

THE ECONOMIC SITUATION

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- **Looking for the Yellow Brick Road.**
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What Happened to the Economic Engine?

Last quarter's Economic Situation began with a question. Has the U.S. economic engine lost its steam? This report provides an answer: It surely looks that way, at least for now.

Since March, we have seen flat to weak data on retail sales, low employment growth--with some recovery in April, pale manufacturing activity, low export sales, and, of course, diminished activity in the U.S. oil and gas regions. The slowdown is associated with faster money printing presses in Europe and falling economic growth in China and Asia. These lifted the dollar's value, improved American's ability to buy the world's goods, but cut down on exports. We see the effects of the stronger dollar on sales by the S&P 500 firms in the accompanying chart. The two series move almost in lock step.

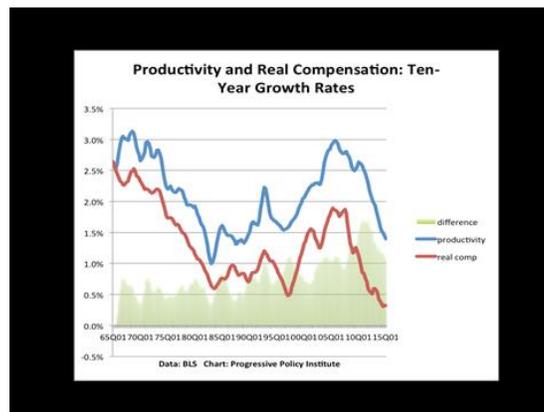
Meanwhile, the Fed, which three months ago seemed resolutely determined to nudge up interest rates before the onset of summer, is now keeping its powder dry while not even giving a hint that it sees the white of the eyes of oncoming inflation. From the way things look now, interest rate increases will be a winter activity. Look for a first upward nudge near the end of the year, if in 2015 at all.



The Productivity Slowdown

Slow growth data were amplified on May 6, when the Bureau of Labor Statistics released a productivity growth study. The report indicated that for the last 10 years, productivity growth has averaged just 1.4%.

Progressive Policy Institute president Michael Mandel responded: “Based on today’s release from the BLS, ten-year productivity growth has now plunged to 1.4%, the lowest level since the 1980s. By comparison, ten-year productivity growth was 2.2% when Bill Clinton left office at the end of 2000, and hit a high of 3% at the end of 2005.” The accompanying Progressive Policy Institute chart tells the tale.



As Mandel and the chart indicate, it is impossible to have meaningful growth in wages in a low productivity growth economy. Indeed, in recent years, wage growth has captured a larger part of productivity gains than in the past.

