

THE ECONOMIC SITUATION

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Note: Cartoonist Robert Aial generously allows 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

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- **Finding prosperity pockets.**
- **Housing and energy: Two silver linings.**
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Is the Great American Bread Machine gaining speed?

As 2012 comes to an end, how is the Great American Bread Machine faring? Are we about to move from the pale-growth doldrums and shift into passing gear? Or will 2013 bring more of the same?

There was a glimmer of hope in the November 29 Department of Commerce second estimate for 3Q2012 GDP growth. It looked like good news..., at first. The growth rate was revised up to 2.7% from the previously announced 2.0%. This followed 1.3% growth in 2Q2012 and 2.0% in the year's first quarter. After that, 2.7% looked mighty good, but still a long way from the 3.5% growth we once thought of as normal.

But probing a bit deeper, brings doubt that 2.7% is the real thing. Consider the growth drivers. Inventory investment. Residential investment. Exports. Defense spending, Is the inventory build-up intentional or does it represent disappointed sales. Will the defense spending continue apace or does the surge represent an effort to get ahead of future budget cuts? Time will tell, of course. This said, we can safely bet that homebuilding activity is on the side of the economic angels. More on this later.

Consider what forecasters are saying about 2013 and 2014. Not a single one that I can find calls for anything close to 2.7% growth in the next two years. As indicated in the accompanying chart, the more recent the reading, the more pessimistic the outlook.

GDP Growth Forecasts, 2013 - 2014

Forecaster	2013	2014	Date
Bloomberg	2.1%	2.0%	10/5/12
CBO	0.5 – 1.7		11/9/12
Conf. Board	1.8	2.4	11/14/12
IMF	2.2	2.1	10./12
Moody's	2.1		11/5/12
NABE	2.4		10/15/12
Wells Fargo	1.6	2.2	11/8/12
WSJ	2.4		11/5/12
World Bank	2.4		6./11

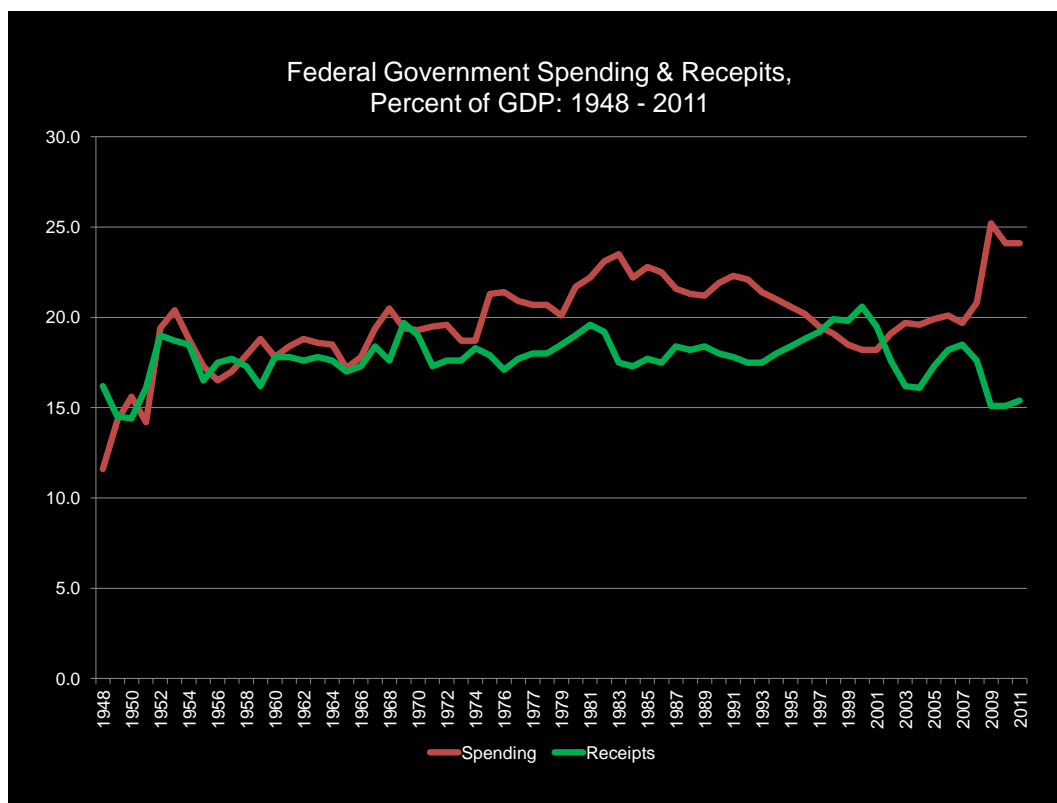
The forecasters say 2013 will be non-stellar, perhaps no better than 2012, and that 2014 will look a lot like the current year. Buried behind the numbers lie differing assumptions regarding the fiscal cliff. These are seen most vividly in the Congressional Budget Office estimates. CBO shows a range. The low estimate accompanies higher taxes and budget cuts if the economy rolls over the cliff. The upper estimates assume meaningful action is taken to avoid the crash.

