THE ECONOMIC SITUATION

A Quarterly Commentary on the Economy

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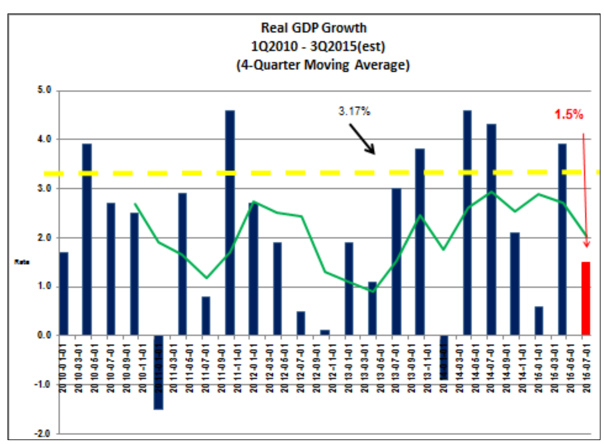
- The Winter Economy
- Employment and Higher Education
- The Regional Imprint
- Suggested Winter Reading
- The Road Ahead and the Middle East Tragedy

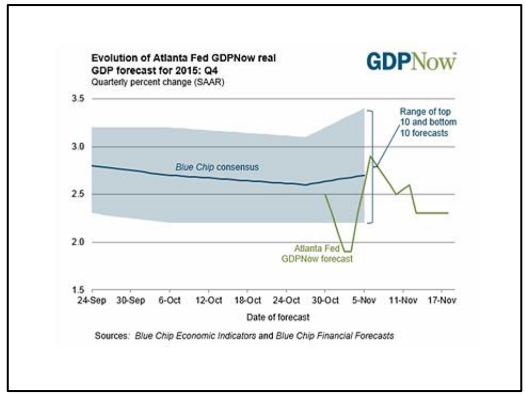
The Winter Economy

Fed uncertainty, the levitated dollar, China's continuing weak economy, Europe's mixed bag, and US political crazy season combine to yield a slow but somehow sound winter economy. Let's take it from the top. The most recent 3Q2015 GDP growth estimate arrived to the tune of 1.5%. When considered in terms of a 4-quarter moving average, the more inclusive trend yields a rather cool 2.0%, well below the yellow dashed line in the accompanying chart that reminds us of the gap between current performance and the



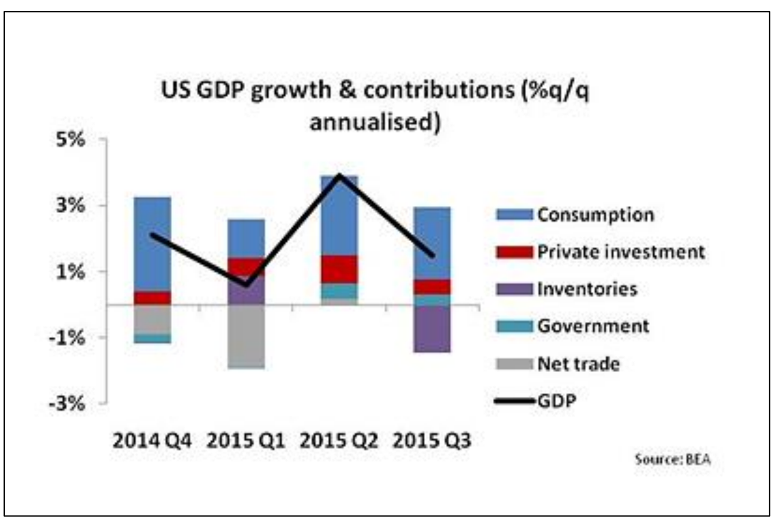
longer-run average.

What about the prospects for closing the GDP gap in the months ahead? Don't bet on it. According to most soothsayers and forecasters, the chances are slim to none. The Atlanta Fed's GDP Now analysts' November indicator showed GDP growth hitting better than 2%, which, as indicated in the accompanying chart, is well below the Blue Chip consensus. Construction, while recovering, is still weak, as is investment in new plants and equipment. Dramatically lower energy prices are stimulating some sectors but newly imposed energy regulations are weakening others. The economy is operating like a strange washing machine that is taking in fresh water while also caught in a spin cycle.



Growth Components

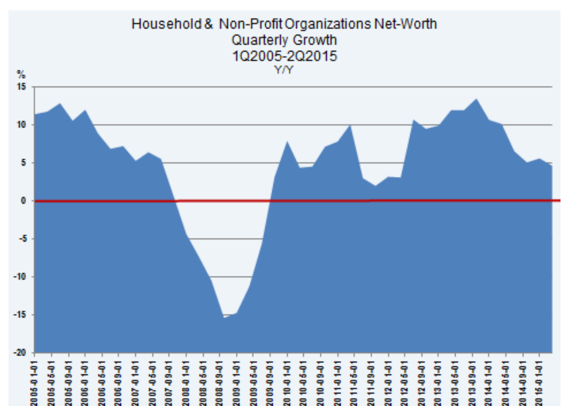
The effects of this are seen when we examine recent components of GDP growth. As indicated here, consumption—consumer spending—is the big driver. Growing expenditures on services, with healthcare being the larger item, account for the stronger part of this. Net trade, driven down by the strong dollar and weaker trading partner growth, is either adding little to the mix or subtracting from it. As indicated in the chart, the advance estimate for 3Q2015 shows inventory reductions as a large negative component of GDP growth. We have no way of knowing if decision makers over-reacted to the economy when managing their supply chains or whether sudden increases in consumer spending caught them off guard. But based on recent retail sales data and weaker consumer balance sheets, those inventory cuts may be well justified.



