THE ECONOMIC SITUATION

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GDP Growth: Too Good to be True

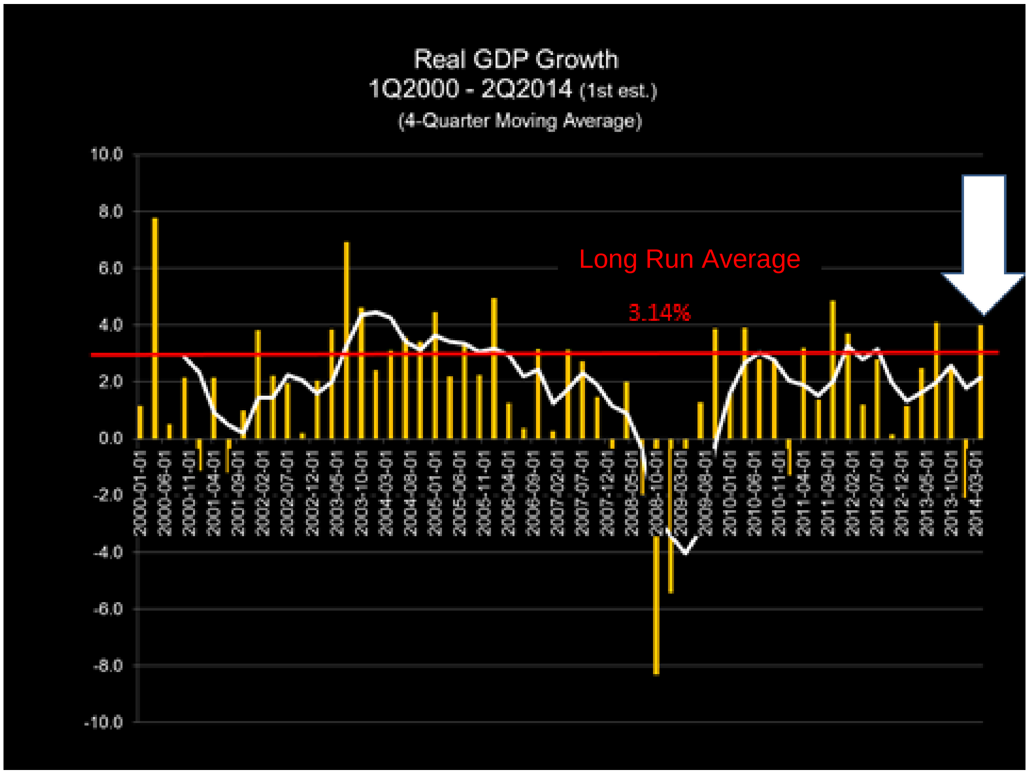
In the June Situation report, I promised a better second-half economy. I did more than keep my promise. The second estimate for 2Q2014 GDP growth brought a steaming 4.1%, along with an earlier revision of lQ2014's growth from minus 2.9% to minus 2.1%. We swung high after swinging low.

Is this too good to be true? I am afraid so. Are we headed toward a steaming second half? No steam, but better than lukewarm positive growth. Look for calm waters.

I am not suggesting that Commerce economists fudged the number. No, not at all. What I am saying is that 1.66 percentage points of that 4.0% came from increased inventories. Subtract the 1.66 and you get 2.3%, which is closer to the real thing. The problem here relates to intended versus unintended build-up. If all producers taken together believe the economy is moving into high gear, then more packing the store is called for. But if those producers made an earlier miscalculation, the unintended build-up will be corrected. It's final sales that count.

I think there is some miscalculation reflected in that 4.0% number; we should look for 2.3% in 3Q2014 and 3.0% in the year's final quarter. If that happens, GDP growth for the year will hit 1.7%. That's a bit pale considering that 2013 hit 1.9% and 2012, 2.8%.

As shown in the accompanying chart, which gives estimates for 2014 and 2015, at least one other forecaster agrees. I call attention to the general agreement that 2015 will generate 3.0% growth.



U.S. GDP GROWTH
Recent Forecasts

	2014	2015
Conference Board	1.5%	2.9%
IMF	1.7	3.0
Kiplinger	1.5	3.0
Wells Fargo	1.4	2.9
Livingston Survey	2.2	3.0

Recession in 2018?