Of course, headlines report continually that Mr. Obama's agents are meeting with congressional leaders on the fiscal cliff. Indeed, references to the fiscal cliff as a location are so frequent that I wonder when it will get a zip code. If the talks are long lasting will the negotiators



be called cliff dwellers? But wherever the meetings occur, the matter under discussion is indeed serious. As described by cartoonist Robert Aial, the consequences of doing nothing are pretty well understood. Unfortunately, we also understand that unpleasant actions can be postponed again, and again, and again. At least until world currency and credit markets force our hand. But unlike Greece, the U.S. has no bail-out buddy large enough to come to our rescue.

While cliff negotiations are couched in terms of whether to cut more spending or raise more taxes, there is an overwhelming reality that has to enter the discussions at some point. Well, at least it should enter the discussion. Consider the data in the next chart. Here we see federal receipts and spending as a percent of GDP for the years 1948-2011. Notice that receipts have exceeded 20% of GDP just one time, and that was in conjunction with four years when GDP growth exceeded 4.0%. In sharp contrast, expenditures have been above 20% of GDP many times. The data suggest the sheep love to be led to greener pastures but there is only so much wool the sheep will give up in a given year. Clip too close to the skin and the sheep stop growing wool.

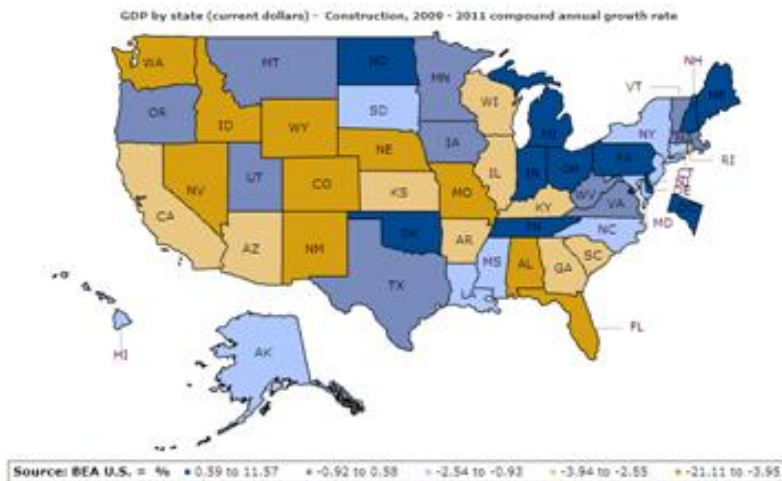
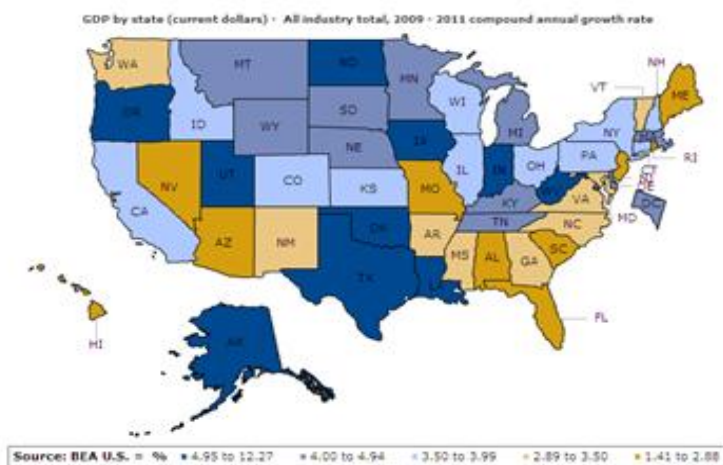


