THE ECONOMIC SITUATION

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Note: Cartoonist Robert Arial has generously allowed his cartoons to be used in the Economic Situation report. To add your name to the report email list, please send an email: economic_situation-l-subscribe@strom.clemson.edu

June 2011

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- **The Employment Picture.**
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- **Four kinds of capital for capitalism.**
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The Economy at Mid-Year

June is that wonderful month with the year's longest days, at least in the northern hemisphere. That means there's more daylight for working, gardening, searching for a job or starting a business.

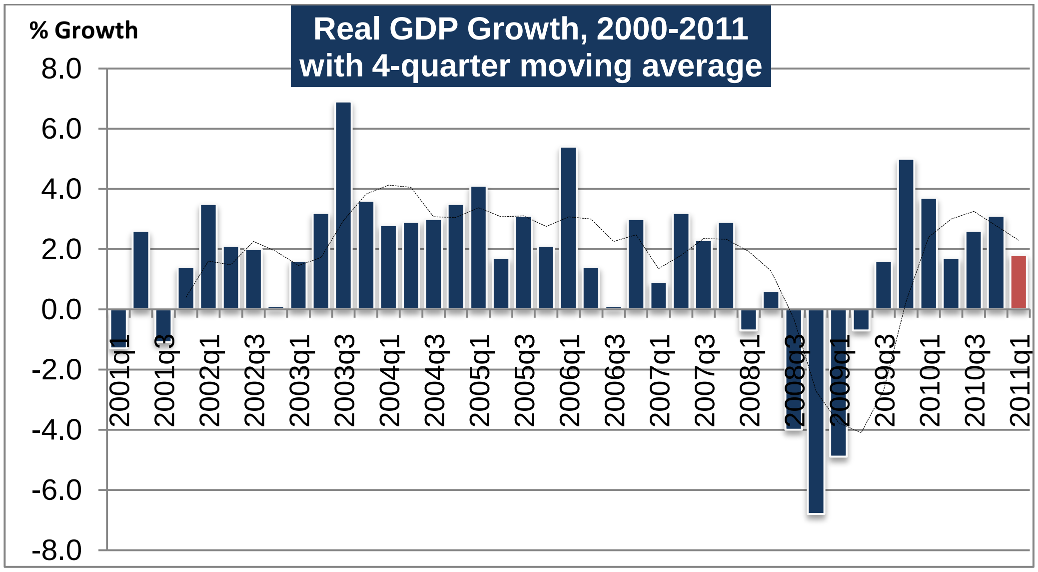
A lot of people are doing all these things in an improving economy, for some, but in a stalled economy for others. And even for those who see things looking better, there seems to be a loss of lift.

What's going on in the economy? Is the loss of lift a fact? Is it the terrible Japanese tsunami, too little spending, high gasoline prices, tornadoes? Or what?

Yes. All of the above. Let's look at some data.