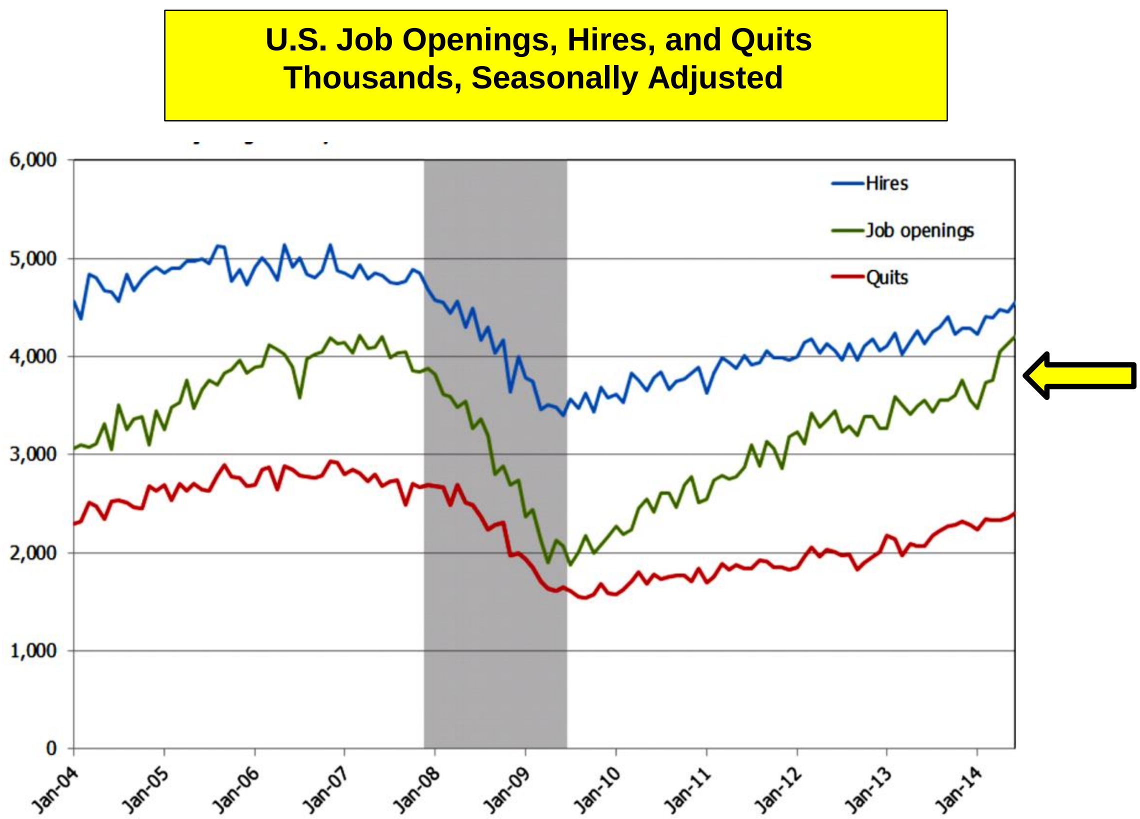
Expect 1.5% to 3.2% real GDP growth, 2014-2017. Recession in 2018.

For much of the year, in presentations around the country, I have included this orange-backed summary of GDP growth expectations. In just one of these events, someone in the audience objected. “I don’t know of any other economist who is even talking about a recession…, any time,” was the comment. I responded by explaining why I was predicting a 2018 recession. My forecast is based largely on the fact that the United States has a recession about every five years, and that most of those were caused when the Federal Reserve Board, out of fear of inflation, hits the monetary brakes, and the economy hits the ditch. With this expansion long in the tooth, but still lacking evidence of meaningful inflation, I hold the opinion that inflation will show up and then get a Fed stiff arm around 2018.

For what it's worth, I am no longer a Lone Ranger on the matter. "How long will the expansion last"? asked the August 16th *Economist* (p. 22). The answer? Until 2018. The logic? The same as mine. Of course, this doesn't say to mark your calendars and batten down the hatches. We could both be wrong. It does say that there is an historical and an analytical basis for expecting a recession in about three to four years.

Job openings, quits, and hires

Without even mentioning recession, an August report from the Bureau of Labor Statistics provides another metric on our expanding economy. Monthly data on the number of job openings, the number of job quits, and the total number hired reflect the vibrancy of U.S. labor markets. When things are tough, people hold on to their jobs; the quit rate falls. When the number of job openings expands, more hires immediately follow. The accompanying BLS chart shows a healthy increase in the number of job openings, which can reflect improved certainty about the future economy, and offers the prospect of strong employment gains.



But what about the Ukraine and trade wars with Russia?

But before placing bets on 3.0% for 2015, trade war actions have to be taken into account. In the hope of cooling things in the Ukraine, the U.S. and much of Europe have imposed increasingly stringent economic sanctions on Russia. Now experiencing negative GDP growth, Russia has responded with embargos on agricultural products from the West. The effects of the Russian move on the United States are expected to be minimal overall. Unlike European countries that have huge export sectors, just 13% of U.S. GDP is generated by export sales. In 2013, the U.S. shipped $1.3 billion in agricultural products to Russia, less than 1% of total U.S. exports.

But the situation is different for Europe. Russia is a large export destination for many Euro countries. Prior to the ban, export-dependent EURO zone countries were themselves just barely generating positive GDP growth, and Germany, the heart of Europe's engine was teetering on going negative.

