THE ECONOMIC SITUATION

Bruce Yandle
Dean Emeritus,
College of Business & Behavioral Science, Clemson University
Director, Strom Thurmond Institute Economic Outlook Project
yandle@clemson.edu

To add your name to the report email list, please send an email to Joyce Bridges. She is joyce@strom.clemson.edu.

December 2009

- **Recovery and the year of the tiger. A bumpy road with ghosts from the past.**
- **Financial markets and the outlook for the world.**
- **Oil and gold: An oil price warning.**
- **Combining knowledge and freedom: Which states will lead the charge?**
- **Can the Little Engine help?**
- **Outlook for 2010: A summary.**

Closing the book on 2009, recovery and the year of the tiger.

Robert Arial's cartoon expresses some of the deep frustration felt by people generally when they hear someone say the recession has ended. Try explaining that to the folks at the unemployment office. Closing the books on 2009 will bring many of us a feeling of relief. Memories of 2009 will find a place alongside those of 1929 and 1933 talked about by our grandparents. One thing is certain: The Great Recession will be remembered.

Let's take a look at where we are as 2009 ends and the Year of the Tiger begins.

Yes, according to the Chinese calendar, 2010 is the year of the tiger, which gives Clemson fans something to celebrate. Revered by the Chinese for bringing better times, the tiger, we are told, will ward off the three worst hazards faced by a Chinese family: fire, theft and ghosts from the past.

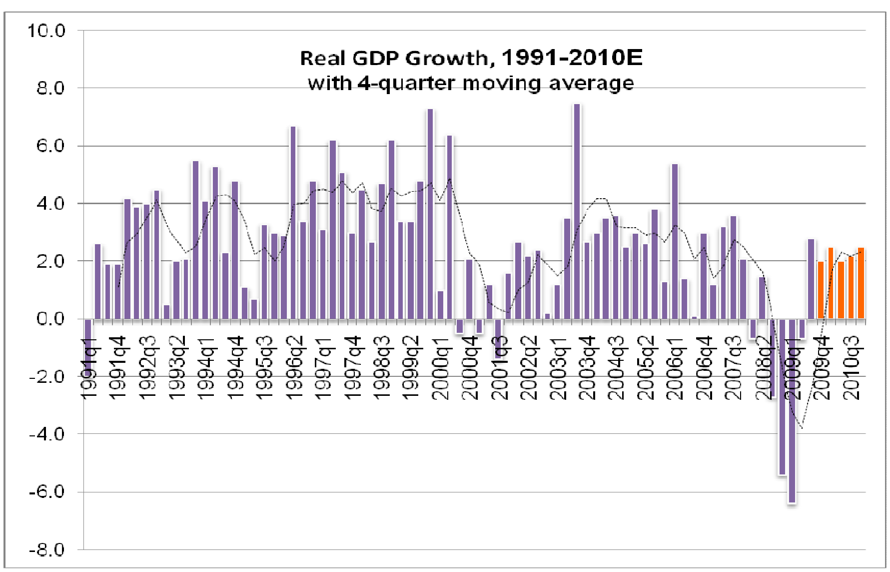
Has the Great Recession ended? For good? Will 2010 bring a happy recovery? What about the recovery's shape? And what bumps in the night will the ghosts bring to frighten us as we travel the road to recovery?

Evidence that the bottom has arrived.

The Great Recession is now a ghost of the past. Of course, this is not the final word on the matter. That will come eventually from the National Bureau of Economic Research when the dating committee makes its final judgment. But with 3Q2009 real GDP growth hitting a revised 2.8%, with Industrial Production showing positive growth for five consecutive months, and with a number of other indicators blinking green, one can mark the end as occurring in mid- to late summer 2009.

Saying that the recession finally ended is not the same thing as saying that happy times are here again. Indeed, happy times for most people are defined by being able to find a job and create wealth. There is a lot of pain that comes with a 90% employed economy. But it is the 90% economy that will eventually pull us forward.