First, a look at GDP Growth

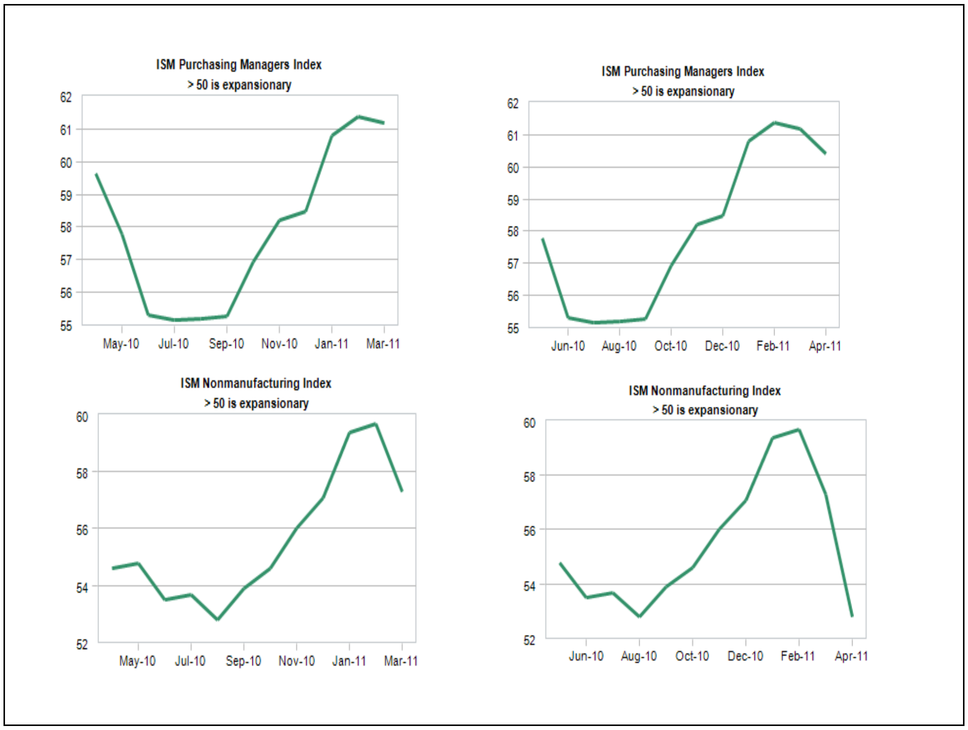
There's no doubt about it, the second estimate for GDP growth for 1Q2011 came in with a pale 1.8% rate, down from 4Q2010's happier 3.1%. Part of the weakness can be blamed on bad weather; it was an unusually cold winter. Another part, on rising gasoline prices, which translate into larger imports. A third on weak public sector spending. A fourth? The Japanese tsunami occurred on March 11, a bit late to have affected first quarter numbers. Put the rest together with an expanding economy, and we get the chart below.



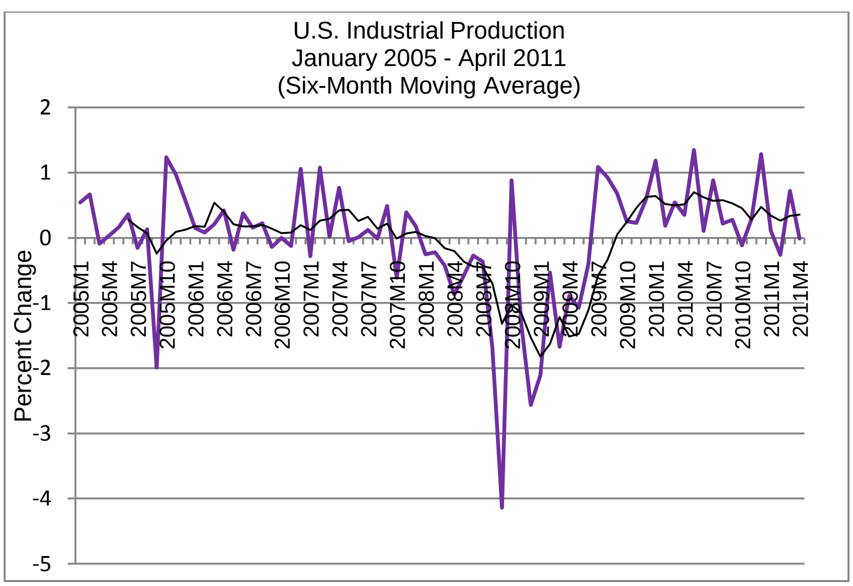
Notice the 4-quarter running average, which is nudging just above 2%. Some forecasters see this year's growth falling close to that number. Others are still smiling about a nudge given by the year-end employment tax cuts. But then there are Japan's problems, tornados in Alabama, Missouri and elsewhere, Mississippi flooding, and, get this, rising expectations for meaningful cuts in federal spending, which reduce estimates for this year's GDP growth but improve the prospects for long-run growth. Slice and dice the data, and something a bit south of 3% real GDP growth seems to surface.

With that said, there's a lot of noise around the estimate. There is also a matter of bank lending. There's not much going on there.