Drawing on Federal Reserve Bank of St. Louis data, I next report retail sales growth for 1994 through October 2015. Please note the weaker growth rates in the most current periods, and compare those rates with earlier ones, particularly those in 2005 and 2006, prior to the great recession. There are lots of factors that enter when we seek to understand what is driving the weak sales growth. Household wealth is a factor we will now consider.

Consumer Net Worth

Many long conversations at the dinner table tell us that changes in the household balance sheet always bring changes in spending. If stock portfolios are heading south and real estate values are flat, the folks at the dinner table will reduce their plans for holiday celebration and spending. That is, unless they can see brighter days ahead. As Milton Friedman taught us, major expenditures are based on estimates of permanent income; spending on holidays and meals away from home may be affected by transitory income. The latest data on growth in household net worth, shown in the next chart, gives us some clues as to what to expect. I have drawn a red line at the chart's zero point in an effort to make it easier to see what is going on. Remember, we are looking at growth rates. The most recent quarterly growth is certainly positive, but diminishing. When eyeing this data, I was reminded of what has been happening to my own stock portfolio. Growth rates are headed south.

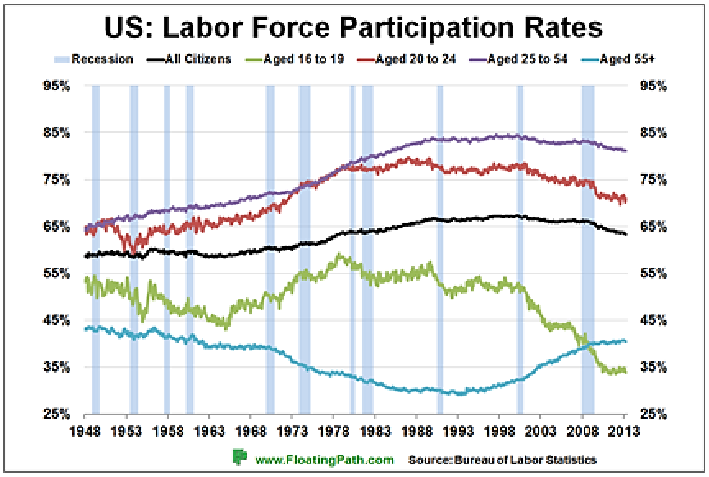


Employment and Higher Education

The October employment report was a shot heard around the world. Payroll employment rose 271,000, well above the 230,000 average for the previous 12 months; the unemployment rate fell to 5.0%; and average hourly earnings for all private sector employees rose 9 cents to $25.20, up 2.5% over the last 12 months. News of the 271,000 gain brought immediate reactions in world credit markets; interest rates jumped 20 or 30 basis points on 10-year notes and shorter bills. Fed watchers let out a sigh of relief. Surely, they thought, the Federal Open Market Committee will raise Federal Fund rates when the members meet in mid-December. We may finally put an end to the seemingly endless Fed interest rate speculation. But, on the other hand, employment growth was accelerating with not much increase in average wages.

Job openings are expanding. Qualified workers are harder to find. Not much movement in wages. How can it be?

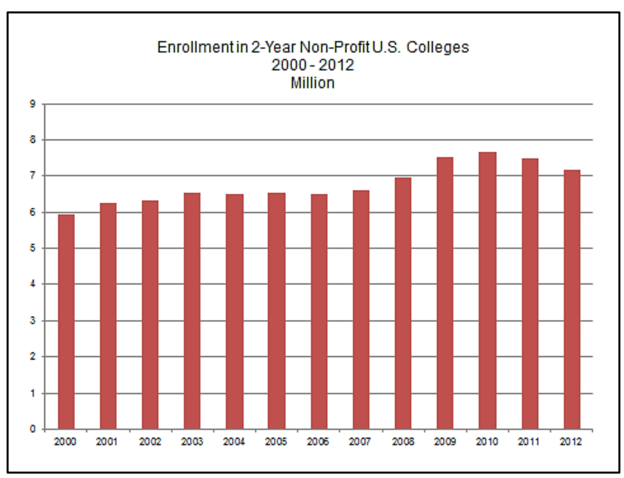
There are several arguments about this. One line of reasoning, richly supported with empirical work and now embraced by the Congressional Budget Office, says that younger unskilled workers have been shut out of employment by higher minimum wage laws and mandated healthcare insurance. These combine to raise the cost of hiring. This story tells part of the participation rate story but does not explain where workers come from when employment opportunities brighten.