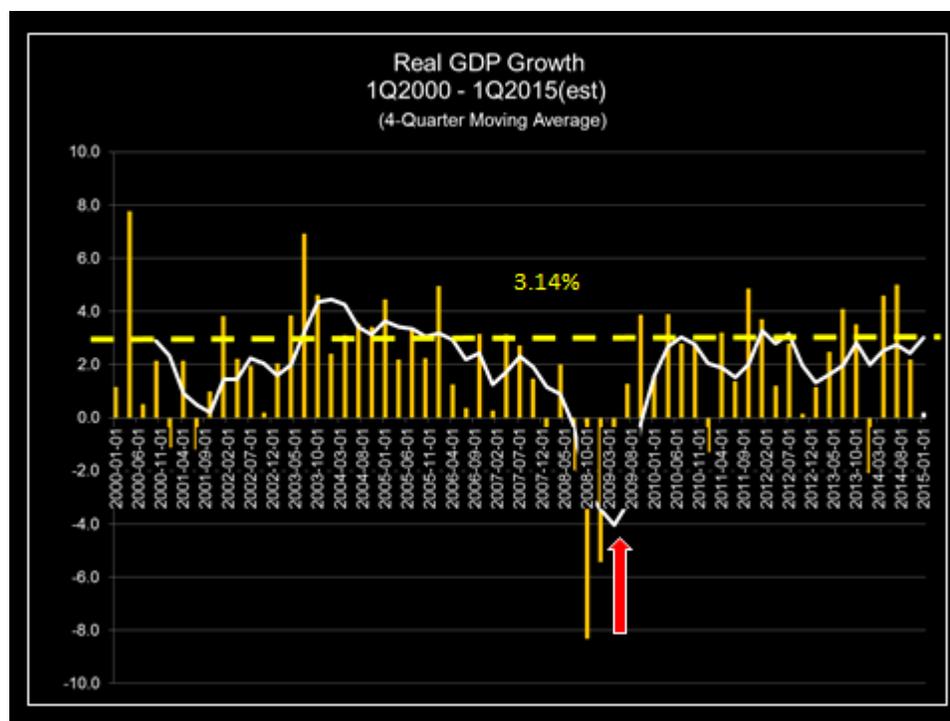
GDP Growth: The Final Reckoning

Talk about slow! The 0.2% Department of Commerce first estimate for 1Q2015 GDP growth, which is getting awfully close to zero, seemed to capture all this weakness, as well as some unusually bad weather. 2014’s better than 5.0% growth quarters stand in sharp contrast to the first quarter estimate.

But is it really this bad? Most likely not.

The Atlanta Federal Reserve Bank’s GDP Now estimate indicates that the economy is chugging along right now at about a 1.0% growth rate. Better prospects were also seen in the April employment growth data, which showed 235,000 new jobs added in the economy. In fact, the sharp improvement from March’s weaker 138,000 new jobs was enough to make the Federal Open Market Committee reload, but not fire, its interest rate gun.

But do take note of the 4-quarter running average GDP growth shown by the white line in the accompanying chart. And check the broken yellow line that runs at 3.14% growth—the longer term average. As noted, the 4-quarter average is touching the Yellow Brick Road!



Looking for the Yellow Brick Road

With the results of very bumpy GDP growth on their minds, lots of people are looking for the Yellow Brick Road, that marvelous pathway that leads to the certainty and security of “Kansas.”

Perhaps this is an appropriate metaphor for the current situation.

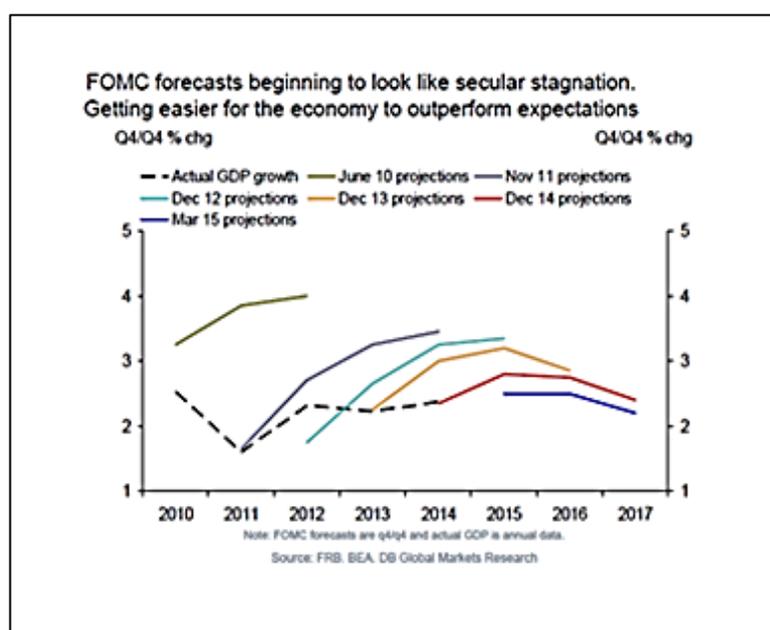
Most of us happily remember The Wizard of Oz, and the marvelous characters that accompanied Dorothy, her pup, Toto, and her traveling companions—Tin Man, Scarecrow and Lion—on their search for the Wizard, who they hoped would get them back to happier times. But we also remember that every time the foursome thought they were on the Yellow Brick Road lo and behold the Wicked Witch of the West would show up with her frightening cackle and threatening actions, much like the avalanche of unpleasant economic data that just hit our economy.

The Yellow Brick Road was a risky road, indeed.

Just as with Dorothy and her friends, it seems that hope springs eternal for a Washington Wizard, another economic maestro who will take us to the promised land.