The data also remind us that expenditure growth has been almost unbounded since 2001. And there is no lack of explanations as to why this has happened. No matter what, though, the data tell us that if we are to get out of the deficit trap, long-run spending plans should conform to long-run revenue generation possibilities. A sick

economy will not generate much revenue growth, and a sick economy with higher taxes will generate even less. Two points should be made here. First, the cliff debate needs to be about tax revenues not tax rates. Second, as painful as it will be to pull off, and it will be painful, cutting expenditures to fit revenue expectations is the order of the day.

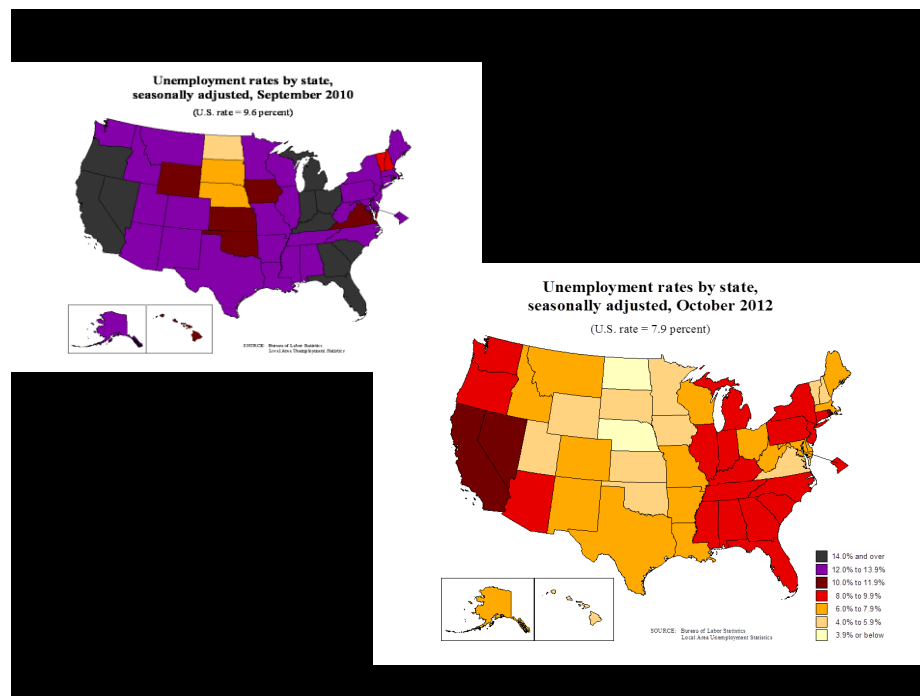
Finding Prosperity Pockets

Fortunately, even pale GDP growth generates pockets of prosperity in a quilt-like pattern across the U.S. State GDP growth is higher across oil, grain, and auto-producing states and boosted a bit in states with recovering construction activity. The outcomes are seen in the next two charts. The first shows total GDP growth rates for states, 2009-2011; the second reports construction GDP growth, 2009-2011. By the way, for those advising recent college graduates on where to settle, the blue states are the locations of choice.



Labor market improvements

Pockets of prosperity may also be seen in lower state unemployment rates. Shown below are outline maps for September 2010 and October 2012 state unemployment rates. While improvements can surely be appreciated, prosperity is seen from the middle of the country out, with the grain, energy, and higher educational attainment states showing greater progress.



But unemployment rates rise and fall on the basis of individual preferences and incentives for staying in the workforce or pursuing some other option, such as attending a community college or starting a small business. Operators of business are not counted as employed! This brings up another way to check on labor market pulse beats. Shown next are data on job openings across the U.S. economy. In building the chart, I selected data for September for the years 2002-2012.