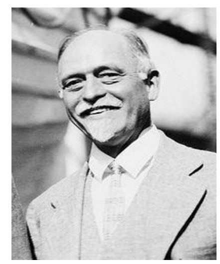
We see evidence of the noise and weakness in the monthly Institute of Supply Chain Management's indicators. To show how much air can escape the balloon in one month, I show next the indicators for March and April. The two left-most charts are for the manufacturing sector; the right-most are for the services economy. Both indicators have values greater than 50, which means growth for the sectors. But the services sector really took an April swoon. The culprit was a lack of new orders entered.



On top of this, April's Industrial Production growth came in with a big fat zero. There were a couple of bright spots in the data, higher production from utilities and mining. But some very negative Japan-related dark spots. Hungry for parts from Japan, U.S. auto production fell 8.9%. The production data are shown next, with a six-month moving average. Notice that the trend points south. Also, notice the sharp 2008 drop and recovery caused by hurricanes Gustav and Ike that curtailed oil and chemical refining and production in the Gulf along with an aircraft strike that practically shut down the industry.



And then there is money. The latest FDIC report on bank activity nationwide for 1Q2011 indicates that total loan and lease balances declined by 1.7 percent, the fifth-largest quarterly percentage decline in loan balances in the 28 years for which data are available, and the tenth time in the last eleven quarters that reported loan balances have fallen. Residential lending continued to fall, as did credit card debt. A small increase in commercial and industrial lending was the report's one ray of sunshine. The report tells us that banks are constrained by too much bad debt and too few credit-worthy borrowers who might be ready to expand their businesses. Yet we know that the economy is expanding. This means that expansion is being fueled with internally generated funds by enterprises that do not depend on banks for capital. The other side of the coin says that smaller firms that do depend on banks are still not ready or able to borrow.

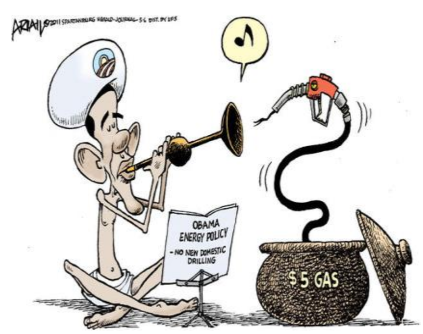


The FDIC report generates memories of the often brilliant economist Irving Fisher (1867-1947) who did pioneering work in monetary economics. Among his notable achievements was the development of a theory of debt deflation. This was his effort to explain the cause of the Great Depression. Debt deflation occurs when a credit bubble collapses, prices fall, and widespread bankruptcies follow. Increases in the money supply can counter the deflation tendencies, if the additional money circulates apace in the economy. Facing weak loan demand, Federal Reserve quantitative easing, which is scheduled to end in June, is an effort to prime the pump with printed money. The FDIC data tell us the pump is still not catching.

In summary, my three favorite indicators, Supply Chain Management , Industrial Production, and Money Supply Growth show a weakening economy.

This is the time to revise 2011 GDP growth rates from 3.2% to 2.8%.

What about $4.00 gasoline? Is that taking a toll?



Yes. A few things to consider. The average family now spends 5% of its income on gasoline. The share was 2% two years ago. The collective increase means there is less to spend on other things. What are some of those things? Retail sales and other data suggest lower spending is hitting the following: household formations, meals eaten away from home, household furnishings, longer vacation trips.

Higher fuel costs take their toll directly and indirectly. We can see the $50.00 or more purchase registered on the pump, but we cannot be as conscious that an important part of higher food prices is driven by transportation costs, or that food manufacturers are making package sizes smaller to keep down unit costs…, all due to rising energy prices.

The cartoon suggests we will see $5.00 gasoline before long. And until the data softened recently, it surely looked that way. The longer trend still points to higher prices. The data are also pointing to something that may put the squeeze on them. The Obama administration is now accelerating approval of drilling permits.

As someone has said, higher prices are the best remedy for higher prices.