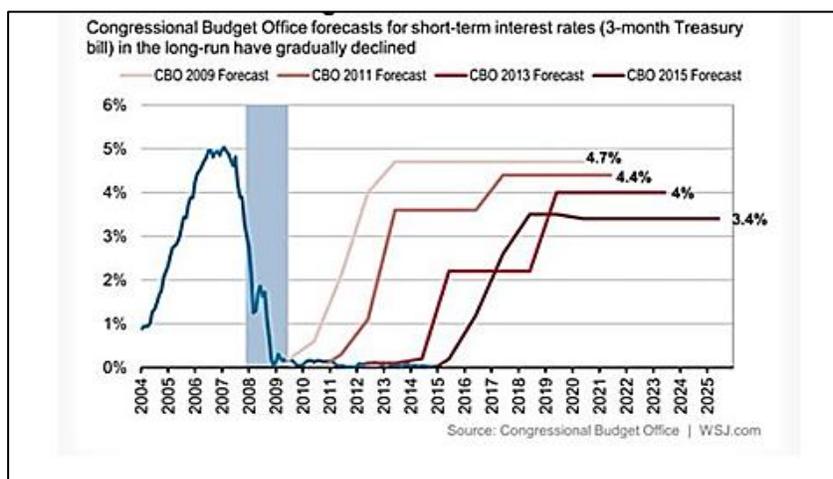
And we are getting wizard promises as presidential candidates throw their hats into the ring for the 2016 election. They know we want a wizard. Even now, commentators far and wide are watching every twinkle in the Fed chairwoman's eye, looking for clues for when the much anticipated interest rate lever will be pulled. But, again and again, Fed chair Janet Yellen reminds us by her actions that she is no Wizard of Oz pulling economic levers to move the economy in just the right way at just the right time. In fact, if we examine the Fed's record for forecasting the nation's economic activity, we have to conclude that Fed Chair Janet Yellen and her colleagues have reason to be humble.

Consider the next chart. Here we see the Federal Reserve Open Market Committee's changing forecast for GDP growth for 2010 through 2017 along with actual GDP growth. The data are for fourth-quarter-over-fourth-quarter percent change.



What can we say? As time passed, the forecaster becomes more accurate, or maybe gives up hope for a beneficial macro response to past Fed interest rate policies. Finally, in March 2015, the Fed makes such a weak forecast, that data may provide confirmation.

As shown next, the 90-day T-bill interest rate forecast record for the Congressional Budget Office for the years 2009, 2011, 2013, and 2015 reveals a similar weak record.



Both the Fed and the CBO were expecting a strong response to heavy doses of Keynesian medicine, as were most of President Obama's advisors, but the response was not forthcoming.

The Policy Play Station Doesn't Work in a Kudzu Economy

But the economic play station no longer seems to work, if it ever did. Nudging up government spending and deficits and printing vast amounts of new money have to contend with other government actions such as imposing tighter lending standards, subsidizing mandated health care, jawboning increases in minimum wage, and pushing capital toward government favored automobiles and energy sources, which reduce work incentives, and encourage wasteful investment.



Once upon a time, when the U.S. economy was decidedly private and unregulated—those of us over-80 can remember those days long ago, politicians and their appointees could concoct and dish out different economic brews that had positive short-run effects on GDP and employment growth. But that was long before regulatory kudzu was planted across the landscape and the economy had become entangled with multiple forms of regulation.

The kudzu analogy is interesting for several reasons. First off, the asian tuber was introduced to American agriculture by the USDA in the 1930s as a way to remedy serious soil erosion problems. Government confidence in the remedy was so strong that farmers were paid \$20 per hectare to plant kudzu in their fields. In a matter of a few years, some 1.2 million hectare had been planted. And the kudzu never looked back.

What had been eroded fields unfit for planting became entangled fields, unfit for planting. The the government managers took notice. The subsidy ended; eventually

kudzu was declared to be a pest, which meant it could be poisoned. A tough kind of kudzu deregulation ensued.

Just as kudzu looked promising in the 1930s, the prospects for regulation may look bright when read initially in a *Federal Register* announcement. But when regulations are imposed, one after the other, throughout the economy for year-after-year, the results may be stifling. Indeed, the decade-long, low 1.4% annual growth in productivity must surely be associated with some of the regulatory burden.

Command-and-Control?

Research on regulation tells us that there are a number of available regulatory choices when politicians are building a regulatory state. If there is a desired outcome—reductions in nitrogen and phosphorous discharge that may damage the Chesapeake bay, for example, the politicians can impose a per unit pollution tax to be paid by all dischargers in the region. This gives incentives to find less polluting activity as well as to discover lower cost ways for avoiding discharge.