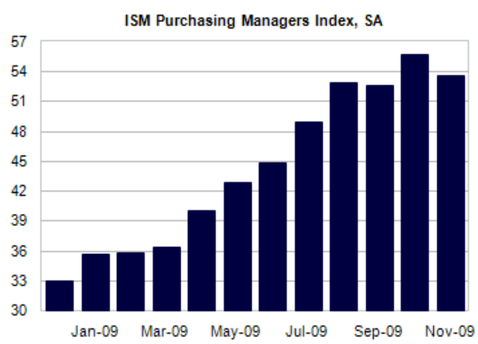
The next chart shows real GDP growth beginning in 1991 and reaching to 2010 estimates. The quarterly data show the severity of economic collapse and by contrast, the sharpness of the 3Q2010 spike. This remarkable economic chatter indicates a chief difficulty encountered in deciphering 2010's prospects. There are real and artificial forces affecting economic performance. Aside from the famous stimulus, which is now better than 30% spent, there are the auto and housing shots in the arm that significantly raised 3Q2010 GDP growth. The stimulus funds continue to creep into the economy, but Cash for Clunkers is gone, and weak October and November auto sales confirm its obituary was not a false signal. The housing stimulus continues, but it too will eventually fade. Their coming and going generate the bumpy growth path I show in the chart.

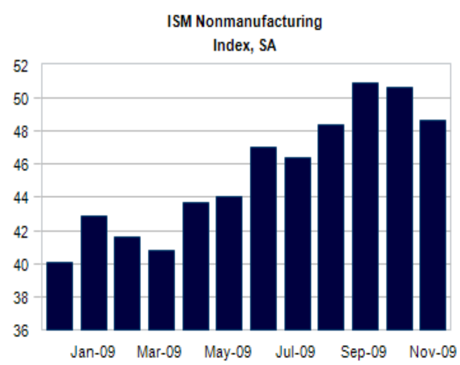


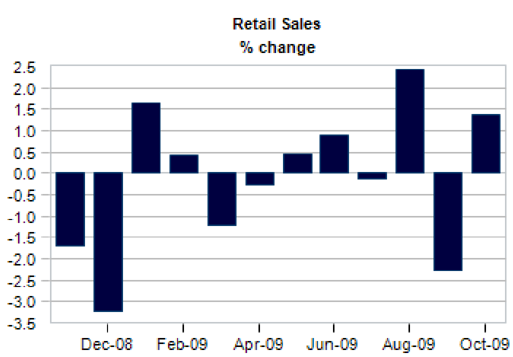
What about the shape of the recovery? V? W? U? Or caterpillar? 
I choose the caterpillar. The recovery path will be irregular, bumpy, and uncertain. Indeed, its shape may change as recovery is occurring. The irregular path is associated with large government interventions that come and go, but eventually, as shown in the chart, positive GDP growth will emerge for the year. I expect 2010 will bring real GDP growth of 2.2% to 2.5%. The low growth rate should continue through 2011.

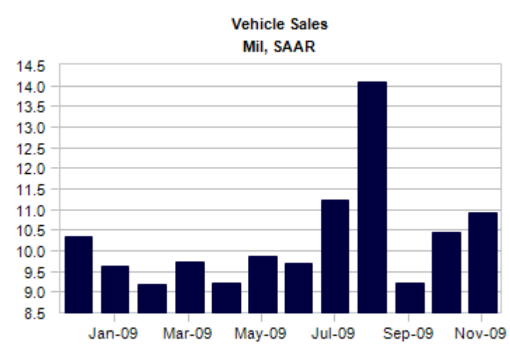
Looking at some of the evidence.

The next few charts may help us identify the strong and weaker parts of the economy. Here we will see the Institute for Supply Management's manufacturing index, which has been in growth territory (above 50) for four months; the ISM's nonmanufacturing economy index until November, was creeping into positive ground, but like the caterpillar has changed shape and slipped into slightly negative territory. The retail sales chart reveals the weaker consumer-driven part of the economy and the resulting chatter in data that reflect consumer behavior; and the auto sales data show what happens when a major government program gets turned on and then off.









Those locked up credit markets.