Some analysts have suggested that there is a large reservoir of discouraged workers, no longer counted in the labor force, who become active as the economy accelerates. The chart above speaks to part of this theory. It reports labor market participation rates by age for the years 1948 through 2013. I call attention to the 16 to 19 age group and the sharp decline that occurred around 2000. The falling observations may be associated with a series of increases in the minimum wage that began in 1997 and continued to 2009, raising the minimum wage 40%. Notice how participation for this group fell during the Great Recession. Then, consider the 20 to 24 age group. Here again we see a decline during the recession, though far smaller than for the 16 to 19 category.

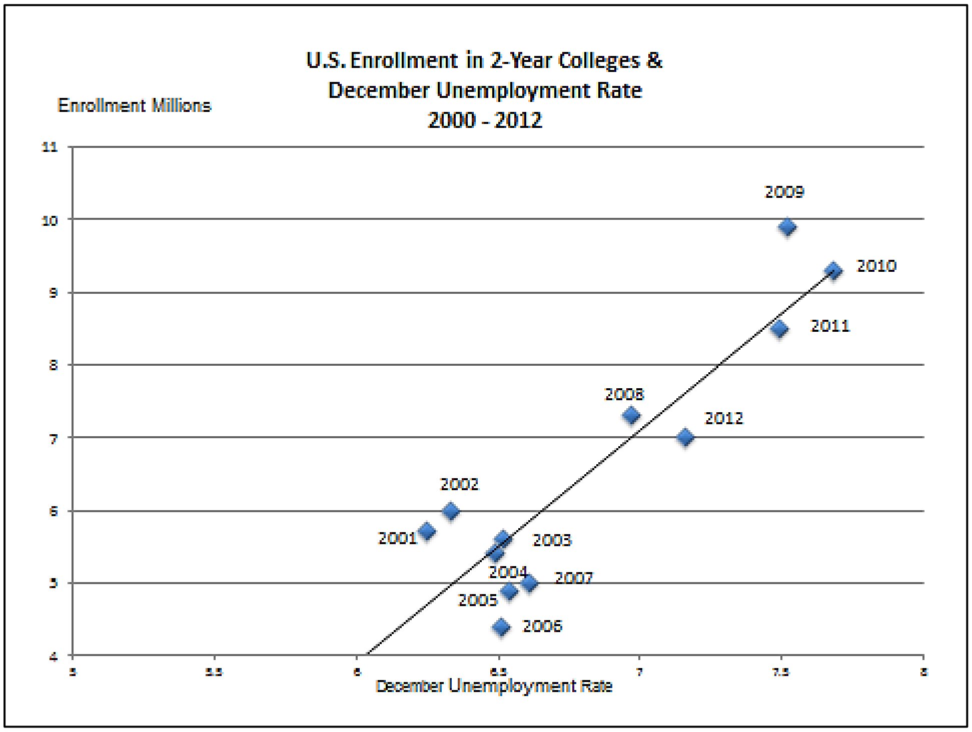
The gap between the 16 to 24 groups and the black all-citizens line tells us that younger workers were far more engaged in the labor force in 2005 than they are today. Further inspection tells us that participation rates were even higher when we go back to 1995 and 1985. What might explain the apparent disinterest in gainful employment? And does all this relate to a reservoir of workers? Where are they?

I think that part of the reservoir is found in the student ranks in 2-year community and technical colleges where enrollments rose markedly during the Great Recession. After all, the opportunity cost of going to college is what one may earn if not in school. No employment opportunities yields no opportunity cost. But we are talking about 2-year degree and certificate programs. If college enrollees form the reservoir, then we should see a strong positive relationship



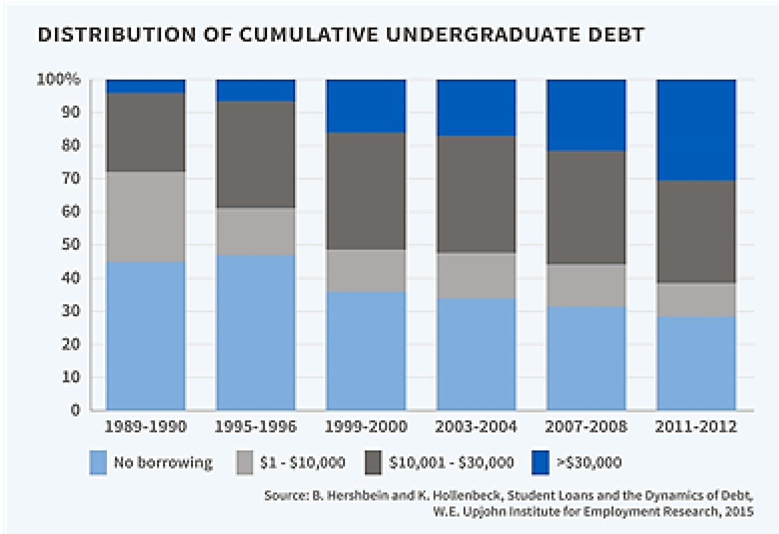
between enrollment and the unemployment rates.