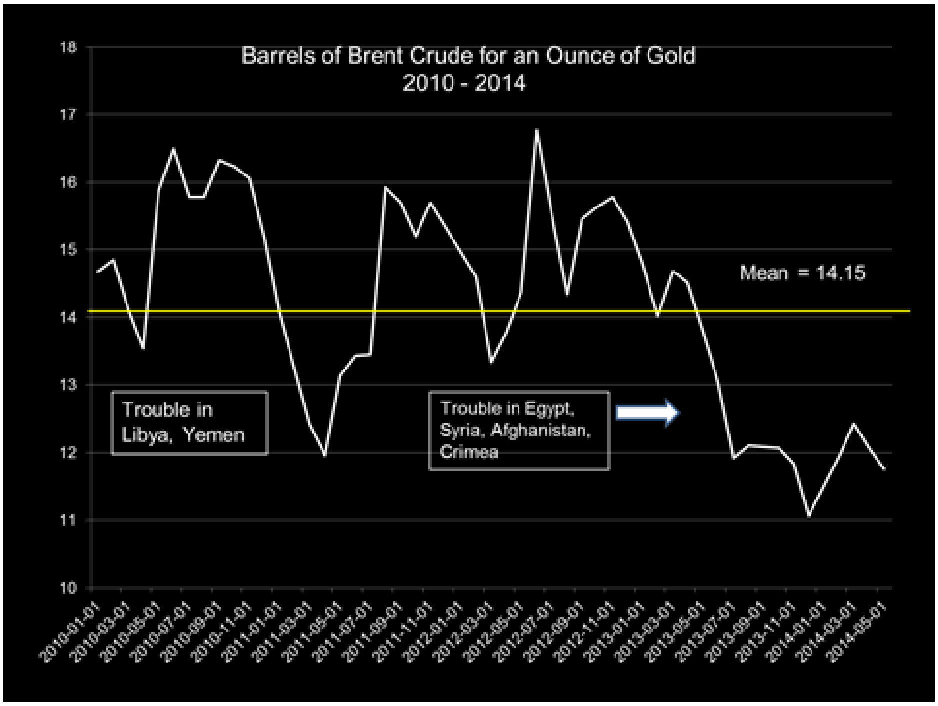
A weaker Europe takes some wind out of our sails.

Roughly 17% of U.S. exports go to European destinations. Just to give a feel for the range of possibilities, if Europe's imports from the U.S. fall to zero, our GDP would fall by 2.2 percentage points. We would be in the tank. But our Europe-bound exports will not fall to zero. A 20% decline, which is a more believable number, would bring a U.S. GDP growth reduction of 0.4 percentage points.

In spite of the horrors of wars around the world, including trade wars, the U.S. economic expansion should continue…, at a slightly slower pace.

And then, there are those pesky petroleum price increases

Yes, there is more than one cloud on the horizon. Rising crude oil prices have to be considered. I next show monthly data for the number of barrels of crude oil that can be purchased with an ounce of gold. The data cycle around a mean of 14.15 barrels. Note that when oil becomes expensive in gold the line in the chart heads south.



Focusing on the more current data points, we see the effect of disturbances in Afghanistan, Iraq, and Crimea. But while oil has become dear, when expressed in terms of gold, the recent increase in price is still not large. The hard blow came in 2013. For now, the data appear to be cycling around 12 barrels an ounce. I do not think that this development will have a measurable impact on the U.S. economy.

Resource Curse: Part Two

A second glance at the oil/gold chart calls attention to the two periods when the price of oil has soared. (In the chart, one sees a sharp drop in the series.) Both have to do with political instability in oil producing countries. In fact, it is the presence of oil that assures the instability. Today, hords of people led by war lords, would-be billionaires, and clerics struggle to stretch their barbed wire around the wells that produce the black gold. Many decades ago, colonial powers took a similar approach. Relgious fanatism may be part of the current tactical strategy for seizing the wealth, but it's a safe bet the struggle would lose lots of steam if the wells suddenly went dry.

The resource curse in natural resource studies refers to a tendency for nations or tribes of people who have vast reserves of oil per capita to simply not work. Abilities to produce and a culture that requires work are just not cultivated. But while work is not cultivated, defense better be. Access to oil under the ground requires one thing. Get rid of the people who control it; push them off the ground. This is the curse part two. Political control, once attained, can be fragile. And struggles among power seekers during a disequlibrium can last a long time. Once war breaks out, it seems to become perpetual.

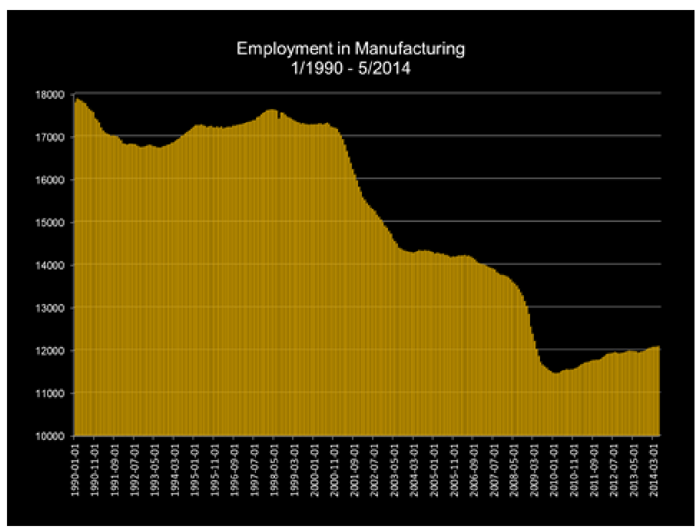
Different belief sysems, which may be a basis for achieving a fanatical build up of forces, can become the driving force that still has to do with controlling the oil. War lords and religious leaders form strange alliances like bootleggers and Baptists who both scramble to support laws that close liqour stores on Sunday. But once the struggles in resource rich regions have ended, the flames of tribal hatreds fanned by efforts to control the black gold continue to fester and grow. Even after decades of relative peace, new generaltions may be taught that they are supposed to hate an opposing group from the past. Why? Not because of the push for oil, but because of religious differences.