To some extent, the difficulty faced by consumers and small business operators in expanding horizons has to do with locked-up credit markets. The financial trauma still experienced in banking coupled with more stringent regulatory requirements for reserves and capital has resulted in much higher standards to be met by borrowers who seek loans. Then, with the Great Recession eroding sales, profits, and asset values, the ranks of blue ribbon borrowers have become rather thin. This is not to say that individual banks are not lending, but it does say that taken together lending is still declining. The November 17 Federal Reserve balance sheet data for the U.S. banking systems indicate that outstanding balances for all loan categories other than home equity and consumer lending are still declining. The latter two are not surging, but seem to have found a bottom and are nudging forward again. Part of this stronger activity seems to relate to home improvement activities. It is time to fix up instead of moving up.

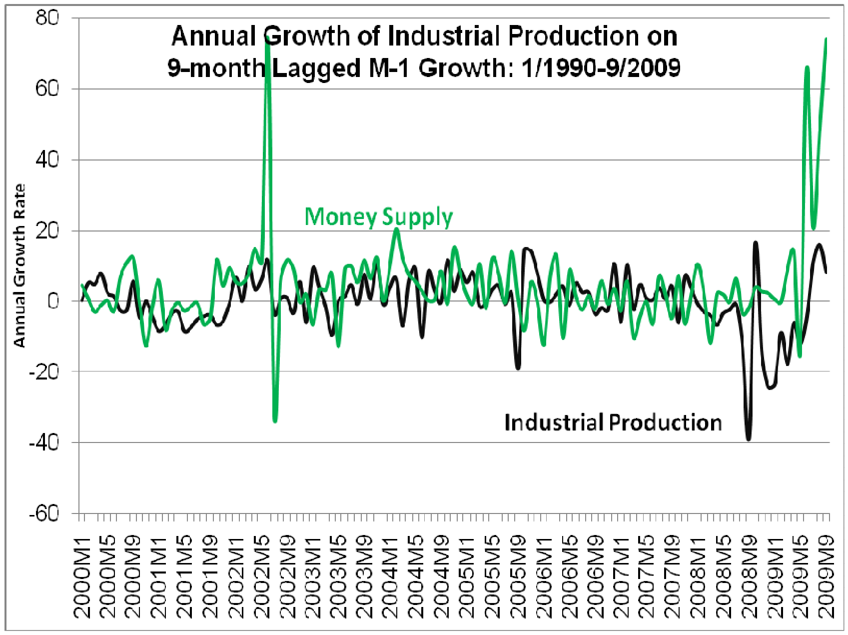
While lending, or, just as well said, borrowing is in the cellar, it not because of a lack of reserves and cash in the system. The next chart shows a long relationship between the growth of money in the economy, in this case, cash and demand deposits, and U.S. industrial production. The money growth is lagged nine months on production. Money injected in the economy this month has a measured output effect nine months later.

The mapped relationship is fairly tight. If you want more output, get more money. But the last few observations are the ones to worry about. There is an explosion of money supply and little output response. Even so, the surge keeps coming.

The potential for inflation is massive. And unlike the 911 spike, which as the data show was mopped up almost immediately, as shown by sharply negative growth in fall 2001, the current spikes are still heading north.

At some point, but not this year, the Fed will face a difficult challenge. To chill inflation's flames, will it sell off part of its huge portfolio of subprime paper and by doing so reduce the availability of money and credit in the economy? Doing so during an economic expansion, not now, will raise interest rates and slow economic activity. Or will the Fed err on the side of keeping the money valves open only to find that even larger brakes will be needed to slow an overheating system? Is there a future bubble on the distant horizon?

With so much excess capacity in the economy and with serious regulatory constraints on lending, it is doubtful that the Fed will face this dilemma until mid- to late 2011.