Two things seem to jump out from the chart. First, the economy is surely generating demand for labor; job openings are recovering. Second, there is little growth as between 2011 and 2012. The movement from 2010 to 2011 is much larger than from 2011 to 2012. Apparently, Europe's problems, tax uncertainties and slow growth in Asia have taken the edge off the job machine.

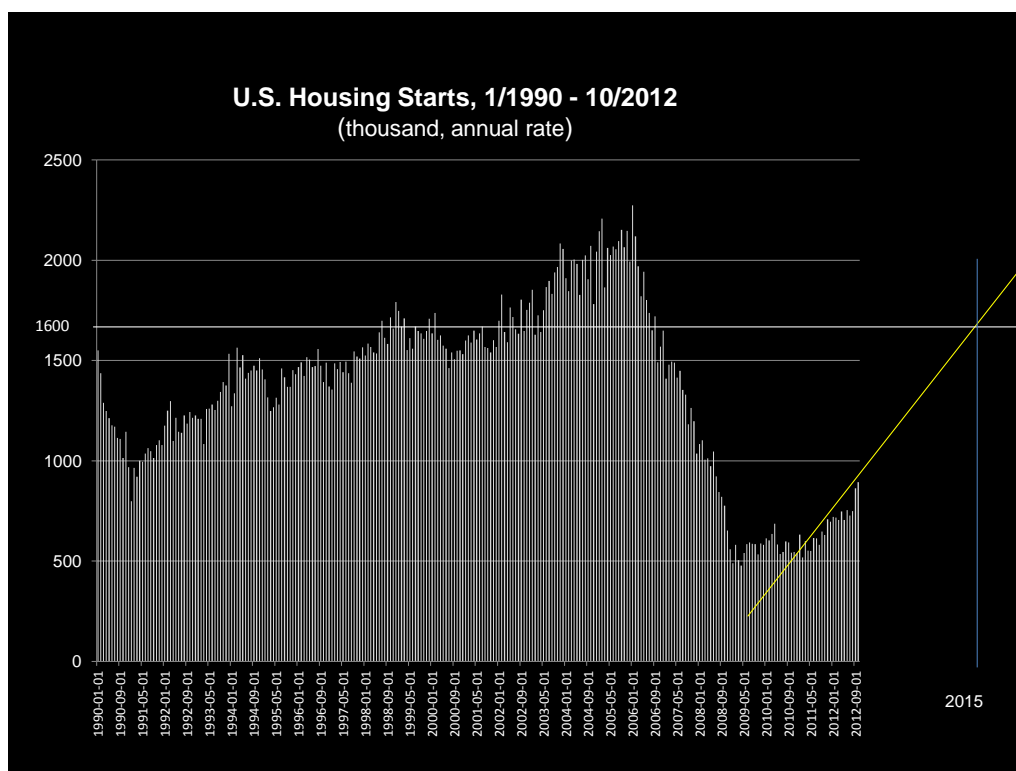


Housing and Energy: Two Silver Linings

The housing recovery

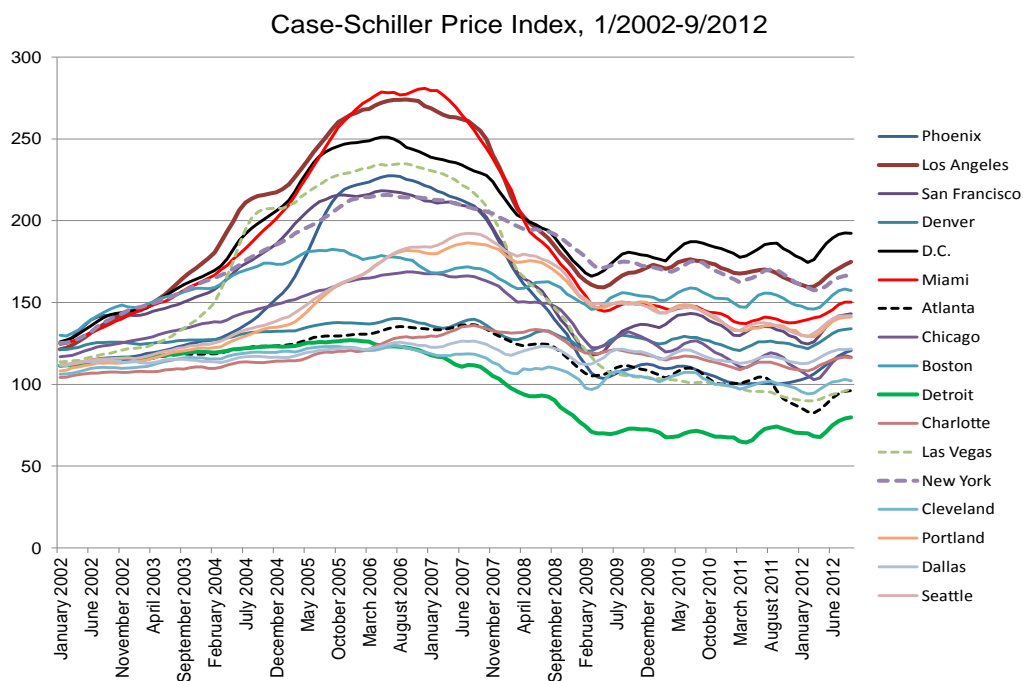
Staring too long at the fiscal cliff can cause one to become pretty pessimistic about future prospects, but if we look around a bit, we will find a bit of silver in the cloudy skies. So get ready for some good news.

The housing sector offers the first sliver of silver. Monthly housing starts are beginning to look healthy again. As indicated below, the taller bars for the last two months are getting tall enough to be noticed. Better yet, a trend seems to be forming that suggests the nation could hit the long