Resource curse, part two, creates religious fault lines that do not heal, even after the oil runs out.

Avoiding the resource curse seems almost impossible. Again, the emphasis is on the amount of the resource available per capita. Fortunately, the United States has avoided the curse, even though there are states and regions will large amounts of oil, natural gas, and coal. Still, with the exception of Alaska, the amount per capita is not large. Alaska is a case where the resource curse part one may have had an effect on the urge to work. There is a soverign fund fed by extraction fees, that provides some support to citizens. But the turmoil of curse part two is voided by accepted constitutional constraints and the rule of law. These limit the ability of one group or another to push resouces owners off the land.

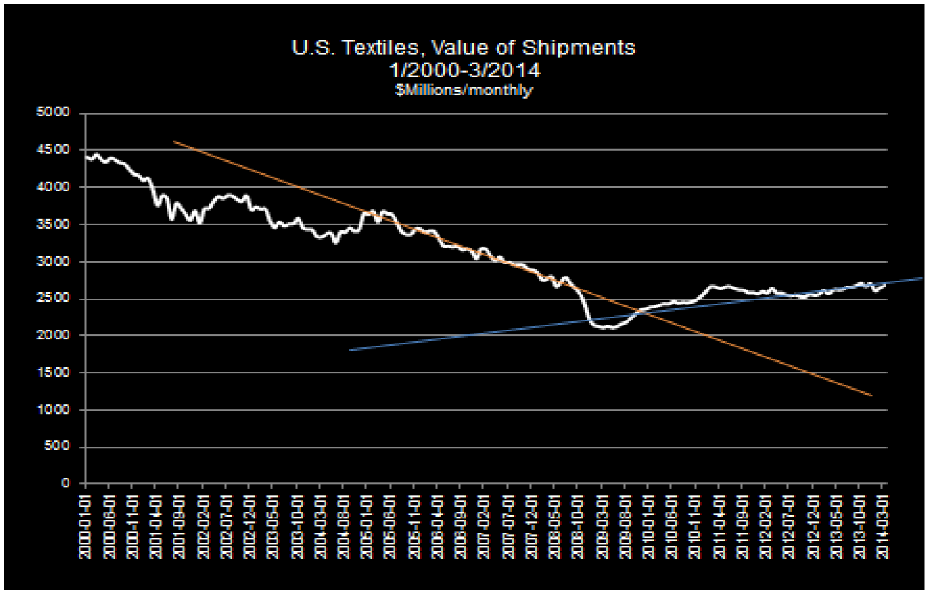
The U.S. Manufacturing Economy

U.S. manufacturing output just recently hit the recovery point, where current production was equal to the prior pre-recession peak. Now in an expansion phase, manufacturing output is growing at a faster pace. While output is hitting new highs, manufacturing employment, is again growing, as shown in the accompanying chart.