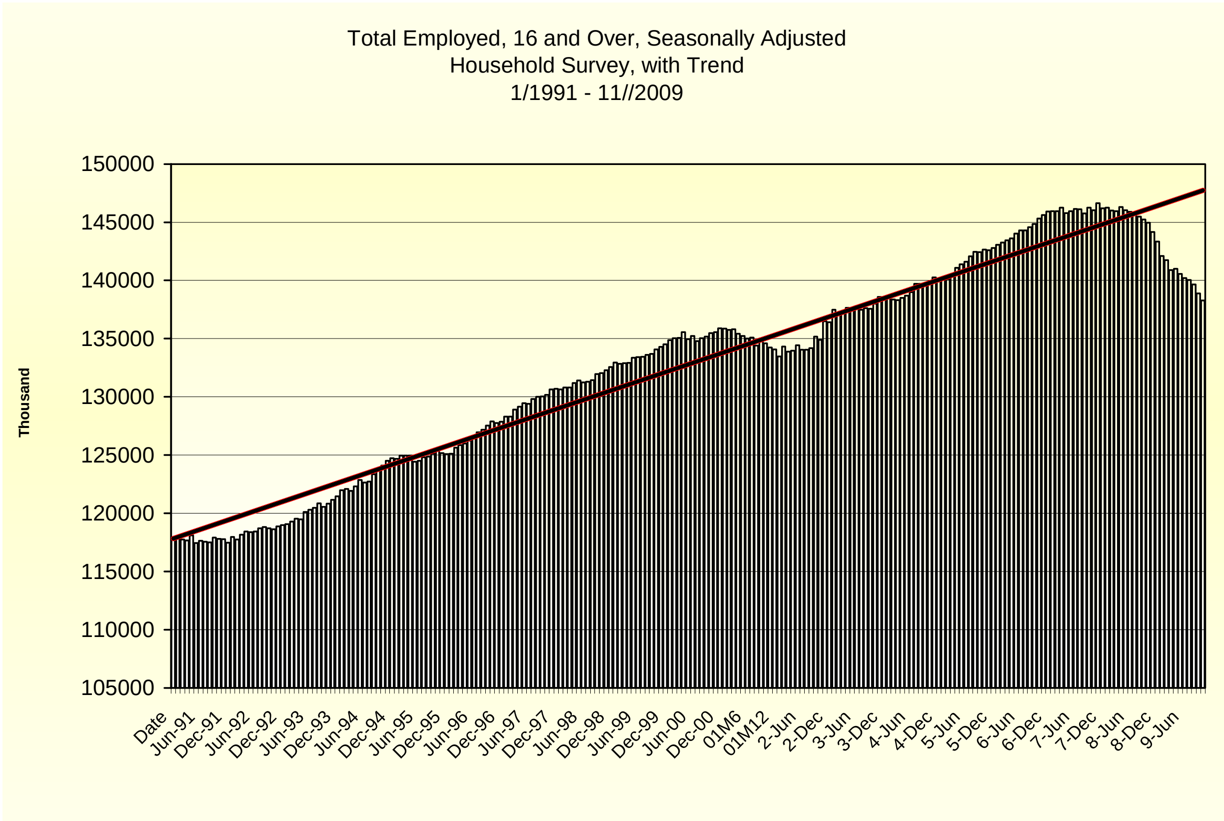


What about employment?

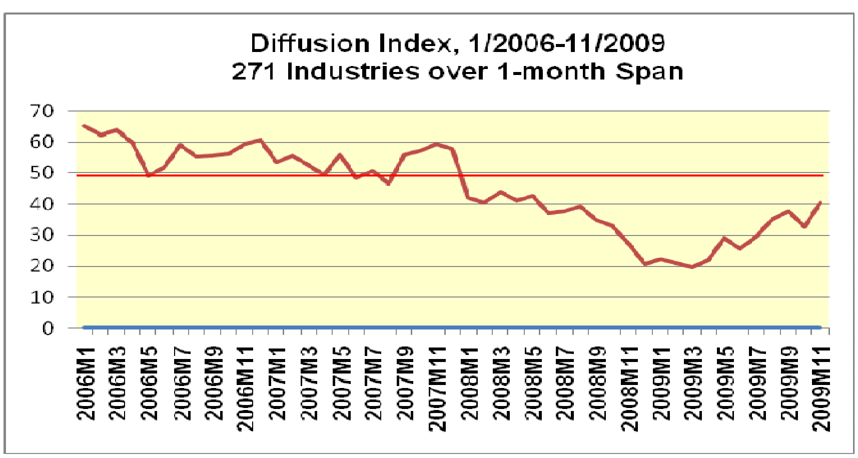
As shown in the next chart, the level of total employment peaked in November 2007 at 146,647 thousand. At the time, the unemployment rate was 4.7%. The current level, 138,502 thousand, is about equal to that of April 2004. To recover to November 2007 levels requires adding some 8.1 million jobs. Generating enough growth to absorb 8.1 million unemployed workers while absorbing a growing labor force will take years, not months.