The Employment Picture

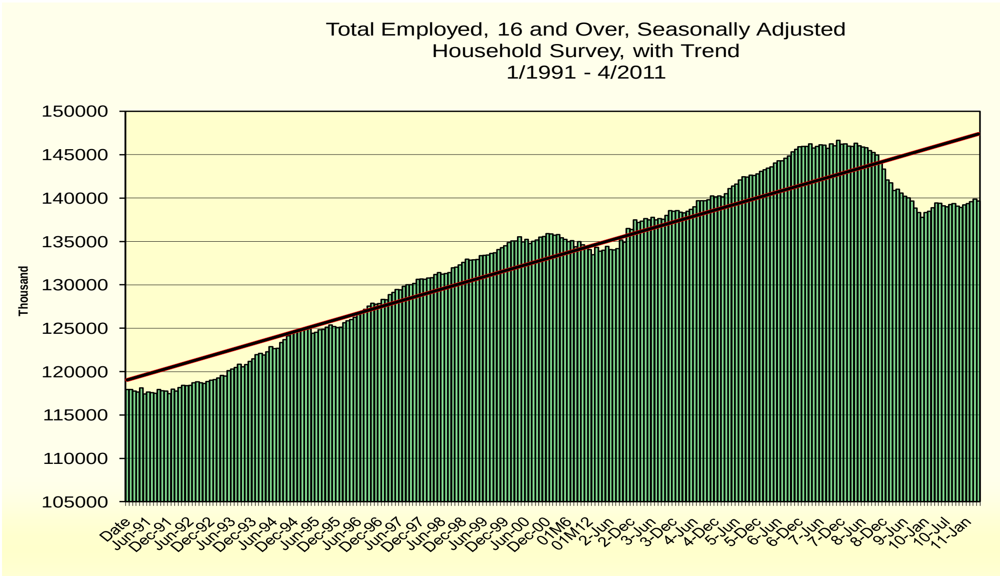
Looking for work

The economy is now in an expansion phase. That's better than recovery. Expansion means that the level of GDP is higher than it was when the recession started. The economy is creating wealth, lots of manufactured goods, and a higher level of services, but not a lot of jobs. When we received April's strong reading on employment growth, 244,000 workers added to payrolls nationwide, Antony Davies at Duquesne University, commented that at that rate, it would take 16 years to return to the employment level of December 2007. Why? It takes about 200,000 additional jobs each month to accommodate normal growth in the labor force. In April, we gained 44,000 jobs for recovery.

Some of those new entrants recently walked off graduation stages nationwide. And while it is definitely a buyers' market, the outlook for this year's graduates is a bit brighter than it was last year. There are bunches of new jobs created each month, and lots of new hires, more than six million in the quarter that ended September 2009. It's just that the number of jobs that disappear has been greater than the number added. Obviously, we have a massive, highly dynamic job machine. Recently minted graduates can make it in today's knowledge economy. But it's just almost impossible to absorb unemployed construction workers when construction is practically dead.

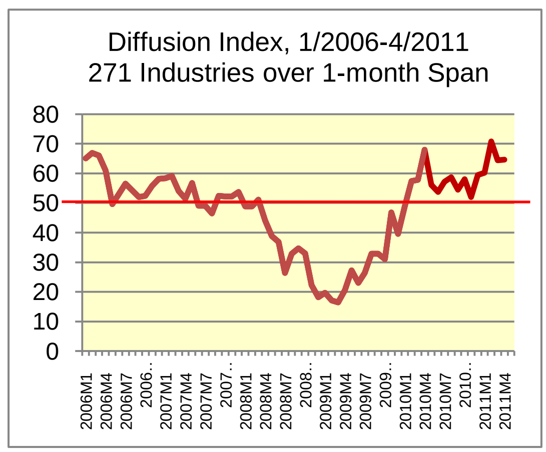
Taking a look at the record

The total employment picture is shown in the next chart. I call attention to the tall bars that go above the trend line in the years 2002-2007. A lot of that high employment was associated with construction and what came to be a massive misallocation of resources to housing. The underemployment cavity seen in the chart is hardly being filled. At the current pace of job creation, it will take a long time to fill the cavity.



But let's focus on the donut, not the hole. After all, we have an expanding economy, even though it is still sputtering.