I provide enrollment data for 2000 through 2012 in the chart above. Notice that enrollment rose from 6.6 million in 2007 to 7.6 million in 2010, a gain of one million students. I now provide a scatter diagram that maps enrollment into the December unemployment rate for each year. This also contains a regression line that explains 85% of the variation in the data.

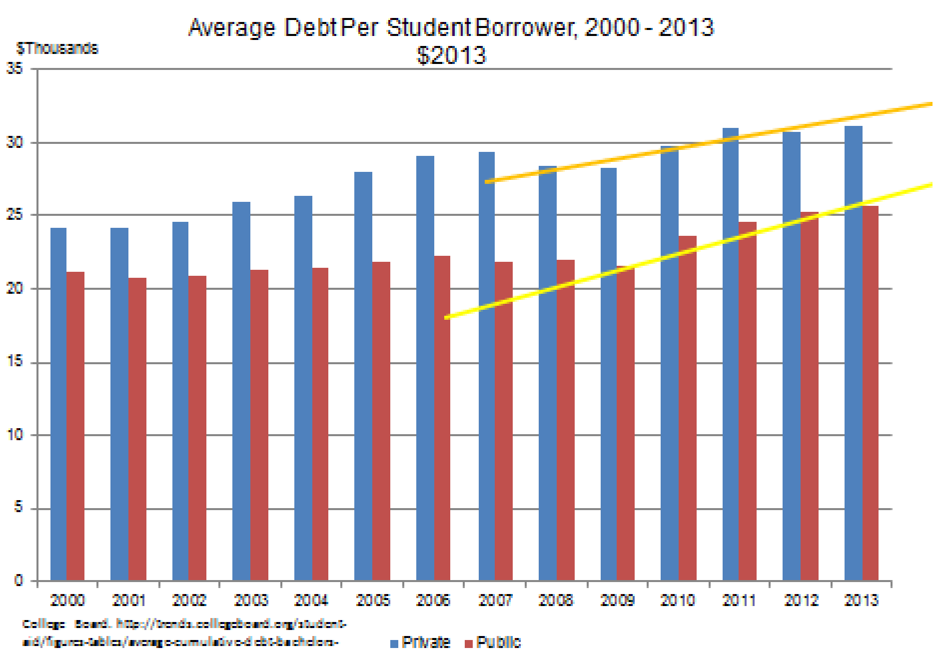


Higher Education and Student Debt

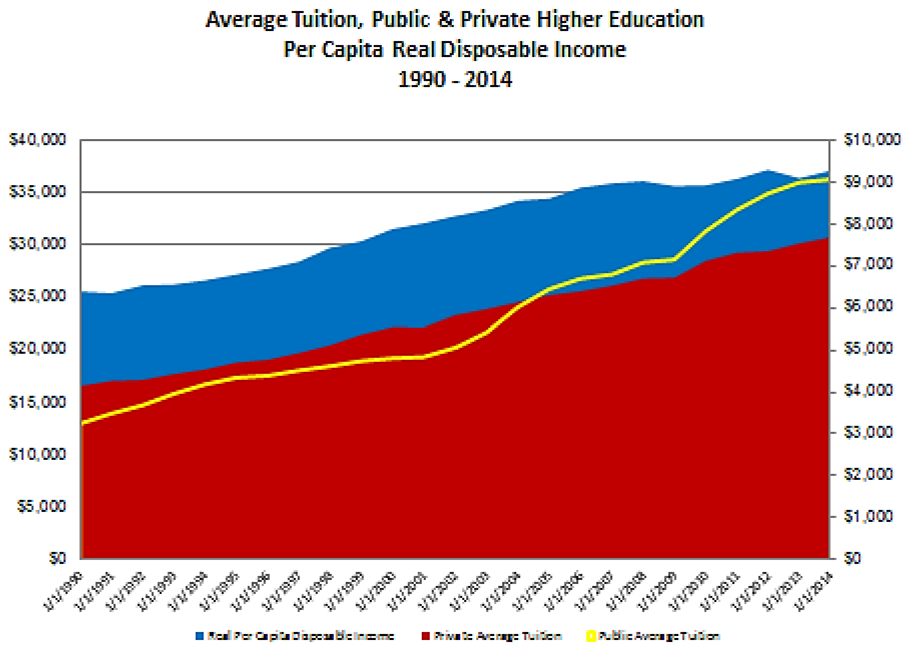
The availability of credit is another feature of the higher education expansion that has occurred in recent years. Socialization of student debt came with federal legislation on July 1, 2010. Expectations that some debt would be forgiven or payments rescheduled arrived with the legislation. Government guaranteed and direct lending have risen, as have university enrollments and debt per student. In 2007 total student debt outstanding stood at $657 million. The number was $1.1 trillion in 2014. The next chart provides data on the distribution of debt for a number of recent years. Here we see the shrinkage of the no-borrowing category and expansion of the greater-than-$30,000 category.