In 2007, the labor force grew by 800,000 workers. In 2008, a much weaker year, the growth was 600,000. Using 600,000 as the annual expected labor force growth over the next few years, back of envelope calculations suggest that hiring 8.1 million workers plus the new entrants in just one year would require adding 725 thousand jobs a month, an impossible outcome. The average monthly job growth in 2005 was 200 thousand, in 2006, 250 thousand. So let's lower our sights. If we extend to two years, it cuts the necessary addition to 387,000 new hires per month. Still highly unlikely. A three-year profile adds more new entrants, but brings the goal to 275 thousand per month, and that may still be a bit of a stretch.

With U.S. employment hovering at 10% in November 2009, with expectations that it will rise a bit more, we can expect to see an average of 9.5% for all of 2010 and 8.4% for 2011. By 2012, we should begin to see lower single digit unemployment rates again, provided no major disturbances occur along the way.

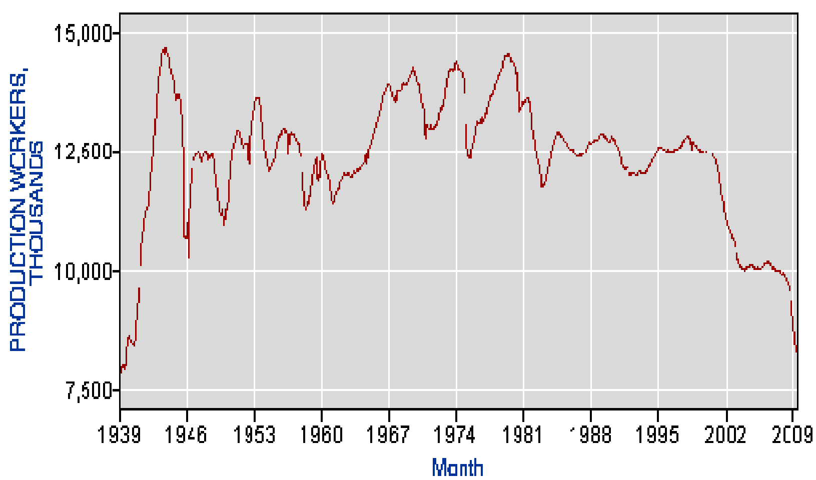


Even with Industrial Production and real GDP rising, there is anemic job growth. This is seen in the next chart that shows the diffusion of job growth in the economy. A value of less than 50 means that less than half of the industries are expanding employment. At present, the value is 40.6. By the way, the diffusion line looks a lot like a sick caterpillar.



The anemic job growth comes about for several reasons. First, employers seeing some growth in demand will extend hours of work, add part timers, and then hire temporaries before bringing back permanent workers. Second, recessions are times when less efficient plants and stores are closed first and sometimes not reopened. These are generally the labor intensive operations. Then, unemployed workers respond to incentives also. Extended unemployment benefits make it possible for those who are hurting from lack of work to look a bit longer before settling for work that may be far less attractive than what they had before being hit by the recession. Finally, recessions bring a search for more efficient production and operations, new software, new management techniques, and more production per worker.