run annual average of 1.6 million new units by 2015. If so, stronger construction activity will generate job growth in the hard-hit housing sector. But before getting carried away by two very positive data points, let's admit that two observations are hardly enough to form a trend. But it's still fun to think that they might!



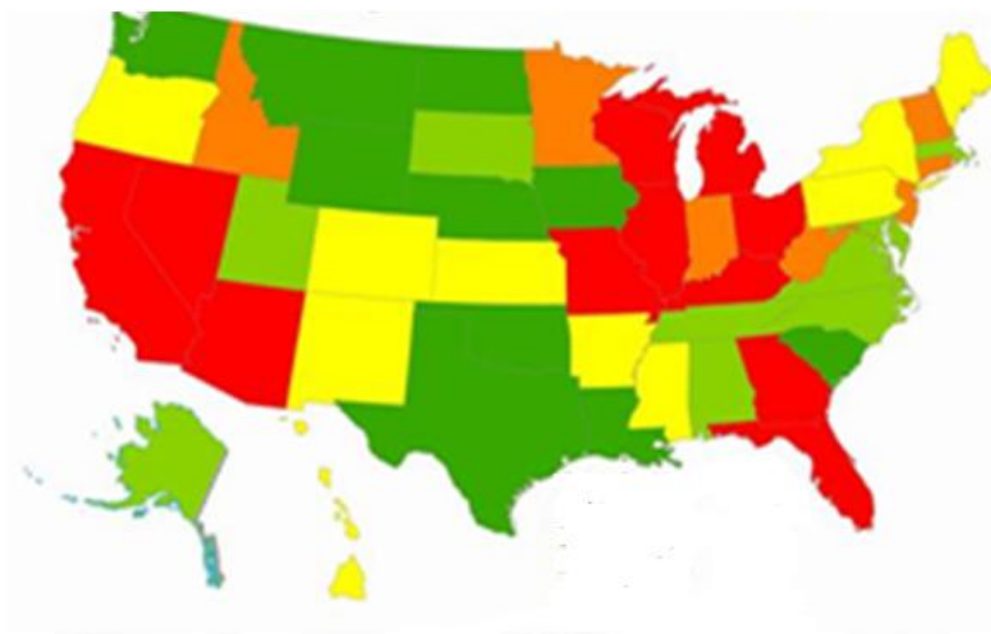
Rising prices and homebuilding outlook

Improvements in the price of houses sold across major metro areas provide another piece of evidence that housing is in a recovery phase. The next chart shows data for selected cities from the S&P Case-Schiller Index. Notice first how prices rose through the bubble years for a number of cities, then fell sharply, and are now rising again. Included in the most expansive cities are Miami, Los Angeles, D.C., Las Vegas, and Phoenix. Also note that Detroit, Cleveland, had other things going on and Dallas sort of missed out on the bubble. In a number of cases, city indexes are back where they were in September 2003.