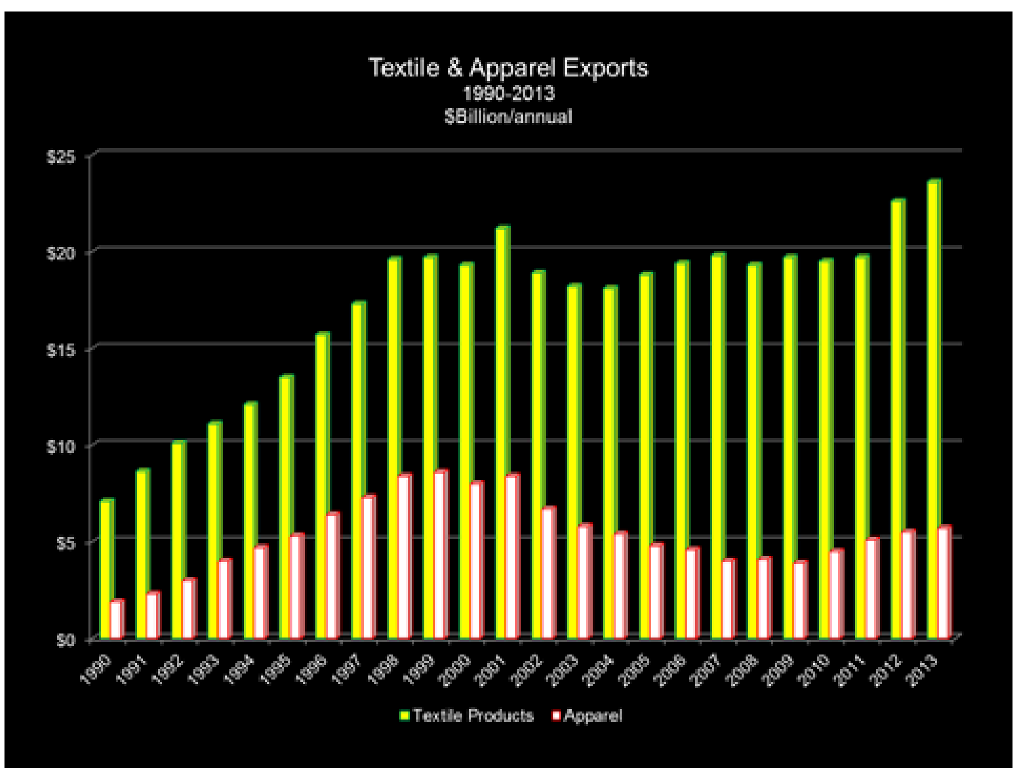


There are several moving parts in the mechanism that explains the stronger employment picture. Part of the growth is driven by lower energy costs, especially from abundant natural gas now flowing from American wells. Another part relates to America's strong position in global competition. Delotte's 2013 Global Competitive Index places the U.S. in third place. China is first; Germany second and India ranks fourth. (See http://www2.deloitte.com/global/en/pages/manufacturing/articles/2013-global-manufacturing-competitiveness-index.html) Five years from now, the Delotte predicts India and Brazil will rise in the ranking. The U.S. will fall to fifth place. But third place in the world now, and fifth in five years, is a pretty good place to be.

A case in point. As shown in the next chart, the U.S. textile industry, which is one of the largest employer of labor in U.S. manufacturing, is again expanding. The expansion has in turn increased the demand for cotton. Cotton fiber consumption is at the highest rate since 1942.



Export sales fuel an important part of the industry's expansion, and that part of industry output is sensitive to actions taken by the Office of the U.S. Trade Negotiator in opening markets through trade agreements, such as NAFTA, CAFTA, and the Andean Trade Agreement Act. The cumulative effects can be seen in the next chart.



Economic Freedom and Jobs

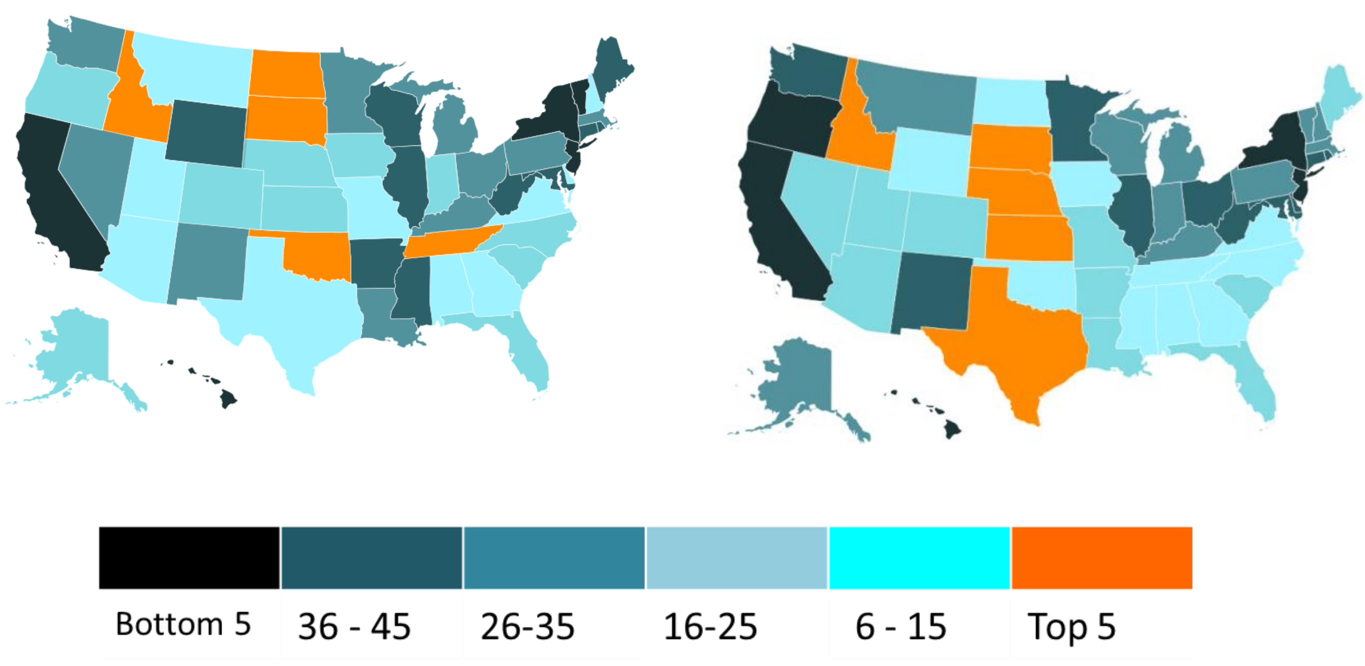
George Mason University's Mercatus Center has just produced its latest family of freedom indexes for the 50 states. Included in the family are overall freedom, personal freedom, and economic freedom. Overall freedom is a composite made up of personal and economic freedom. Details on the indexes and their construction can be found at http://freedominthe50states.org/.