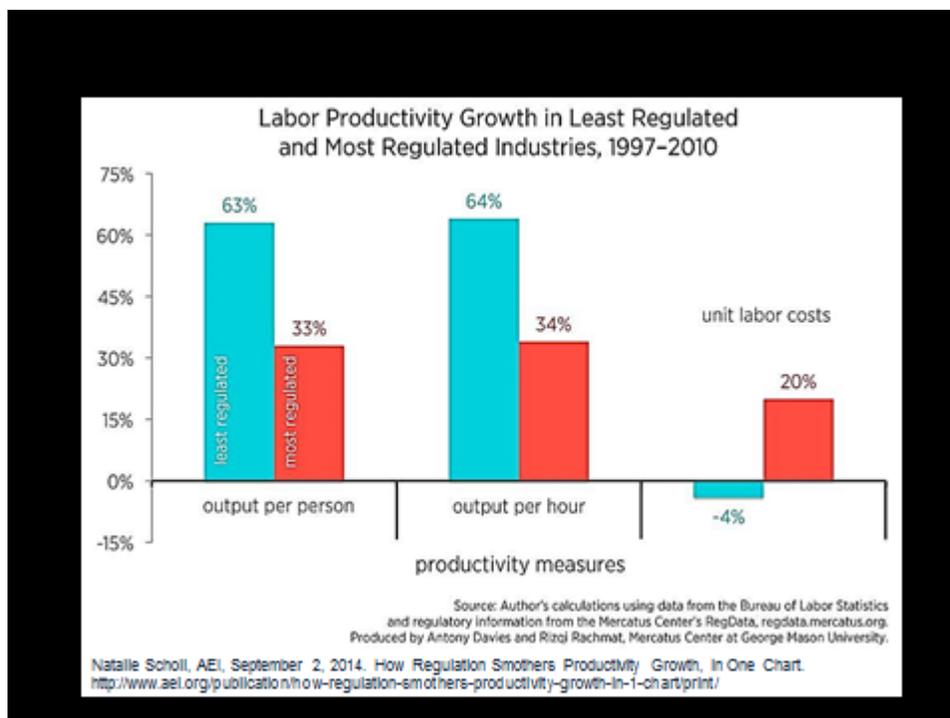
Alternately, the politicians can simply state the goal to be achieved, say, a 50% reduction over a specified baseline achieved in five years with a specified penalty for failure, and leave it to real world forces to generate the outcome. Again, competition and creativity contribute to a solution, one that cannot be defined in advance. Or, the politicians can direct regulators to identify technologies to be used by all parties who are now polluting and then require that all polluters follow a common command-and-control formula. Doing it this way, focuses the attention of all the interest groups on the once-and-for-all technology choice that will emerge. Exceptions can be made for favorite polluters under any of the schemes, and there are always incentives for lambs being led to the slaughter to somehow escape the endgame.

But command-and-control, technology based regulation, almost always preferred by environmental organizations because of its apparent certainty, provides the ideal way for politicians to target specific firms and specific industries with valuable regulatory outcomes. For example, owners of modern plants with the latest clean technology in place can lobby for similar requirements to be imposed throughout the industry, thereby raising rivals cost. Operators of existing plants may lobby for stricter standards to be imposed on all new pollution sources, gaining barriers to entry at the same time.

It turns out that command-and-control is America's preferred way to regulate. It is also generally the most costly way to regulate, particularly in terms of lost productivity.

Now, let's tie the growth in command-and-control regulation to the decline in productivity. George Mason University's Mercatus Center has developed a measure by U.S. industry of the extent of command-and-control regulations found in that industry's Code of Federal Regulation. The Mercatus RegData metric is for the years 1997 through 2010. Anthony Davies, an economist at Duquesne University associated with