Firm and rising housing prices may not look so good to first-time home buyers who are enjoying a bargain basement bonanza, but the picture is rather pretty for bankers who are holding below-water housing loans or bank-owned real estate. Rising prices help hard-pressed families and their bankers avoid bankruptcy and insolvency.

As an indication of homebuilder improvement, consider data provided by the National Association of Homebuilders. The outline map here gives forecasts for 2013 housing construction recovery relative to the norm for each state. The dark green states are predicted to be 70% recovered by 2013. The lighter green, 61%-70% recovered; yellow, 49% to 61%; brown, 45% to 49% and the red states to be less than 45% recovered.



Energy discovery: The best news yet

The housing story is about recovery. But the energy story is about discovery, discovery of new drilling and recovery technologies, discovery of massive deposits of recoverable oil and gas, and importantly, discovery that government regulators may at least pause in their effort to rein in fossil fuel production. Today, natural gas is slated to be the fastest growing fossil fuel, worldwide, and the U.S. is the major player. When combined with vast newly identified oil reserves and the long recognized U.S. position as a leading coal producer an amazing picture emerges.

What a difference 40 years or so can make. Are you old enough to remember April 18, 1977 when President Jimmy Carter came on the TV screen to talk about America's energy crisis? In his talk he told about forming the U.S. Department of Energy, which now spends about \$9 billion annually on energy research and subsidies. He went on to describe government pursuit of alternative energy as the moral equivalent of war. Those were turbulent times.

Never one to pull punches or exaggerate sparingly, Mr. Carter brought the tough news this way:

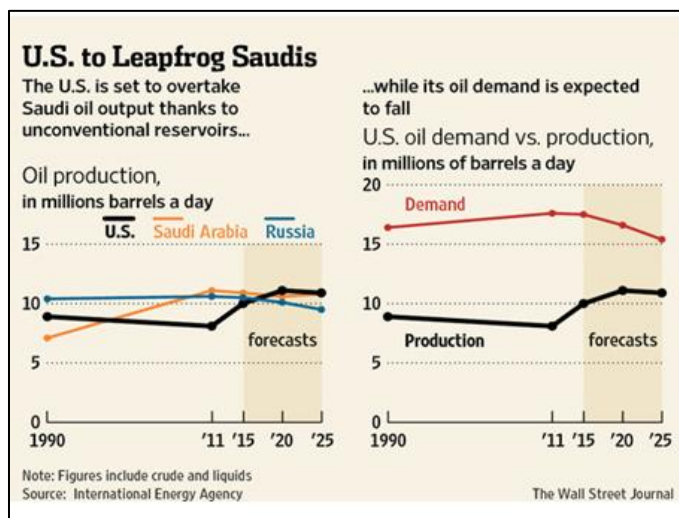
"Tonight I want to have an unpleasant talk with you about a problem unprecedented in our history. With the exception of preventing war, this is the greatest challenge our country will face during our lifetimes. The energy crisis has not yet overwhelmed us, but it will if we do not act quickly. It is a problem we will not solve in the next few years, and it is likely to get progressively worse through the rest of this century.... Our decision about energy will test the character of the American people and the ability of the

President and the Congress to govern. This difficult effort will be the ‘moral equivalent of war’—except that we will be uniting our efforts to build and not destroy.”

Along with the new Department of Energy, in 1980 Mr. Carter led the formation of the Synthetic Fuels Corporation (SFC), a public/private venture that spent some \$2 billion pursuing coal gasification, tar sand and shale oil production with little to show for the efforts. Finally, the scandal-plagued SFC was put to rest in 1986.

