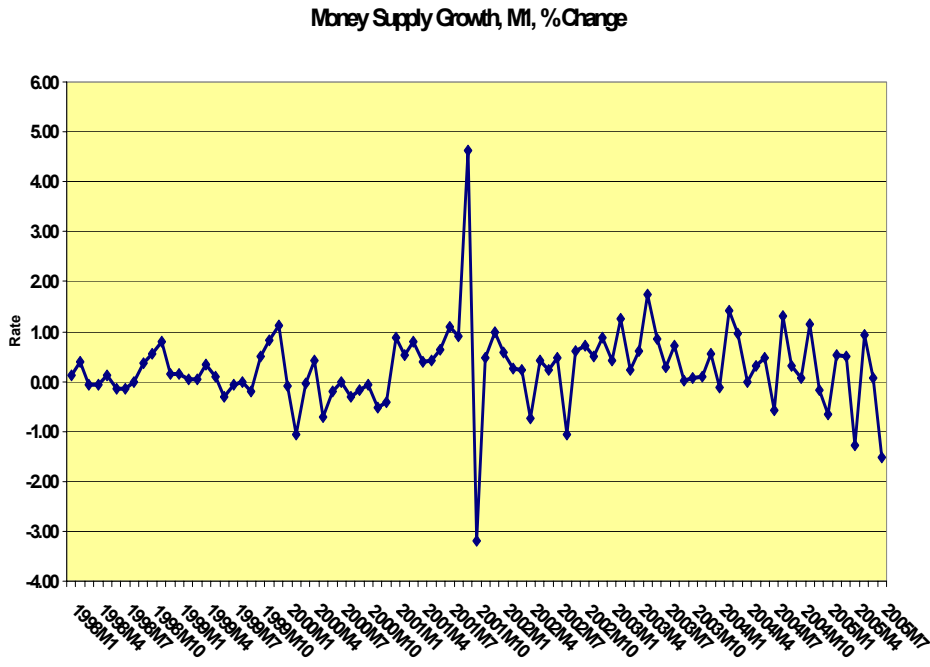
Each quarter I am privileged to give comments on the economy to a group of congressional staffers on Capitol Hill. My lectures are a part of George Mason University's Mercatus Center program called the Capitol Hill Campus. And each time I speak on the economic situation, I get composite opinions on three future scenarios for the next six months. The choices relative to the current situation can be labeled "about the same as now, a good bit better, or considerably worse." It turns out that the central tendency staffers' forecast is pretty good.

On September 9, I gave my quarterly lecture and gathered up the opinions about the future. For the first time ever, the poll was almost evenly split across the three choices. In other words, there is a lot of uncertainty out there about where Katrina and congressional action will take us.

When there is uncertainty, it is sometimes helpful to look at some data and relationships. I attach a lot of importance to money supply growth in the economy. When the Fed pumps money in we generally see a positive economic response about nine months later. Reverse actions works the same way, in reverse.