The average debt per student in private and public universities is seen next. Notice how debt has risen more sharply among public universities. A positive jump in both categories is seen in 2010.



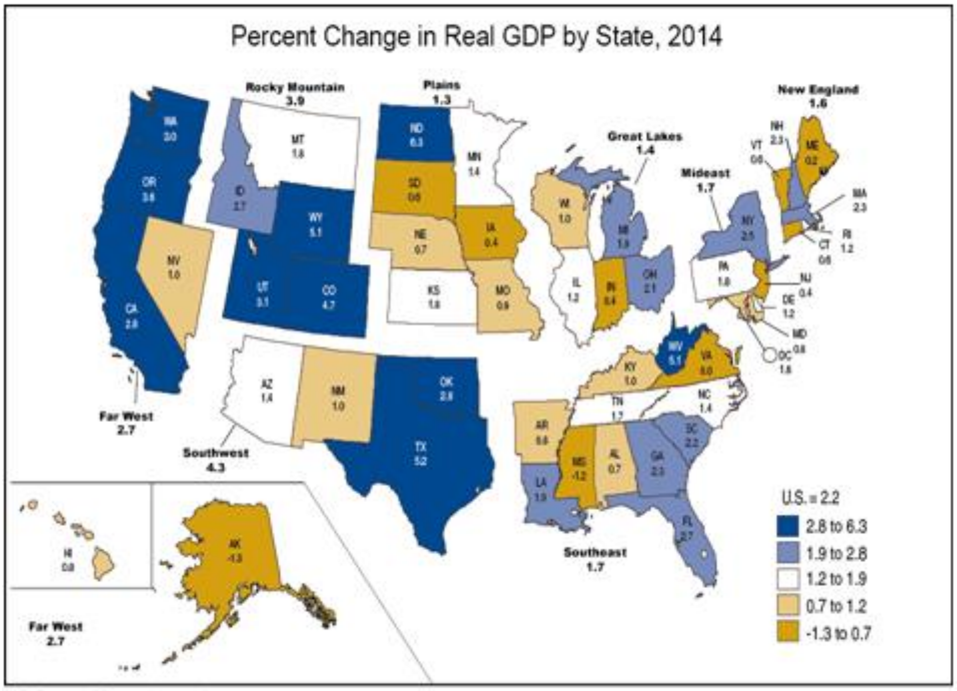
And finally, consider what has happened to the average undiscounted sticker price for tuition in public and private universities compared with per capita disposable income during the same period. Until about 2004, listed tuition prices for both university categories paralleled per capita disposable income. After that, public university catalog tuition accelerated markedly, with an obvious discontinuity in 2010, while private tuition rose a bit faster than in the earlier period.



The implication? Government lending and debt guarantees change incentives. Increased lending, rising enrollments, and higher tuition follow. Student debt makes for good politics. We can expect to hear more talk about a student debt bubble and the need to provide free college access to colleges and universities.

The Regional Imprint

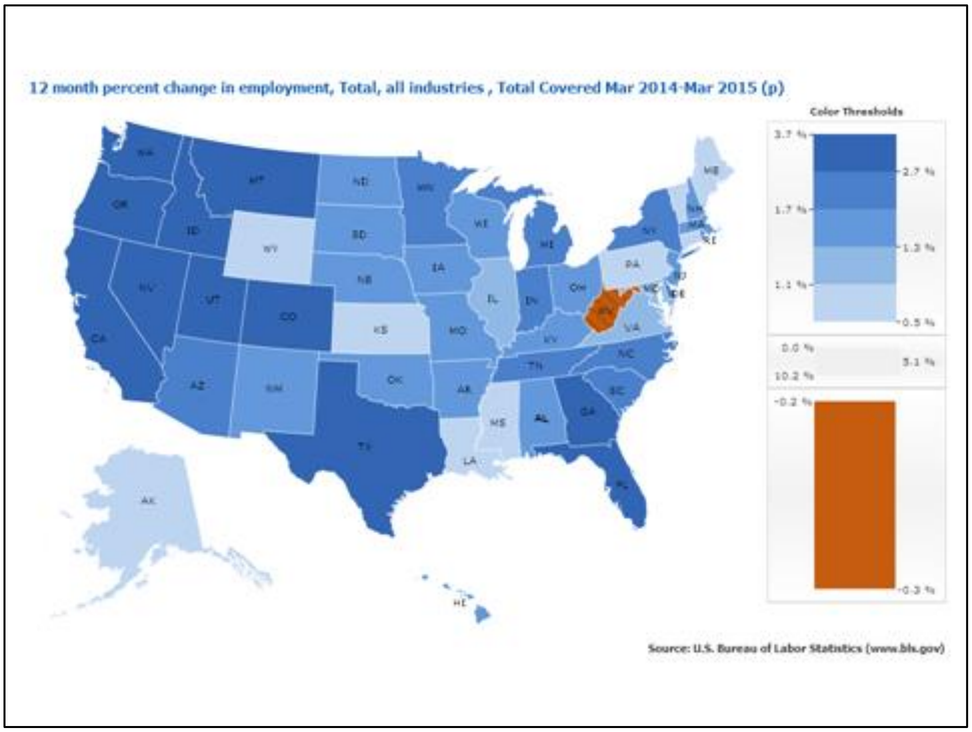
When asked how the economy is doing, I often reply "Which zip code are you interested in"? There is a lot of variation across US regions. The next chart reports growth in real GDP for 2014 by state and region. Blue is the happy color. The darker, the better. Mustard is to be avoided. It is a mixed bag, even in the regions. Among regions, the Southwest is running at top speed, mainly due to Texas, and the Plains states are taking up the rear. A quick glance tells us that west of Mississippi looks much better than does the eastern US.

