THE ECONOMIC SITUATION

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September 2009

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- **South Carolina Digest**

The signs of a recession ending

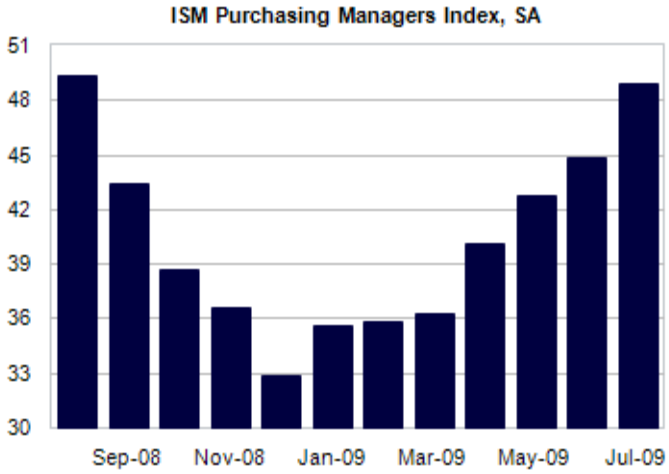
Cartoonist Robert Ariail has generously granted permission for me to use his cartoons.

Robert Ariail's cartoon offers more than a grain of truth in President Obama's good news message. The Bureau of Labor Statistics' July *Employment Situation* report indicated that the nation is shedding employment at a slower rate, and that may well be one of many signs that the 2007-09 recession has ended.

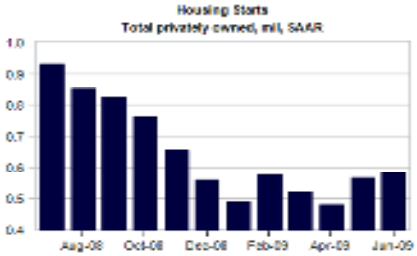
I am betting that when the experts set this recession's closing date they will choose either August or September of 2009. This will make this recession the longest, but not the most painful, since 1948. But remember, the end of a recession means things will not get any worse. Getting better depends on recovery, and the road ahead looks pretty bumpy.

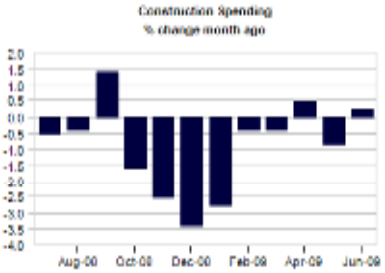
U.S. Recessions	1948 - 2009
DATE	DURATION (Months)
1948-49	11
1953-54	10
1957-58	8
1960-61	10
1968-70	11
1973-75	16
1980-80	6
1981-82	16
1990-91	8
2001-2002	8
2007- ?	20 ... and holding
Average 1945-2001	10

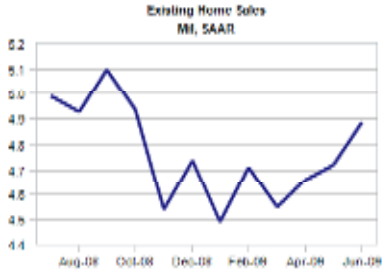
But there is more to the good news story. As shown below, the Institute of Supply Management's July manufacturing economy index is nudging 50, the neutral value that when passed will indicate recovery is on hand.



Even the much belabored housing market, much like Lazareth, is rattling forth from the grave. But remember, the rising factory and housing action is taking place at a very low level of activity.