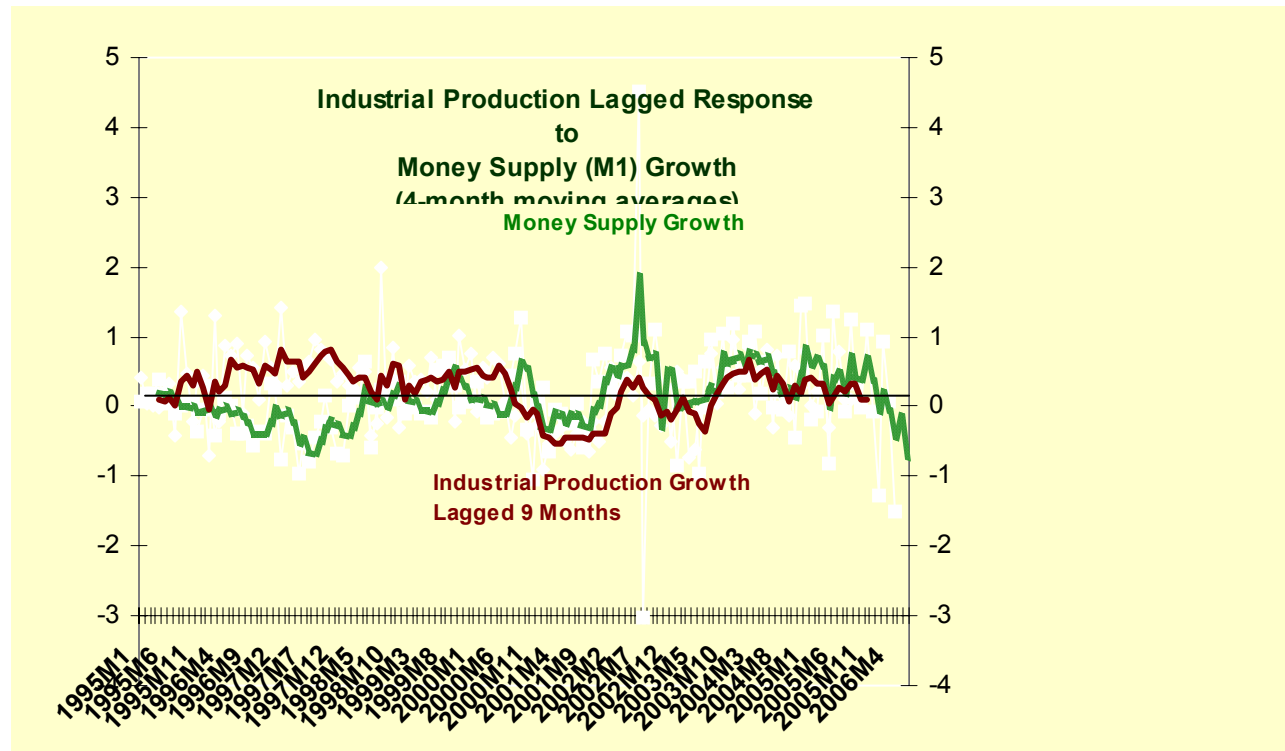
The next chart shows money supply growth since 1998. The huge spike was generated after 9/11 when the Fed pumped a lot of money into the economy to act as a shock absorber. Shortly afterwards, the Fed mopped up the extra money.

It is also interesting to note since the fall of 2001, the Fed has engaged in systematically increasing the money supply for a while and then systematically decreasing the supply, which is what we see in the more recent period. We don't know what the Fed will do now, but we have enough evidence to generate a forecast for the next six months or so.



Money Supply and Industrial Production

The next chart shows how money supply growth, lagged nine months, maps into industrial production. The fit is not perfect, but good enough to draw some inferences about the future.



The green line in the chart shows the money supply path. The red line shows growth in industrial production.

The forecast? The next six months will be slower than the last six months, at least for industrial production.

But wait a minute, we must remember that there is far more to the U.S. economy than manufacturing. Indeed, we are truly a services economy with a strong manufacturing component. What does all this mean to the forecast?

The Supply Chain Institute's most recent reading of the services economy shows that sector motoring on at a fast clip. Put it all together and we get a moderately expanding total economy.

What can hasten it, at least temporarily? Expectations of massive government expenditures and monetary easing.

Looking for Heroes

On June 28, 2005, in *Kelo vs. New London, Connecticut*, the U.S. Supreme Court affirmed a lower court decision saying that the City of New London, Connecticut, could delegate to a private development corporation the eminent domain power to take private property for economic development purposes. The decision, which involved the home and land of Susette Kelo and other property owners, added more than a tinge of uncertainty to the presumed sanctity of private property rights to home and hearth.

The eminent domain controversy came to a head in 2000, when the City of New Haven approved a development plan that projected an employment gain of 1,000 jobs, higher tax revenues, and the redevelopment of an economically troubled city. A new Pfizer Corporation research facility announced for a site adjacent to the redeveloped area was a key element of the plan. Then, a new hotel, shops, and an expanded recreational area were planned for the redeveloped area.

The city authorized a nonprofit redevelopment corporation to move forward with the task of assembling land for the projects. Most of the landowners sold their sites, but nine owners of homes and investment properties involving 15 sites refused to sell. They argued that the Constitution's Fifth Amendment protected their property rights from government seizure when it said: "Nor shall private property be taken for public use without just compensation." At issue was the meaning of "public use."

Over the years and in other related decisions, courts have expanded the interpretation of these words to include public purpose and purpose benefit. In a split decision, the U.S. Supreme Court sided with an expanded interpretation of the constitutional protection.

As a result of the decision, the State of Connecticut and some 23 other states immediately began to entertain legislation that would deny the use of eminent domain for economic development purposes. Some 12 states have passed such legislation, and the U.S. Congress is entertaining similar law.

The *Kelo* case may result in a stronger affirmation of property rights protection. In any event, I am happy to call Susette Kelo a property rights hero.