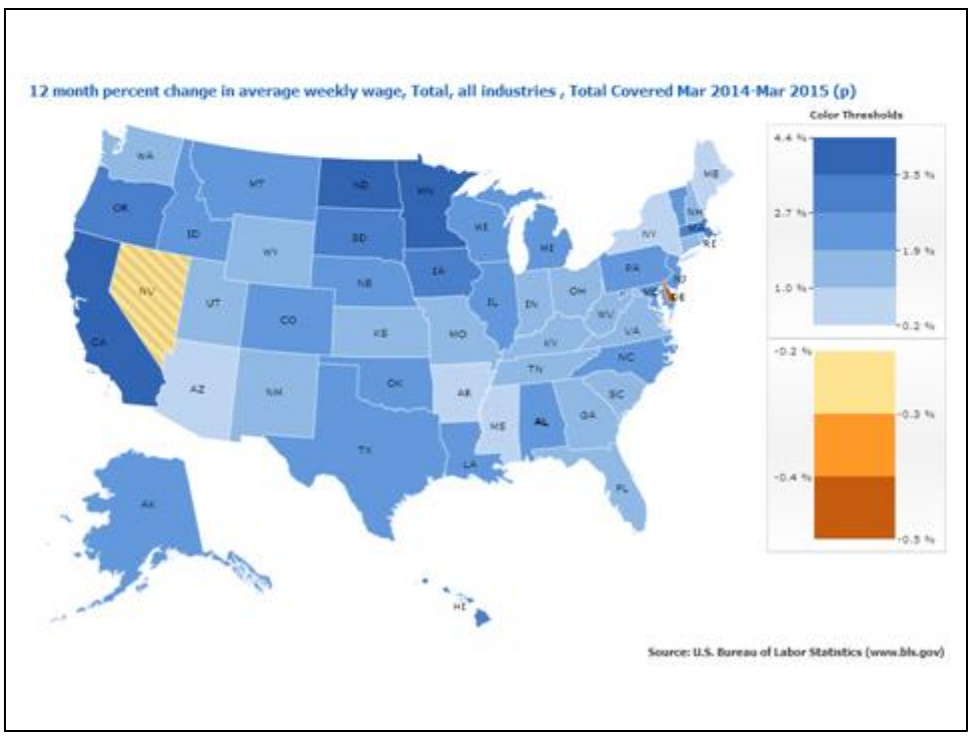


U.S. Bureau of Economic Analysis

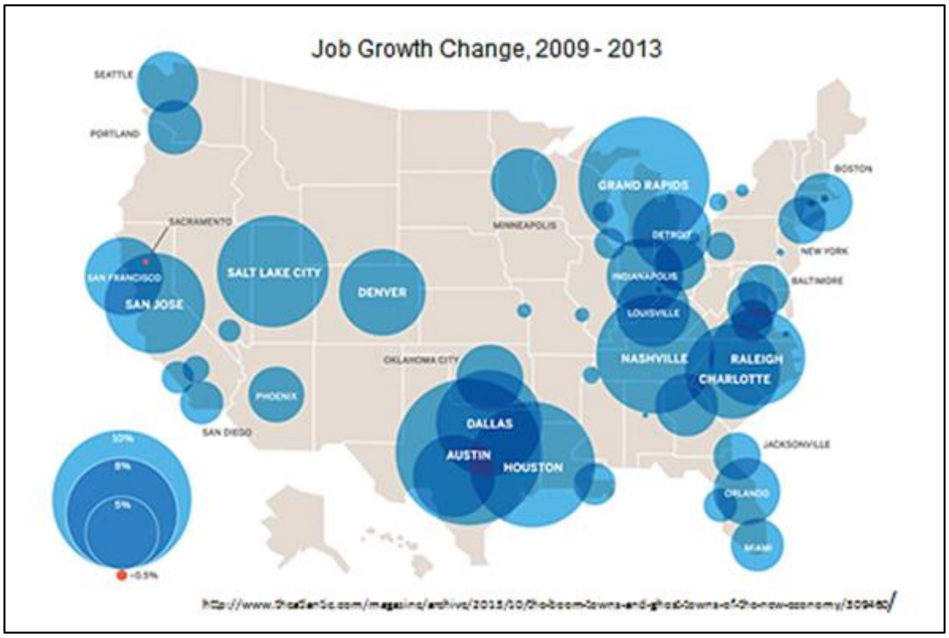
We get a more recent view of things in the next two charts. The first reports employment growth by state across the 12-month period, March 2014 – 2015. Once again, darker blue is preferred, and mustard is to be avoided. This more recent data conforms to the previous chart. The western US continues to show the greater regional strength.