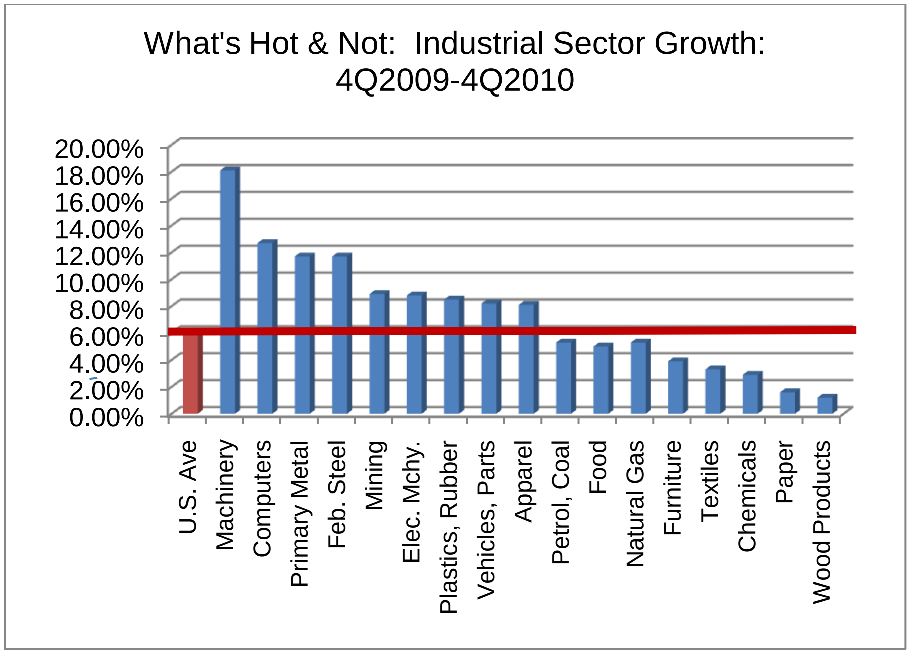
Along those lines, consider the most recent reading on how jobs are being spread across industries. This is shown by the Bureau of Labor Statistics diffusion index. As seen in the accompanying chart, we have an awakening economy. The magic number is 50. When the value is greater, more sectors are gaining jobs than losing them.



But which are the hot industries? Where is the expansion strongest?

I turn to another data source to provide a reading on the top industries based on the growth of the Federal Reserve Board's industrial production indexes. This is shown in the next figure. I show the national average for all industries as a red horizontal line in the figure. There we have it: Machinery, Computers, Primary Metal, Fabricated Steel, Mining, not the sort of stuff we see at Wal-Mart and Target, but the stuff that America produces for the world. There is still a widespread belief that the U.S. is no longer the manufacturing giant it once was, a belief based on what the average one of us sees in retail stores when shopping.

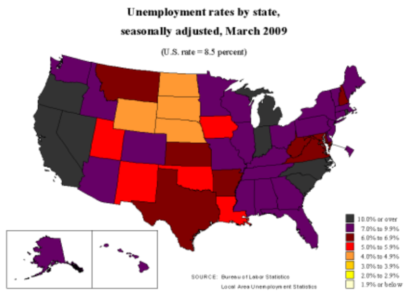
The U.S. is still number one in manufacturing. Pass the word.

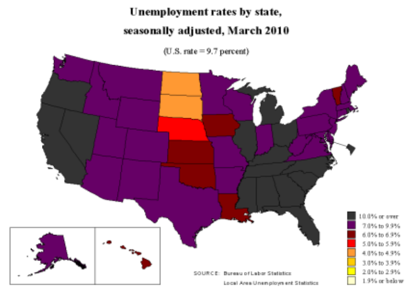


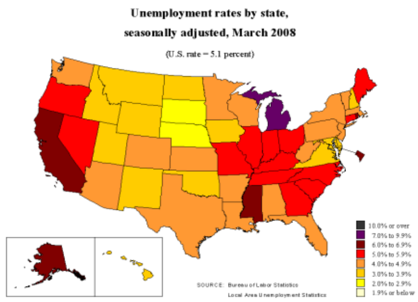
Where the jobs are

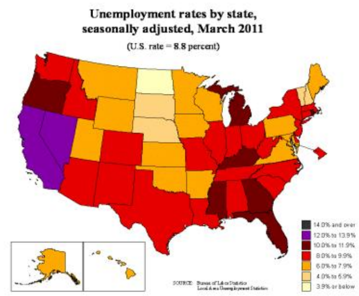
But where, geographically, do we find job growth? Which states are hot, and which ones not, when it comes to employment? Notice that the answers to these questions do not square with where production is highest. Why? Job growth is in services, not in manufacturing.