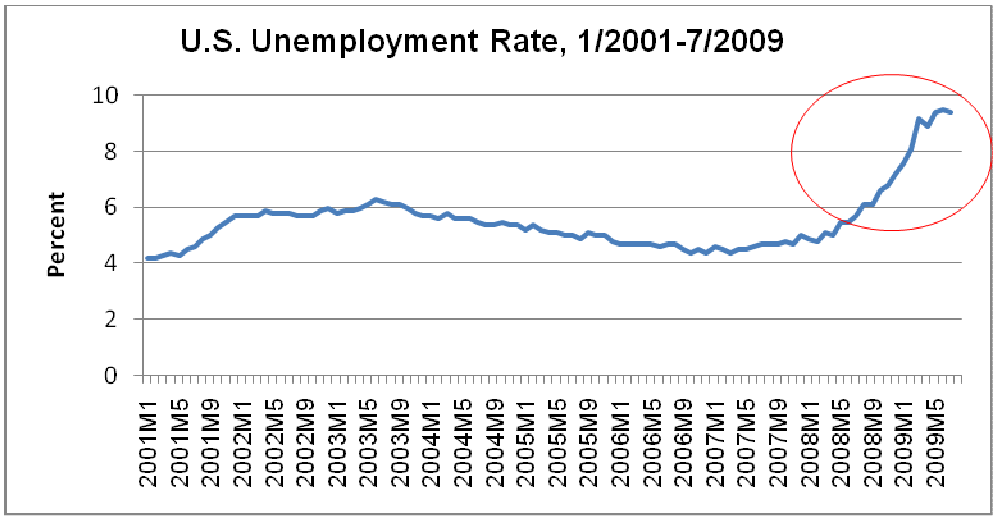




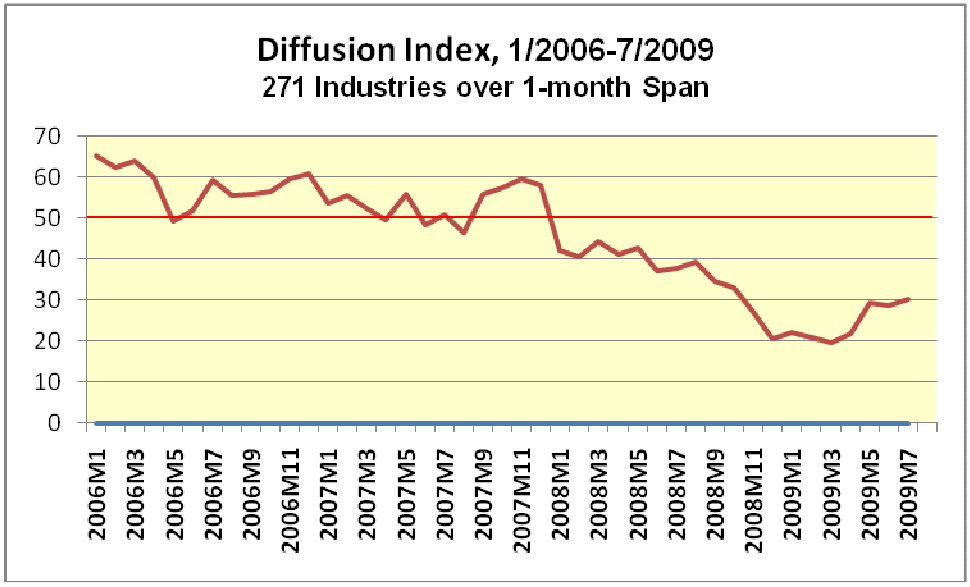


Labor markets are also improving… from a low level.

Improved labor market conditions are seen in the nation's July unemployment rate, which fell ever so slightly to 9.4% from June's 9.5%. The difference is hardly significant in a statistical sense, but the fact that the rate held is one more indicator that the recession is breathing its last breath. The unemployment rate is predicted to continue its upward path for a few more months. When real GDP growth is less than 2.5%, the number of people entering the labor force each month exceeds the number of job opportunities that become available. It is only after economic recovery takes hold that the unemployment rate will decline. Look for this in the first half of 2010.



Continued economic weakness, but with some improvement, is seen in the employment diffusion index, which gives a reading on the share of industrial sectors that is expanding or contracting. As seen below, the index is gradually clawing its way toward 50, which is the neutral no-growth line. There are still more sectors shedding jobs than adding them.



GDP growth is helped by clunkers…, for now. But what about us?