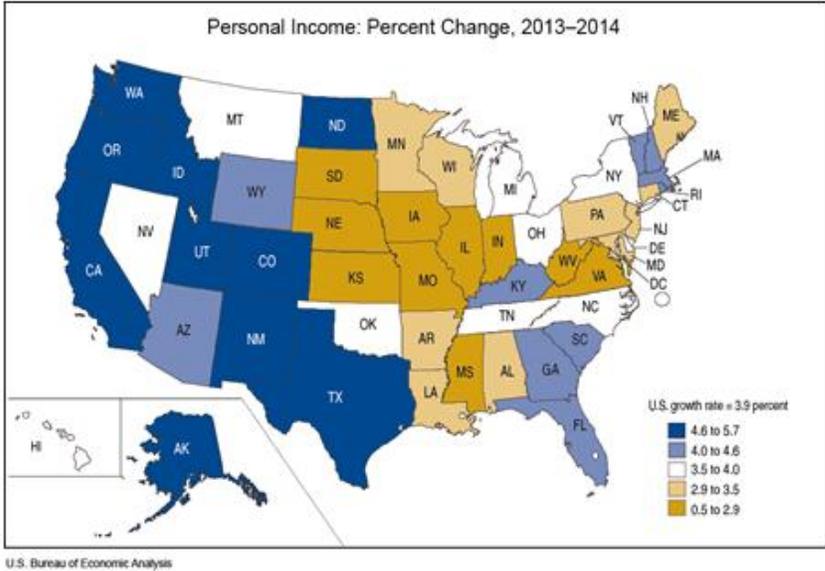
Mercatus, recently estimated the effects of regulation—as measured by Mercatus—on productivity growth for industries that are the least regulated and for those that are lightly regulated. The next chart contains his findings.



The results comport with what common sense tells us. Regulation limits flexibility, adaptation to change, and the discovery and trial of new approaches for doing and making things.

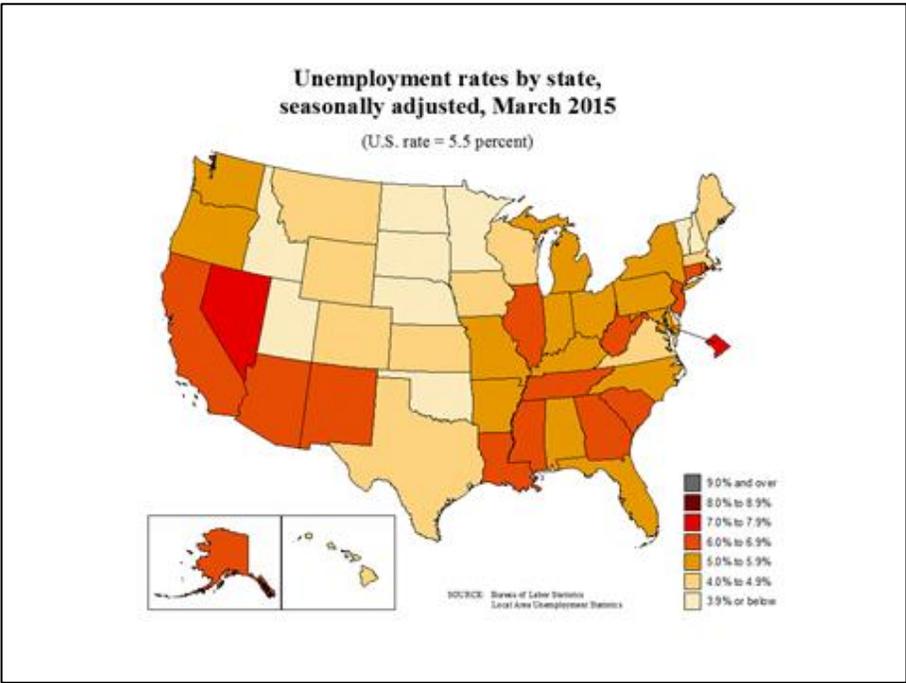
The Geographic Imprint

Whether it is regulation, energy-driven growth, or recovering manufacturing employment, all economic activity leaves an imprint across the 50 U.S. states, and there is wide variation in outcomes. First consider percentage change in state personal income across 2013-2014, reported in the next chart. All of the dark blue—high growth—states are located west of the Mississippi. A combination of energy, high technology, and educational attainment seem to be the dominant forces that explain the strong performance. Dollar strength and weaker export sales contribute to the weaker growth in hard grain and heavy manufacturing states. And the lingering effects of the financial collapse on construction and manufacturing may be the explanation for weakness in the eastern United States.



We see a different pattern when we examine state unemployment rates, which are shown in the next chart. Here, lighter is better. Again, we see west of Mississippi strength, but not always in the higher income growth states. But again, the picture in the eastern United States is not as bright as in the west.

Taken together, the two charts tell us that there is more to employment growth than income growth and that there are other important variables to consider when attempting to get an understanding of what may be driving state economic outcomes.