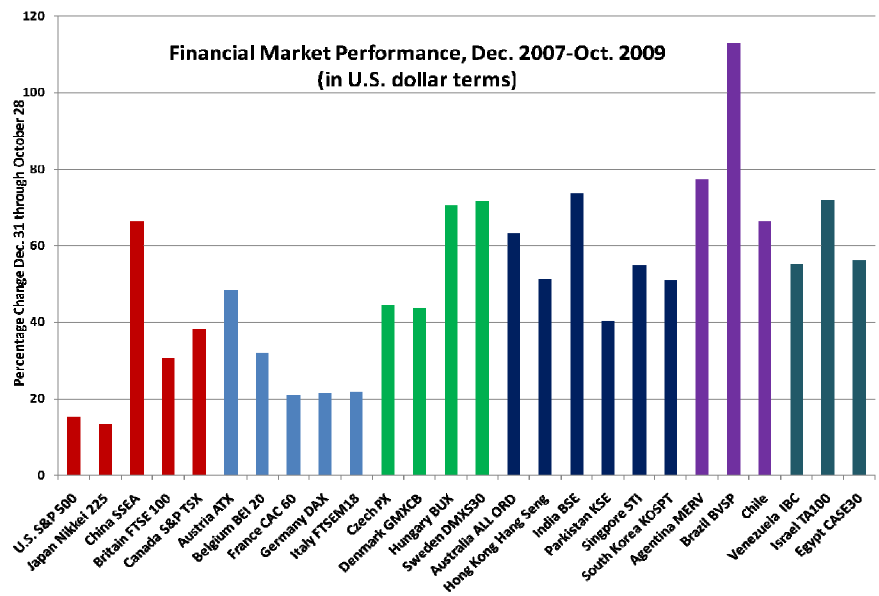
The result of this for production workers is seen in the next chart. Notice that the total number of workers on the U.S. factory floor is now about the same as in 1939. Also note that the total has been falling since about 1977. Remember, please, that this is labor employed not output produced. Even now, the U.S. is still the world's largest producer of manufactured goods.



What do world financial markets say about future prospects?

With the U.S., the United Kingdom and most of Europe still haunted by ghosts of the Great Recession, investors worldwide reveal by their actions just how bright the prospects might be. The U.S. now accounts for some 24% of world GDP. Obviously, most of the action lies beyond our shores.

The next chart is based on data from *The Economist*, which reports stock exchange growth for 12 months, October 2009 over October 2008. The results are sobering, to say the least.