We get an angle on geographic employment gains by considering unemployment rates across the 50 states and how they have changed. In the next composite, we see unemployment charts for March of 2008, 2009, 2010, and 2011. The darker the color, the higher the unemployment rate. Letting the eye move clockwise from the southwest chart to the northwest and then northeast and southeast chart gives a powerful indication of decline and recovery.







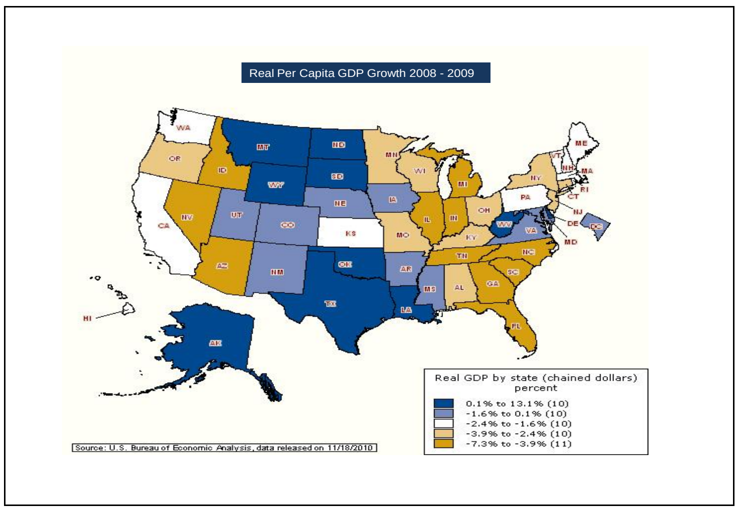


Notice that the March 2011map is beginning to look a bit like 2008…, finally. Notice also the strength in the middle of the country. Some of those wonderful square states did not turn purple or black. Those golden states are energy producers—ethanol, natural gas, oil, and coal. They are also high educational attainment states.

Those thinking about investing in municipal bonds may want to focus on the gold.

Linking to state GDP growth

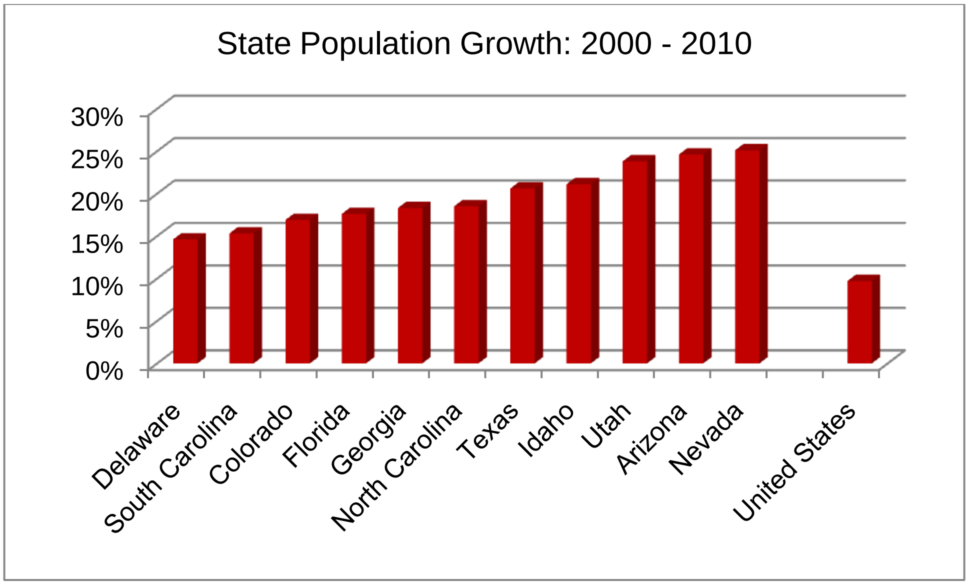
While in the mood to examine maps, consider state GDP growth. In the next chart, I show state real per capita GDP growth for 2005-2009, with states divided on the basis of positive (blue) and negative (mustard) growth. Once again, we see those square states holding forth.