The Mercatus economic freedom index has two broad components: fiscal and regulatory policy. These include weighted measures for tax burden, government employment, government spending, government debt, decentralization, freedom from tort abuse, property rights protection, health insurance freedom, labor market freedom, occupational licensing freedom, and cable and telecom freedom.

In the next panel, I show two 50-state maps. The first is for economic freedom. Note the locations of the five highest ranked states as well as those in the second and third tier. A second map is for the Mercatus "Find a Job" ranking. The mapping is obviously not direct, but is close.

Economic Freedom, 2013

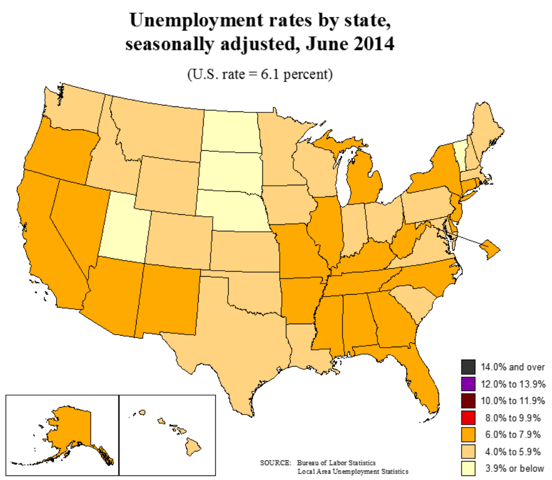
Finding a Job

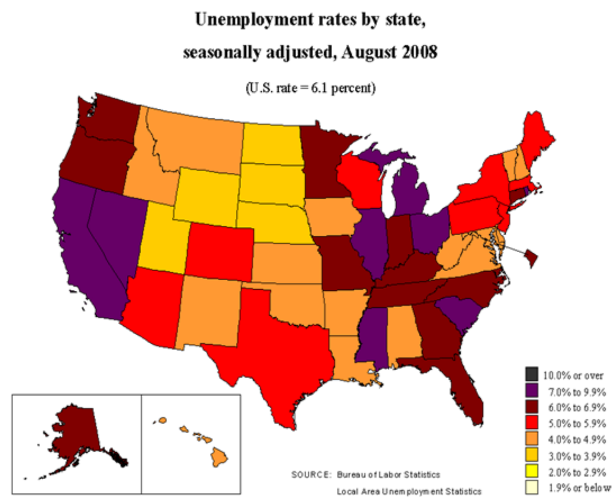


In related work, Tate Watkins and I modeled statistically the determinants of migration patterns across the 50 states for internal migration and in separate work for migration from other countries to the 50 states. Using data for 2004 – 2008, we focused on movers who were 25 to 39 years old, a group we considered to be crucial to economic growth and prosperity.

Along with other variables in our model, we included the Mercatus economic freedom index and in separate studies, the Mercatus personal freedom index. We found that domestic movers are strongly attracted to economic freedom, but do not seem to move on the basis of personal freedom differences across the states. We found just the reverse for international migration. International movers are sensitive to personal freedom—openness and acceptance, but less so to variations in economic freedom.