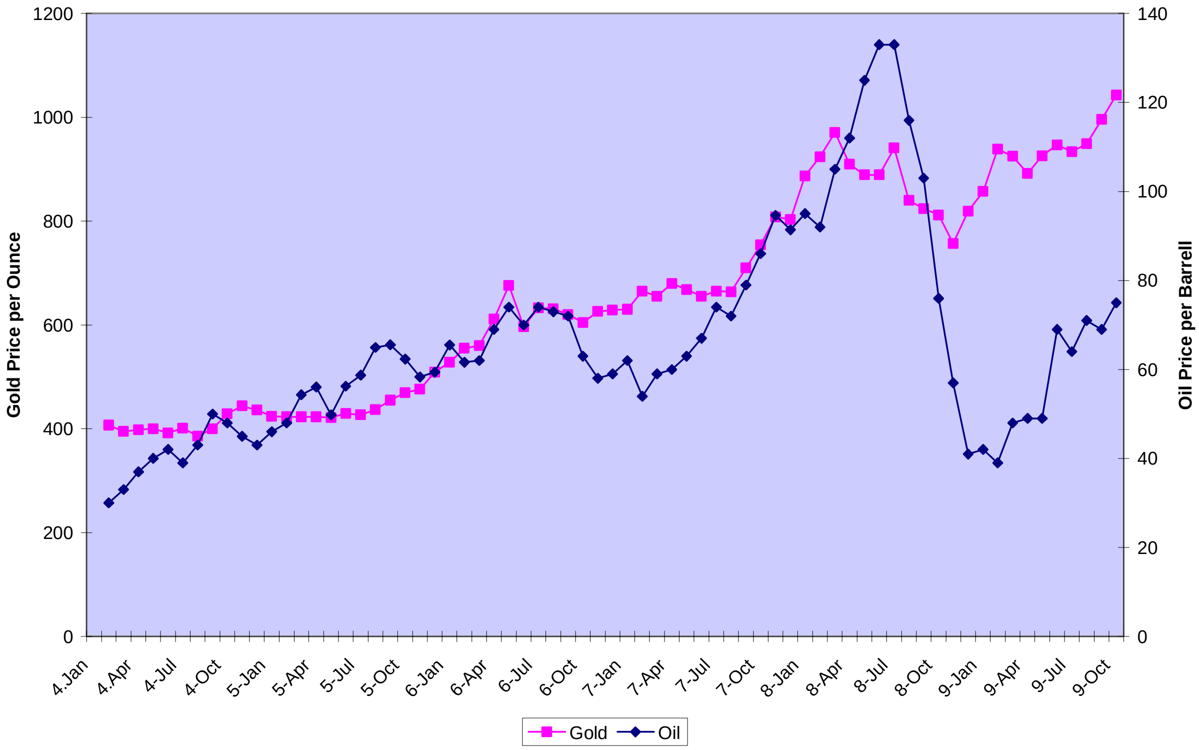


Oil, gold and price prospects.

In an attempt to understand what is happening in crude oil markets, I focus on the price of a barrel of intermediate crude and the price of gold, each expressed in dollars. Generally speaking, oil and gold prices move in the same direction. When they do not, there is good reason to predict that change is in the offing.

I noted an unusual price situation in my mid-2008 Economic Situation report. At the time, the price of oil was out of kilter with gold. The price subsequently fell rather sharply. As shown in the accompanying chart, we now find the price of oil well below the predicted pattern. The prospect? Look for $100 oil in 2010 when the world economy begins to grow again.

Oil and Gold, 2004-2009



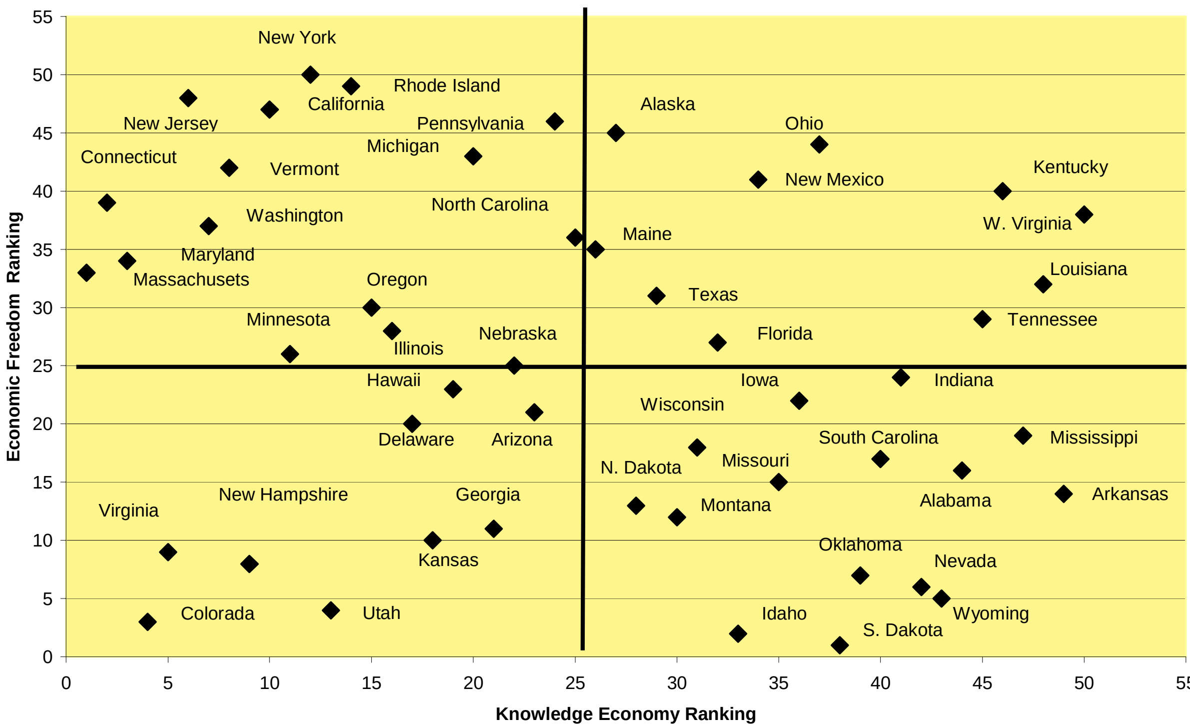
Economic freedom, the knowledge economy and the 50 states.