The next chart shows the same data with five growth-rate separations. It contains more information. Again, we see an economy that expanding outward from the middle. The darker blue states have positive growth rates.

Interestingly enough, some of the higher GDP growth states also have higher population growth, but the relationship overall is weak. Part of population growth is driven by immigration from outside the U.S. There are also other factors at play. For example, my research findings with colleague Tate Watkins indicate that holding income opportunities constant, work-age migrants, both foreign and domestic, are attracted to states with lower taxes and higher freedom as measured by the Mercatus Center freedom index.

I provide next the top tier of states based on population growth for 2000-2010.

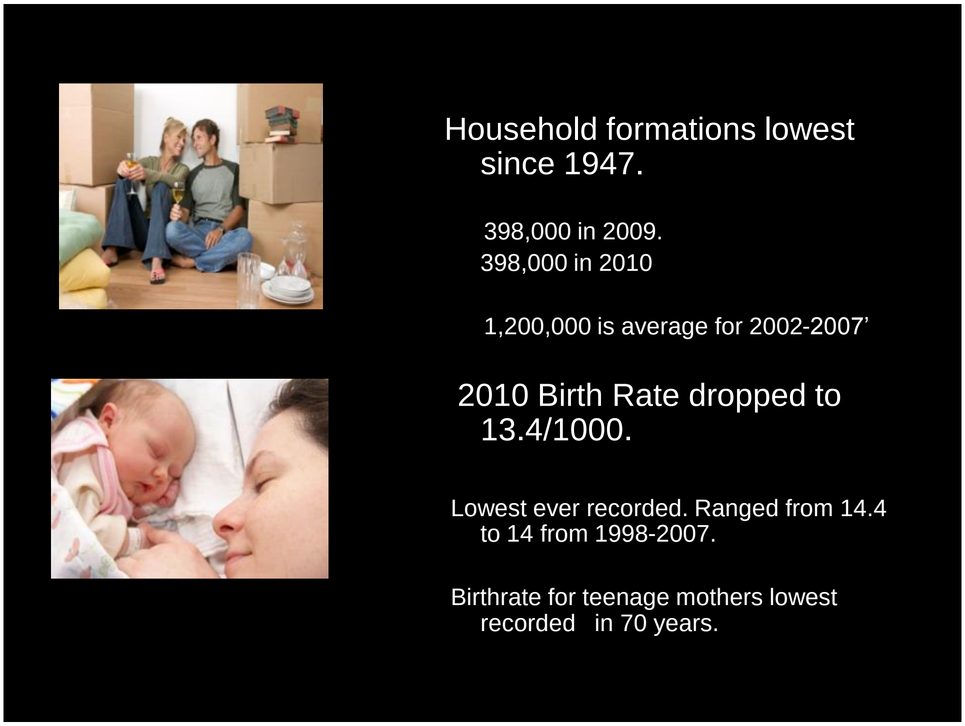


When viewing this data, we must recognize that the Great Recession's effects occurred from 2008 forward.

Is a Great Recession Generation Forming?

We must always be cautious about identifying trends on the basis of a few observations, but there is no harm in calling attention to what the data are telling us. Over the last few years, rather amazing demographic and social change has occurred with respect to household formation and the birth rate in association with difficulties faced by those caught in the backwash of the Great Recession. As indicated in the next box, household formations have plummeted over the most recent two years for which we have data. Of course, the marriage rate has fallen, and the birth rate has dropped. The decline in household formations comes at a time when owners of empty houses would love to see just the reverse.

If the trend continues, and that is a big if, then we might witness a Great Recession generation. This means a sag in the population and another group of people who may be influenced to save before spending and to earn before asking.