Redistribution through the federal government is one important determinant of state economic outcomes. Some states receive a lot more from Washington than they send in taxes. And of course, that must mean that some states receive less. The next chart gives the outcome for 2010.

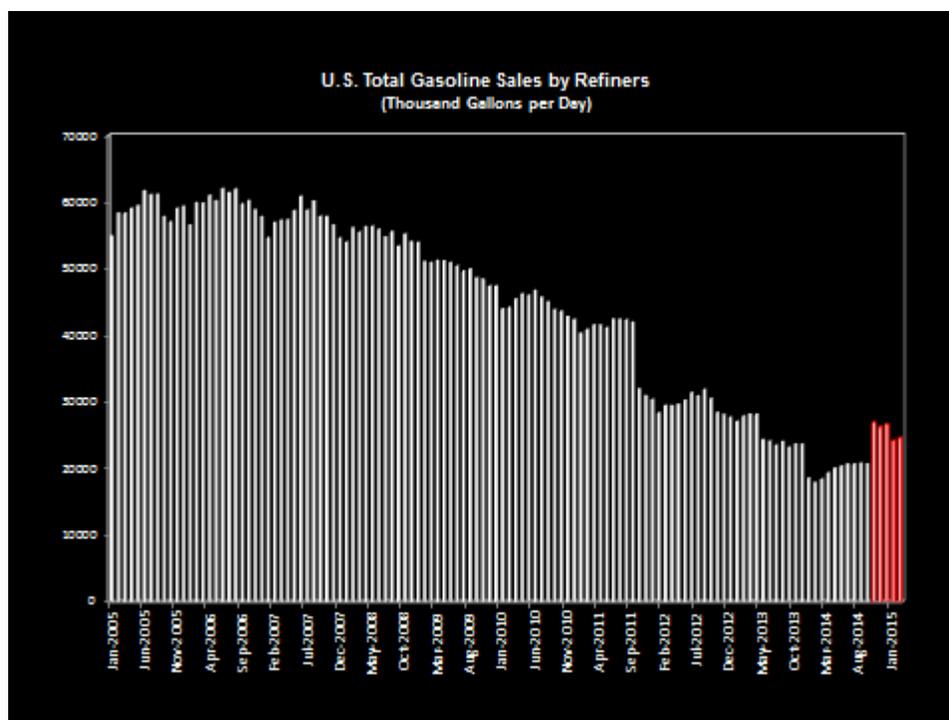


Close examination reveals that higher income states are in the near breakeven or deficit category. We see this for higher growth states, as well, for example, Texas. But then there are puzzles: Utah, Colorado, New Jersey. Do you suppose there are some powerful politics involved here? Perhaps.

Where Did the Gasoline Dollars Go?

For almost a year now, Americans have enjoyed a bonanza at the gas stations. The lower gasoline prices provided, on average, a \$750 annual savings to the typical family. Where did the dollars go?

We don't know the precise answer to the question, but we have data that speak to parts of the question. First off, consumers bought more gasoline! That's right. Once again, the law of demand held. Lower price leads to larger quantity demanded. We see the results in the next chart. Notice the red bars that mark gasoline shipments for the low-price period.