The second chart in this 2-chart series report the gain in weekly wages across the 50 states for the same March over March period. West Virginia looks lonesome; it is the only state that shows a decline in wages. But is there considerable variation across the other states. The northwestern corner of the map shows consistent move to higher wages.

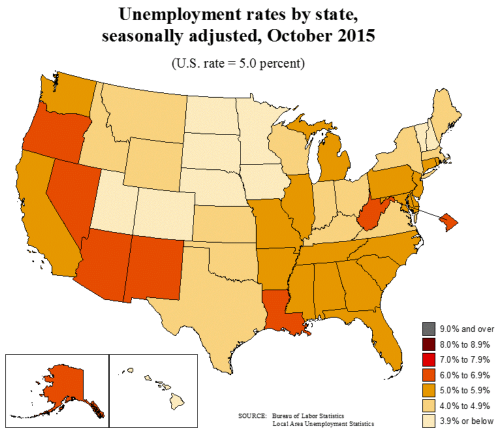

12 month percent change in employment, Total, all industries , Total Covered Mar 2014-Mar 2015 (p)
Color Thresholds
3.7 %
2.7 %
1.7 %
1.3 %
1.1 %
0.5 %
0.0 %
3.1 %
10.2 %
-0.2 %
-0.3 %
Source: U.S. Bureau of Labor Statistics (www.bls.gov)

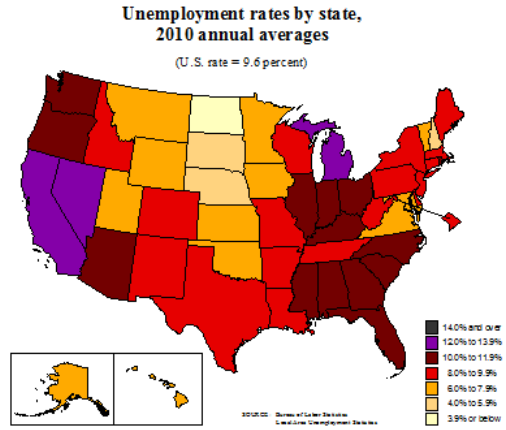

12 month percent change in average weekly wage, Total, all industries , Total Covered Mar 2014-Mar 2015 (p)
Color Thresholds
4.4 %
3.5 %
2.7 %
1.9 %
1.0 %
0.2 %
-0.2 %
-0.3 %
-0.4 %
-0.5 %
Source: U.S. Bureau of Labor Statistics (www.bls.gov)

Examination of Metro area employment growth sheds a bit more light on how the new economy is taking shape. As might be expected, urban growth is the driver. I call attention to the large overlapping Texas metro circles. These are to be expected, I suppose. The surprises? Nashville and Grand Rapids. At least for me.



A much more distinct picture of relative strength is seen when we examine state unemployment rates. In the next panel, I report data for October 2015 and the year averages for 2010. The 2015 data tell us that the nation's solid economic strength, as revealed by unemployment rates, is found in the fold of the map, in those wonderful square and almost-square states that are known for energy and hard grain production. A deep sense of economic progress emerges when the 2010 data are compared with 2015. But take a look at those square states. They were hustling along nicely even during those tough times.





Recognizing this suggests there is far more to the strength of the square states than abundant energy. Educational attainment may be the elephant in the room. Those square states and their neighbors are characterized by an unusually high share of the adult population with a high school diploma or more education. They have lots of the ultimate resource: human beings with human capital.

For Winter Reading

A few weeks ago, Dot and I went to the annual Pickens County Library sale of surplus books. Once again, we came home with 30 or 40 irresistible items. (For some reason, they seemed more irresistible when we were looking than after we got them home.) There are some gems. Let me tell you about one of them. In the "oldie but goodie category," I read and now recommend Truett Cathy's 2002 *Eat Mor Chikin. Inspire More People*, (Decatur, GA: Looking Glass Books). It is a deeply personal autobiography that recounts the amazing Chick-fil-A story. In 2002, when the book was written, the chain, which began in 1946 with one restaurant, had 1,000 locations and $1 billion in sales. In 2014, locations topped 1,900 and sales hit $6 billion. By the way, that very first restaurant is still operating. Chick-fil-A seems to be on a roll. Pardon the pun!

What explains it? According to Cathy, who died in 2014 when 93 years old, the secret is so simple as to be obvious. Business should focus on building loyalty by serving a top quality product, keeping the menu simple, doing so in an uncompromisingly clean and attractive facility, and caring for customers with a top performing staff.