For the last three years, Clemson graduate students and I have worked to develop knowledge economy indexes for the 50 states and more than 130 southern metropolitan areas. Our work was supported by the South Carolina Research Authority. In earlier work, I participated in building an economic freedom index for the 50 states. Based on more than 100 variables, the freedom index takes account of taxation, regulation, the legal environment and the welfare burden. Both indexes were recently updated using 2008 data.

I have mapped the rankings for the two indexes in the next chart. This shows how the states stack up with respect to freedom and knowledge. The states that enjoy higher rankings for both measures should experience more rapid wealth creation in the coming years. States that rank low in either or both measures will have greater difficulty competing for new wealth-creating activities in the years ahead. For example, we would expect the weaker states to offer greater economic incentives when attempting to attract new industry.

The states in the southwest corner are the strongest, based on the two indexes. Four of those states are east of the Mississippi: Delaware, Georgia, New Hampshire, and Virginia. The others are in the west. The states in the southeastern quadrant have relatively strong freedom profiles but lack human capital. The rougher situation is seen in the northeast quadrant. These are states that rank low in freedom as well as with the knowledge economy index.

2008 Economic Freedom & Knowledge Index Rankings



Will *The Little Engine that Could* help?

The good folks in Anderson County, SC, will eventually confirm what they know at the outset. When mothers and fathers regularly read stories about achievement and good living to young children something good happens…, at least for some children. The relationship between achievement and the theme of achievement found in children's stories was explored years ago by Harvard psychologist David McClelland and reported in his book, *The Achieving Society*. Now, the Anderson United Way and Success by Six are embarking on an effort to provide children's books to each four and five year old in the county each month. The program requires a pledge by a parent or guardian that the books will be read.

Local supporters of the program can provide a book a month to a child for one year for $30. The rest of the cost is taken care of the Dolly Parton Foundation's Imagination Library program. The first book mailed is Watty Piper's *The Little Engine that Could*. Watty Piper's book is Dolly Parton's favorite (and mine). She believes strongly in spurring early reading programs that bring good books to children. In 1996 she put her money where her mouth is and launched her program. In 2008 with Rotary Club and other partners participating, some five million books were mailed.

Books are now being provided to every young child in Tennessee. West Virginia is considering doing the same thing. Georgia and Canada are looking at the program. And according to the Dolly Parton Foundation website, experience with the program is deep enough for the Tennessee Board of Regents to determine that reading readiness improves significantly for children enrolled in the Imagination Library program.

Want to do something to improve human wellbeing? Help a young child develop excitement for reading. And do it by reading *The Little Engine that Could* or one of the other great children's books.

The Outlook for 2010

We have traveled from GDP to children's literature in this report, so it may be helpful to summarize the situation for 2010. Here are the key points:

- GDP growth will range from 2.2% to 2.5% for both 2010 and 2011.
- The unemployment rate will average 9.5% for 2010 and 8.4% for 2011.
- Inflation will remain low, perhaps at 1% in 2010.
- Interest rates will remain tame, with perhaps a 50 basis point increase at the long end of the yield curve by the end of the year.

There are four hazards or ghosts from the past that may disturb the outlook.

- Fear-driven increases in personal savings, which means rebuilding consumer net worth but further reductions in retail sales.
- Rising energy prices.
- A potential for massive inflation or credit market manipulation by the Fed to avoid it.
- Government entanglement in the economy that regulates and otherwise limits economic freedom.

Think what would have happened if the fireman of *The Little Engine that Could* had been required to get congressional approval before using an old switch engine to pull the car of toys over the mountain. After all, switch engines are not supposed to take on such tasks, and the little blue engine had never been over the mountain. "I think I can" might be changed to "I doubt I will get permission in time to do the job."

There's a lot of sand in the gears of the Great American Bread Machine but it is still running. Pass the word.