Changing unemployment across the states

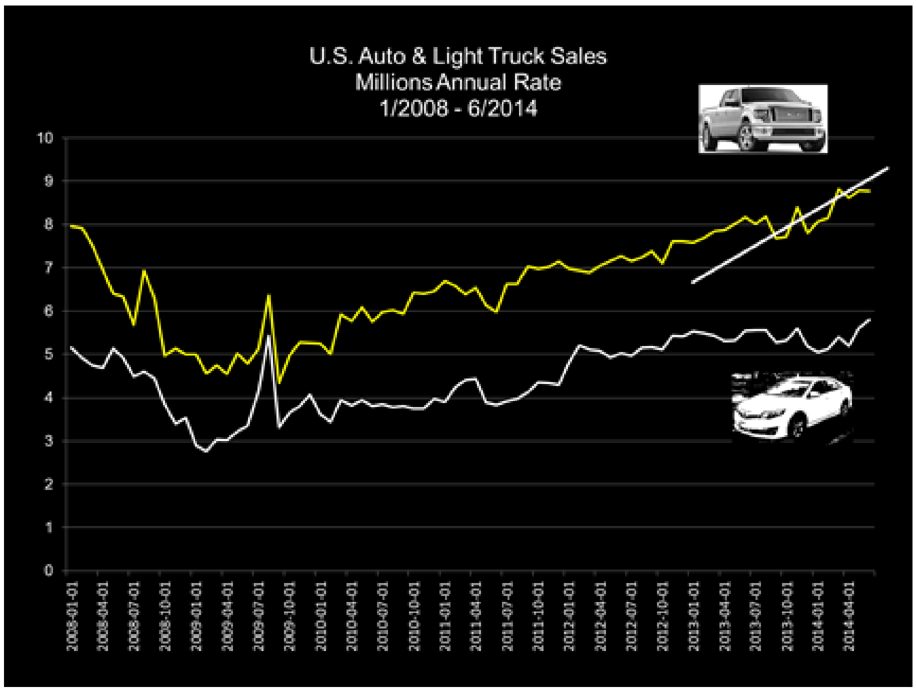




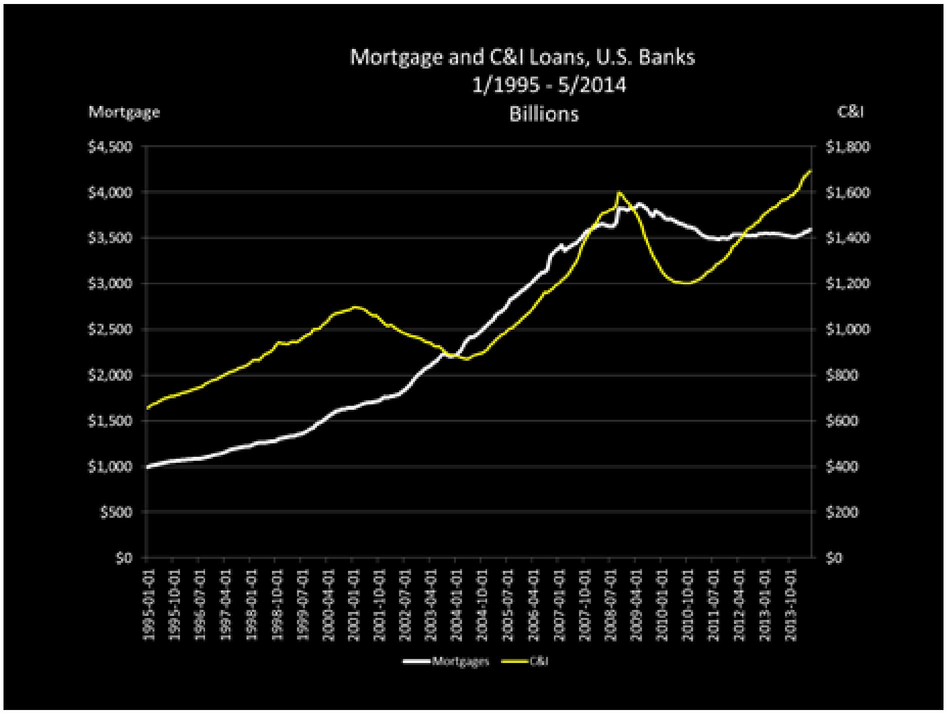
Speaking of jobs, comparing the most recent unemployment rates across the states with 2008 reveals an interesting pattern. As shown above, the nation's unemployment rate in August 2008 stood at 6.1%, the same as for June 2014, this in spite of all the high sounding promises of better days from economic stimulus. But while the overall rate has not budged, there are huge differences to be found across the states. Anyone comparing the two maps would have to agree that 2014 looks a whole lot better than 2008. Like the old adage that says one can drown in a lake that has an average depth of four feet, the 2008 map shows that one can have a hard time finding a job in an economy where the average unemployment rate is 6.1%. 2008 was a much riskier world.

Updated Indicators

My June Situation report contained two economic indicators that I bring up to date. The first is my pick-up truck indicator, which is one of my favorites. This indicator captures a lot of things, including America at work. The continued high level of truck shipments contains the promise of stronger construction, manufacturing, and distribution activity. As can be seen, the truck slope is still positive even though the last few observations are a bit tame. It's also interesting that the pace of auto shipments has quickened. I take this to be another optimistic sign.



My second up-dated chart is for bank lending, both commercial and industrial, which we might call business lending, and mortgage lending. As can be seen here, business lending is rising apace, and mortgage lending is finally showing a bit of excitement. Trucks, cars, and lending are each pointing north.



U.S. and world economic freedom

Speaking at the 2014 Public Choice Society meeting in Charleston, Robert Lawson, co-author of the Fraser Institute's Economic Freedom of the World, talked about the freedom decline experienced by the United States since 2000. Up until that year, the U.S. consistently ranked third in the world, falling in line behind Hong Kong and Singapore. But then, something happened. By 2005, the US ranking had fallen to 8th. Then, in 2010, the United States placed 16th; the U.S. fell to 19th in 2011.

I asked Robert what accounted for the decline. Which of the freedom index components contributed most to freedom's demise? I suggested in my note to Robert that surely the fall was not explained by a decline in the rule of law or independence of the judiciary.

I was dead wrong. The areas I mentioned were where serious trouble had developed, those two along with property rights protection. In fact, the sharp fall in legal system and property rights protection places the U.S. even with Venezuela for that category.