Four Kinds of Capital for Capitalism

A common definition of capitalism refers to private ownership of the means of production and freedom to invest, disinvest, and enter and exit different economic activities, all with protection of property rights and enforcement of contracts under a rule of law. The system allows freedom to succeed and freedom to fail. The gains and losses accrue to individual risk takers. There are no bailouts. More often than not, efforts to encourage economic growth and development focus on attracting **physical capital** to a state or region, an appeal to capitalists with emphasis on getting more machinery, buildings, and other assets that will combine with labor to produce goods and services demanded by consumers wherever they may be located. Successful efforts often generate headlines like this one:

BMW to Invest $750 Million in S.C. Facility.

Those are powerful words, the kind we celebrate. But physical capital is just one of four kinds of capital. For wealthier human communities to emerge, the other three are required. In fact, it will be hard to get physical capital to come your way without some amount of the other three.

Human capital quickly comes to mind when we think of a second form of capital. Investment in healthy minds and bodies forms human capital. It is an individual investment with an expected positive life-time rate of return. We know that manufacturers and service providers look for locations where educational attainment is high. And we know that successful firms invest in their workers by way of training and healthcare programs. They do this even though there is a reasonable risk that the improved workers will change jobs later. Just as we cheer when we read of physical capital coming our way, we celebrate headlines that say: **581 Graduate at Tri-County Tech** because we believe this means more human capital will be at work in our community, which means a better life for the graduates and the rest of us.

We also know that there is more to human capital than education. In a recent conversation about employment I heard about the difficulty of finding qualified workers to hire even in today's high unemployment economy. I was told that firms have four common tests: 1) drugs, 2) credit, 3) math skills, and 4) language skills. Trying to find entry level hires who leap the first two hurdles is not easy.

But healthy communities require more than the joining together of machinery and educated workers with managerial guidance to produce more goods and services. Healthy communities require that investments be made in **civic capital**. Civic capital defines communities and enriches them. Not many firms want to expand where civic capital is in short supply. In fact, it is commonplace for owners of regional firms to reward local executives who engage in the production of civic capital. Of course, the affected executives can find other work if community service offends them. But successful firms know it is hard to prosper in an unhealthy community.

Whether it be business leaders working together to welcome newcomers and introduce them to community activities, men and women volunteering to support scout troops, the arts, high school athletic and debate teams, the YMCA, organizing the next block party, planning the next expansion of the regional airport, or home schooling parents joining together to build jointly sponsored music and athletic programs, flourishing communities require networks that generate civic capital. Organizations that range from

Audubon Society, Rotary, and United Way to the Ayn Rand Institute are calling for volunteers. When we live in a viable community, we drink from wells we did not dig. If our communities and favorite organizations are to flourish, we must do some digging.

The fourth form of capital serves as glue for the other three and, when present, helps to keep down crime and avoid costly enforcement of contracts and protection of property rights.

Moral capital represents investments people make in such things as teaching children to do the right thing. Things like telling the truth, keeping promises, getting to work on time and then giving an honest day's work for an honest day's pay. It takes a lot more police, court rooms, and jail cells to operate communities where moral capital is in short supply.

Capitalism means many different things to different people. Capitalism is derived from a word that means "head" or mind. Life tends to improve and flourish when creative minds are able to organize **physical capital** and **human capital** in locations where people have voluntarily invested in **civic capital** and **moral capital**.

It takes all four.

Final Thoughts

I had the rare pleasure a couple of weeks ago to go back in time more than 40 years and interact with a group of industrial machinery distributors who were visiting in Greenville. I was a part of that business from 1952 to 1967 and, believe it or not, some of the same firms are still flourishing. I had been asked to make a presentation on the economy and to offer comments on changes across the economy that might affect the distribution business.

At the very outset, I mentioned that during the years I was in their business, we spent very little time talking about or even thinking about the U.S. economy. Yes, it mattered when things were slowing down or speeding up, but we knew two things: First, there was little we could do about world economic forces and second, whether recession, recovery, or expansion, we faced one real challenge: How to take better care of customers than our competitors and thereby generate enough positive cash flow to keep the doors open and have something left over.

I was reminded of the times in business when we announced, “We are starting a new contest. Those who win get to keep their jobs.” We said this to ourselves, with a chuckle.

Well, it was never quite that bad, but it did get close.