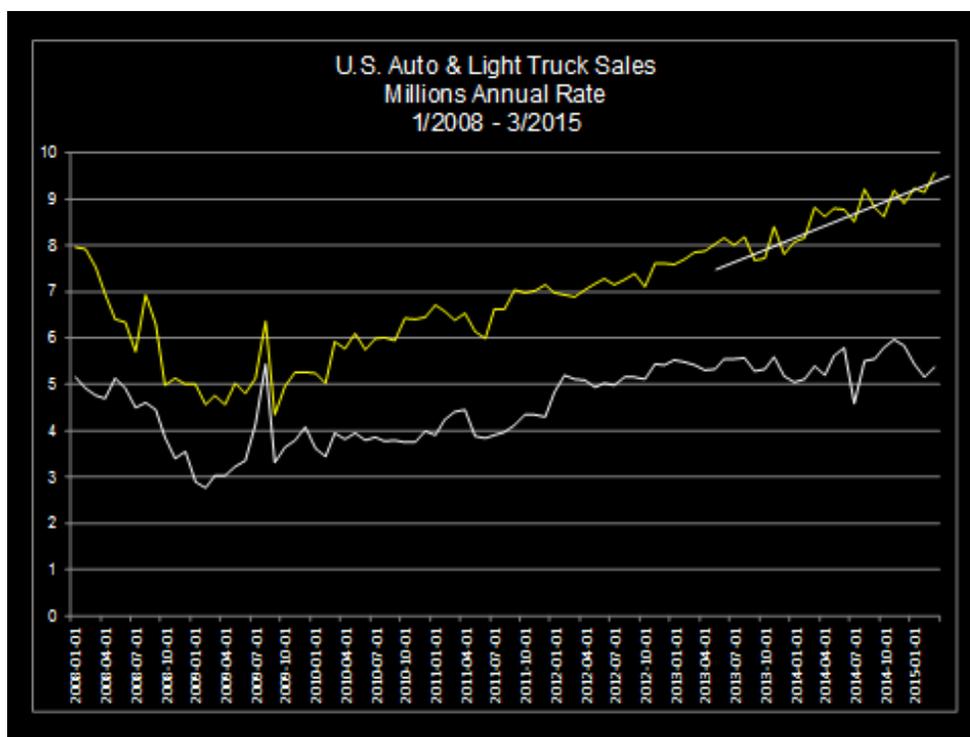


Then, when Commerce Department data on consumer spending arrived, we found that spending on meals away from home rose significantly. In fact, for the first time in the history of the time series, American consumers are now spending as much on meals away from home as they are spending on groceries.

The old moto “Help stamp out home cooking” seems to have taken hold, funded partly with cheaper gasoline!

Finally, as shown in the next chart, cheaper gasoline fueled increased demand for SUVs and pick-up trucks. And this completes an interesting picture. Cheaper gas led to the purchase of larger SUVs and light trucks, large enough for the family to pile in for an evening out at a fun restaurant.

Celebrate!



Suggested Summer Reading

If you are looking for something that is not too heavy and enjoy business history, I think you will enjoy Glenn Beck's *Dreamers and Deceivers: True Stories of the Heroes and Villains Who Made America* (New York: Threshold Editions, 2014). Beck, a prolific and entertaining writer, puts the reader in close touch with Grover Cleveland's successful effort to hide a serious health threat from the American people and with Woodrow Wilson's not so successful effort to do the same thing. Beck has a chapter on Alan Turing, the father of the computer, Desi Arnaz, of "I Love Lucy" fame, and on Walt Disney's final but unsuccessful effort to leave an urban design legacy. There's plenty here to take to the beach for reading after that first day when you get too much sun.

Turning to a totally different reading category, many will find *New York Time's* columnist David Brooks' *The Road to Character* (New York: Random House, 2015) to be a stimulating and challenging read. Baring his soul and sharing some of his most personal thoughts, Brooks challenges himself and the reader to consider focusing on doing things in life that might enhance a eulogy but not a resume. He chews on our understandable tendency to work hard as we attempt to climb the ladder of success and gives a repeat of Wordsworth's warning: The world is too much with us. There's far more to the book than this. Brooks seeks to make his point by introducing a small number of people whose lives he holds out as models for us to consider.

I find myself understanding and at times agreeing with Brooks' main point, but still opposed to the idea that we might encourage our children and others to back off the

effort to get ahead in life. This said, I will point out that Brooks intersperses some of the most beautiful writing I have seen on the importance of love.

To round out the reading list, I move to another floor of the library and recommend Harvard scholar and former federal executive Cass Sunstein's *Valuing Life: Humanizing the Regulatory State* (Chicago: University of Chicago Press, 2014). Sunstein served in the Obama Administration as director of the White House Office of Information and Regulatory Affairs (OIRA), the unit that reviews major federal regulation and attempts to guide the regulatory state in the direction of lower cost and more effective rule making.

Drawing on that experience and decades of thinking and writing about government efforts to improve wellbeing, Sunstein tells how OIRA works, how benefit-cost analysis can be applied creatively, and how widely dispersed information can be brought to bear when government is writing regulations. Sunstein tells us that his heroes are economists Frederich Hayek and Armatya Sen. He likes Hayek because Hayek is deeply opposed to centralized decision making due to the dispersed knowledge problem, yet admires Sen because of his deep commitment to large group decision making, which is paradoxically a way to address the Hayek problem. This intellectual tension underlies Sunstein's analysis and commitment to the idea that the regulatory state can be tamed in ways that improve wellbeing. I would call this a beneficial read, especially for people like me who doubt more centralized decision making is to be desired.