While recalling those tough times and failed policies, consider by way of contrast where we are now.

According to the latest International Energy Agency estimates, the U.S. is predicted to displace Saudi Arabia as the world’s largest oil producer in the year 2020. This combined with the explosive growth in gas production and our huge coal deposits along with Canadian and Mexican production could make North America energy independent on a free trade basis. The sudden shift in supply makes the U.S. the world’s low-cost energy producer.



When viewed soberly, it is amazing that all the stories about peak energy and running out of fuel, have floated down the drain without making so much as a whimper. It is equally amazing that no major news shows have presented a panel of displaced expert doomsayers to ask them what they think about the good news. Should this happen, much like those who make failed promises regarding the end of the world, the much celebrated experts would likely say ‘It is just a matter of time. The forecast is the same. The date is different.’ Through it all, the experts keep their reputations and will be called on again..., or so it seems. The world seems to love scientific pessimism.

Why aren’t people dancing in the streets? Why hasn’t Washington called off the subsidized hunt for alternative fuels? And why have Washington regulators just mandated 54.5 mpg American fleet fuel economy standards for the year 2025?

Obviously, there is more going on here than energy policy. On the environmental side, there is concern about the use of fracking in natural gas production, worry about climate change and distress about carbon emissions. But this is just one side of a bootlegger/Baptist story. On the bootlegger side there are petroleum, natural gas, and coal producers who are worried about the sudden change in relative energy prices, worried to the point that at the behest of President Obama they joined with environmentalists and government regulators in affirming an April 2012 presidential Executive Order that formed a public/private partnership to coordinate energy policies

(some would say to cartelize production). Just as bootleggers and Baptist like Sunday closing laws that shut down legal outlets for booze. Some environmentalists and energy producer like coordinated federal actions that limit production, keep prices high, and subsidize favored technologies.

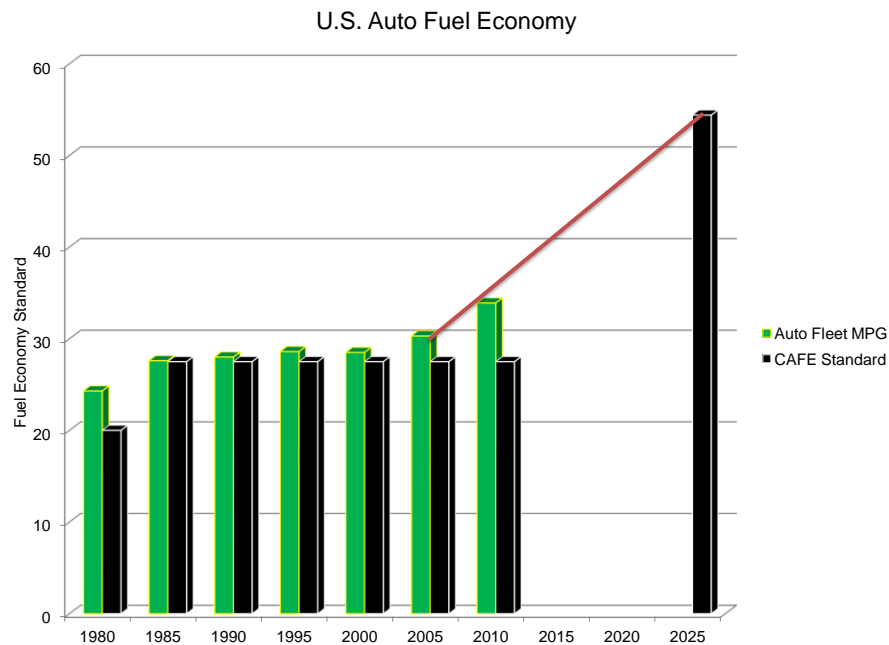
Planning for the past and hoping for the future

It is interesting, to say the least, that Mr. Obama would have celebrated in August the newly announced 2025 fuel economy standards just at the time that fuel is becoming more abundant and cheaper. Mr. Obama indicated that the new standards “represent the single most important step we’ve ever taken to reduce our dependence on foreign oil.” The standards call for the U.S. newly produced fleet to achieve 54.5 mpg in 2025, with 35.5 mpg being achieved in 2017.