But there may be more to the story than this. Cathy makes the case for being passionate about work, looking forward to each day's life opportunity, and about caring a lot for the people in the communities served, especially for children who may have lost out in life's struggles. Of course, Cathy brought a deep commitment to Christian principles that he sought to integrate into all he did. But there is still more to Cathy's success formula, or so it seems. Along with being passionate, owners must be happy to do whatever it takes to make things hum, which includes picking up trash in parking lots, cleaning commodes, and scraping chewing gum from under counter tops.

Upon reflecting on the story, I could not help but wonder where the future Truett Cathys will come from. He grew up poor but proud to be earning part of the family income, absorbing and happily applying survival lessons learned from a mother who struggled to make ends meet. I cannot answer the question about future Cathys, but the thought brings me to a related point and the introduction of a second book, 2015 Nobel Laureate Angus Deaton's *The Great Escape* (Princeton University Press, 2013).

Deaton's *Great Escape* recounts the amazing story of how ordinary people in the 18th century Western world began to escape endless poverty. In describing this ongoing process that now touches populations worldwide, Deaton makes a simple but powerful point. Not every member of a society will simultaneously rise above grinding poverty, all in the same decade or century. The result? Inequality. A society that enables wealth creating opportunities for all will find that "many are called, but few are chosen." Free markets reward the productive, the creative, the hard working, and, of course, the lucky. A goal of limiting inequality implies placing limitations on the wealth creation process. A society so limited will be poorer over all but may exhibit lower inequality. While making these points, Deaton moves quickly to argue that life is about the pursuit of happiness, which is not necessarily collinear with income. Along the way, he provides lots of data on cross-country happiness and on self-reported wellbeing studies.

Is there a Great Escape recipe that wealthier nations can write down and pass on as policy prescriptions to people in low income countries? Deaton leaves serious doubt that well-intentioned Western economic "doctors" can prescribe wealth-creation techniques and policies and expect to see sustainable economic progress get rooted in other cultures and apparently non-performing countries. The process seems to be organic, something that grows from within societies, a process that inspires institutions that enable and protect wealth and along with prosperity greater inequality.

Maybe, just maybe, the 18th century Western world experienced a rare but fortuitous positioning of political and economic forces that delivered a strong system of natural liberty, as Adam Smith termed it, a system that left individuals with freedom to pursue happiness, to work, to succeed, and to fail, in a society constitutionally protected from an overreaching government and with a system of property rights protected by a rule of law. This may be what we mean when we speak of American exceptionalism.

The Road Ahead

Starting with GDP growth, I have now reviewed some major elements of the US economic situation. Demand for US goods has weakened due primarily to slow growth in China and the developing world. A strong dollar generated by European and US monetary policy reduces net exports. That adds another negative element when GDP growth is calculated. These external forces play across a domestic economy that is chastened by growing regulatory constraints, uncertain immigration policy, calls for higher minimum wages, and adjustments generated by dramatically lower energy and commodity prices. Through it all, US consumers form the locomotive pulling the economy forward. Final consumption of goods and services, which includes healthier housing and other construction, keeps the economy chugging, though at a moderate level.

The 2016 Economy

Putting all this in the pot and stirring yields a 2016 forecast that calls for 2.4% to 2.6% real GDP growth, with an occasional bump across the 3% line. Put another way, if the 2015 economy produced happiness in your neighborhood, you should be happy with 2016. Lagging global demand for commodities will keep a lid on inflation, but will not counter the effects of tighter labor market constraints. The year ahead should bring additional gains in wages, especially in the services sector. Overall inflation will begin to nudge higher, but will not likely break through the 2.5% level.

Interest rates? They are already rising. Action taken by the Fed to nudge up rates in the year ahead will reshape interest rate trends, pushing them a bit higher, but not by enough to take a bite out of credit markets.

The Middle East Tragedy

Looking at a larger dimension of human wellbeing, I cannot help but reflect on the tragedy occurring across the Middle East and in affected neighboring and distant countries where almost countless individuals and families are struggling to find safe harbors for themselves and those they love. In the life and death struggles that unfold before our eyes, we witness the best and worst characteristics of human nature and passions. We see some reaching out and giving a push forward while others, perhaps more fearful about their own insecurity, try to shut the door on the many who hope to head to higher ground, who simply want to live. There is profound scarcity on both sides of the borders. One signature or telephone call can open the door for a refugee family or end a job for someone who is barely making it. As we observe images of struggle, we are reminded of stories of our kinsmen, perhaps centuries ago, who made their way through seemingly hopeless situations, built secure nests, raised families, and experienced that rarest of theretofore human experiences—rising incomes and surging human happiness.

I write this report during Thanksgiving week, that exclusively American holiday when we take time to gather as families and express thanks for the exceedingly bountiful harvest that keeps us secure in our homes and in our land. It is a time to count our blessings and to share them with others.