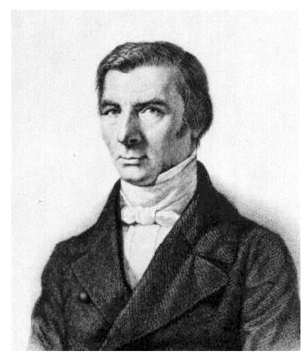
The rule of law collapse

Much of the mischief came with the financial collapse, the bail out of financial institutions and auto companies, and the associated disregard for contracts, rules of liability and shareholder rights. Another part of the decline may be related to homeland security activities, NSA meddling, eavesdropping on news report email messages, apparent bias in IRS activities.

But the freedom index is just one disturbing world metric. The World Economic Forum produces indexes of competitiveness that are worthy of attention. The condition of the macro-economy is one component of the overall index. This is the component that focuses on taxes, deficits, and growth of government. Here, the U.S. ranks 117th out of 148 countries, which places America well within the ranks of third-word countries. As Dorothy said to Toto, "I've a feeling we are not in Kansas anymore."

Frederic Bastiat and Socialism

Frederic Bastiat
1801-1850



Speaking of socialism, Frederic Bastiat (1801-1850) was a French economist, statesman, and author. He was the leader of the free-trade movement in France from its inception in 1840 until his untimely death in 1850. Most of his writing was done in the years immediately before and after the Revolution of 1848—a time when France was rapidly embracing socialism.[1] A prolific pamphleteer, Bastiat wrote several major works, including *The Law* and *Economic Harmonies*, which was published posthumously.

Bastiat famously made the case for free markets and free trade, using clear, common sense arguments that all could comprehend. Just as today, there are concerns expressed about capitalism and an asserted tendency for the rich to get richer, while the poor suffer relatively, Bastiat faced similar arguments popularized by David Ricardo, a leading classical economist. Thomas Piketty (*Capita in the Twenty-First Century*) today argues that income inequality rises with capitalism. Ricardo offered an "iron law of wages," which promised little more than starvation wages for workers in capitalist enterprises.

Bastiat would not buy these arguments. In failing health—he died from tuberculosis when he was 49, Bastiat dedicated his *Economic Harmonies* to the youth of France. In his dedication, he unveils his deep belief about the beneficial tendencies of free markets when operating under a rule of law. Here are his words:

You will think that the title of this work, ***Economic Harmonies****, is very ambitious. Have I been presumptuous enough to propose to reveal the providential plan within the social order and the*

[1] Taken from Library of Economics and Liberty, Economic Harmonies, Liberty Fund, Inc. Available at http://www.econlib.org/library/Bastiat/basHar.html.

mechanism of all the forces with which Providence has endowed humanity to assure its progress? Certainly not; but I have proposed to put you on the road to this truth: All men's impulses, when motivated by legitimate self-interest, fall into a harmonious social pattern. This is the central idea of this work, and its importance cannot be overemphasized.

Bastiat believed that human communities will flourish when enabled by free markets and a government that provides property rights protection under a rule of law, and where the burdens of government regulation and taxation are not oppressive.

The rule of law was critical to his argument. Even with socialistic tendencies, economies can still produce wealth so long as property rights are predictably protected, courts are independent, and government action is somewhat predictable. Wars, depression, and serious financial meltdowns compromise these critical features of wealth creation. Unfortunately, 9/11 and the wars that followed have cast a serious shadow on America. It is not the first time, of course. But, as in the past, when similar shadows were cast, it will take years for wealth-creating institutions to heal.

Suggestions for the Reading List

Henry and Edsel. Richard Bak. 2003. An oldie but goodie. I am always a sucker for biography and even more so when the story is about business history. Detroit Journalist and book writer, Richard Bak tells a fascinating story of the amazing rise of Henry Ford's automobile leviathan and the painful interaction that occurred between Henry, who would always be in charge, and Edsel, his only son, who was to be nominally president of Ford Motor Company. The well-known two phases of Henry's life are painted graphically in the story as we learn again about Ford's first phase labor generosity and the second phase when Ford Motor Company's abusive labor practices became legendary. There is plenty here to inform fans of business history and American capitalism.

Monuments Men. Robert M. Edsel with Bret Witter. 2009. I did not see the movie, but I have surely enjoyed the book. This is a marvelously constructed story of efforts by Allies in WWII to save the Western world's artistic memory against all odds. The magnitude of the Nazi shakedown of artistic wealth is staggering; their efforts to secure and, at the end, destroy are equally amazing. Those with squeamish stomachs will want to avoid sections that describe the horrors of mines and art storage havens operated by slave labor. Even so, the story is an amazing account of human efforts to keep intact history's artistic and moral record.

Berlin Calling. Kelly Durham. 2010. A fictional thriller of WWII intrigue involving a leading Irish-American female character, long embittered about England's treatment of the Irish, who, as a part of the Nazi propaganda effort, broadcasts demoralizing messages to England. Durham's story keeps the reader engaged while hoping the book will not end. Along the way, one learns a lot about the Nazi propaganda machine and unconstrained efforts to secure the Fuhrer's dream.