On reviewing the new standards, Phyllis Cuttino, director of the PewClean Energy Program said “Our nation will be more secure, our environment will be cleaner, and consumers will have more money in their pockets as a result of the new rule.” Transportation secretary Ray LaHood indicated that the standards would save Americans more than \$8,000 a vehicle by 2025 in fuel costs, an amount far exceeding the \$2,000 to \$3,000 of added cost for more fuel efficient vehicles.

But if all this is true, why on earth must government force the regulations on the market? Either something is missing in the calculations or we are a nation of morons, and I’m betting on the former. And what is it that is missing? How consumers discount future savings when making decisions in the face of uncertainty, how consumers respond when gasoline prices go down instead of up, and how consumers build their own preferred bundle of vehicle attributes.

Consider the challenge. The chart below shows fuel economy standards in black and U.S. fleet economy achievements in green going back to 1980. The slope of the line that connects recent achievement to 2025 requirements indicates required inter-year progress for hitting the target. It is a steep slope. In 20 years, the average must move from 30 mpg to 54.4; this requires a gain of 1.2 mpg each year along the way. There is no doubt that vehicle producers can meet the technical challenge. But there is great doubt that producers can successfully market the associated product to American buyers who will likely be enjoying cheap gasoline and other fuels. Consumers are still free to choose, at least when it comes to automobiles. Past efforts to force feed fuel efficient vehicles into the market at times when gasoline prices were in the basement were unsuccessful.



Of course there is much more going on here than reducing the flow of foreign oil. For environmental purposes, the new standards are as much about carbon emission reductions as fuel economy gains. But every knows that unilateral action taken by any nation to reduce carbon emissions, even one as large as the U.S., will make no difference in carbon concentrations so long as the developing world—read this as China and India—offset the gains.

In a real sense, we are mandating a fuel economy future based on past scarcity realities and hoped for gains in global carbon emission reductions. The 2025 mandate will generate a lot of frustration and cost.

If Only One Book

From time to time all who are known to love books are asked for reading recommendations. This happened to me recently after a lecture when a college senior introduced herself and asked a hard question: What one book, just one, would I recommend she read to gain market-based insights into the economic situation. I suggested a couple and after talking with her decided I would pose her question to a group of friends. I did this and received responses with lots of duplicates. Here's the results. Lots of oldies but goodies. Perhaps there's an idea here for a Christmas present, which should be cheap. These books have been around for a while.

One Book to Read

De Soto, Hernando	The Mystery of Capital
Bethel, Tom	The Noblest Triumph
Friedman, Milton	Capitalism and Freedom
Friedman, Milton and Rose Friedman	Free to Choose
Hayek, Frederich	Constitution of Liberty
Hayek, Frederich	The Fatal Conceit
Hayek, Frederich	Road to Serfdom
Hazlitt, Henry	Economics in One Lesson
O'Rourke, P.J.	On the Wealth of Nations
Pirsig, Robert	Zen and the Art of Motorcycle Maintenance
Rauch, Jonathan	Government's End
Ridley, Matt	The Rational Optimist
Rand, Ayan	Atlas Shrugged
Rand, Ayan	The Fountainhead
Rand, Ayan	We the Living
Sowell, Robert	The Conflict of Visions

And now for the wrap up. I provide a short summary of what I expect we will see in the year ahead.

2013 U.S. Outlook

- GDP growth will range from 2.0% to 2.5% across 2013.
- Wealth is being created.
- Housing and construction are gaining new life.
- Energy is America's wunderkind.
- The unemployment rate will stay in 7.5% to 8.3% range.
- Inflation will rise to 2.0%-2.5%.
- Interest rates will be tame, with some increase at the long end of the yield curve by the end of 2013.
- Gasoline prices will see only modest increases.

Hazards or ghosts from the past that may disturb the outlook.

- Government entanglement in the economy that regulates and otherwise limits economic freedom.
- A huge deficit that must be dealt with. Taxes? Cut spending? Print money?