Back when GM and Chrysler were still just teetering on the verge of bankruptcy, some Washington wag suggested that if the government really was serious about helping the auto companies, then the politicians should just make it possible for people to buy a few hundred

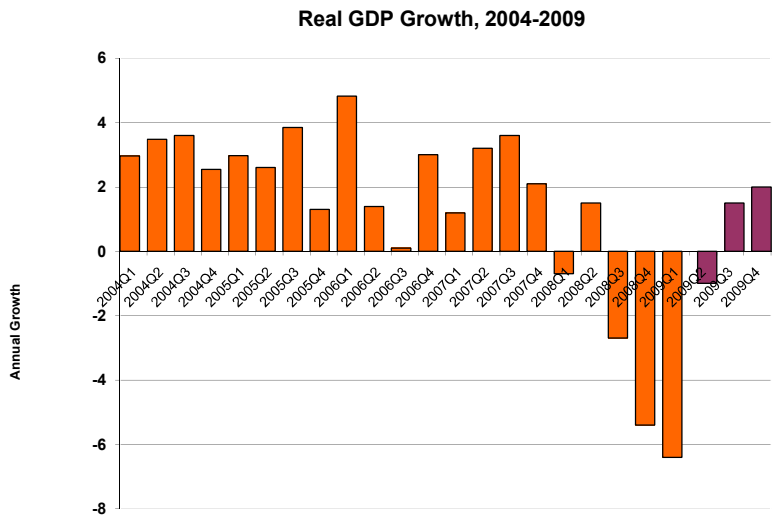
thousand automobiles. Going for the juglar seemed a lot simpler than Washington trickle down economics, which favored running money through state and local government filters.

The idea had political merit, if nothing more. Germany was doing it, and France was ready to start. U.S. politicians starting talking, and talking, and talking. Meanwhile some auto buyers who would have been buying decided to keep their powder dry. Why buy now when good old Uncle Sugar may help in a few months. Auto sales sank further; GM and Chrysler hit the wall.

There is more to the story, of course, but Dollars for Clunkers came to the rescue. The Clunker deal was so good that it ran out of money. Now, it seems, some 500,000 autos will be sold, and we lucky taxpayers will be in hock for $3 billion.

Talk about stimulus! Best estimates suggest that the Clunker program could add a half percentage points to 3Q2009 GDP growth. Part of the auto-driven growth makes up for purchases delayed while the law was being debated; another part is made of purchases made earlier because of the one-time incentives. The auto nudge comes on top of the early effects of the larger stimulus action, which targets state and local governments. But the Clunker stimulus ends in Septembers, while the other stimulus gains momentum.

When combined with all the other ingredients in the GDP kitchen, we get a GDP chart that looks a lot better than the one we saw last quarter.



The chart's optimistic revisions show positive GDP growth emerging in 3Q2009 and continuing forward. The data suggest that recovery is underway and that we will see 2.0% to 2.5% GDP growth in the first half of 2010.

Is the auto stimulus a good idea? Relative to what? If money is to be printed and dropped on the economy to reduce unemployment, targeting auto sales may be better than just pushing the money to state capitals. That said, the rationale is fundamentally flawed. The clunker program calls for productive captial—clunkers—to be destroyed and replaced with new vehicles. Producing wealth that can be saved and transferred is one of life's most difficult challenges. Few societies are able to do it. Government programs that inspire destruction of useable machines send a powerfully destructive message, even in the guise of improving overall fuel efficiency.

As Bastiat pointed out in 1850 in his perceptive *Parable of the Broken Window*, there are gains when a hoodlum throws a brick through the butcher's plate glass window. After all, someone will sell and install a new window. But there is a loss that must be considered. Otherwise, we would give merit badges to scouts who learn to throw bricks more accurately through windows. And we would celebrate politicians who pay us to destroy workable trucks and automobiles, and plow under every other row of cotton, and slaughter pigs to keep them off the market, and convert grapes to raisens to support the higher wine prices, and to destroy energy while producing less energetic ethanol.

Indeed, we do…, as sad as it may seem.

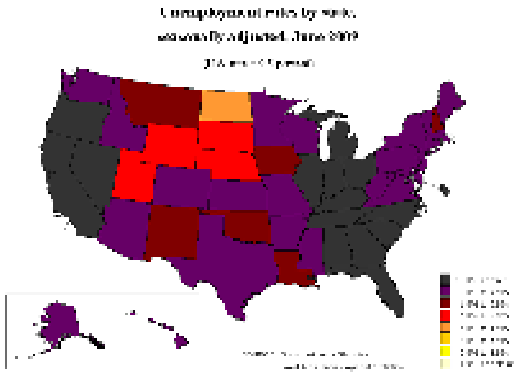
And, of course, there is a larger question of what we taxpayers would have done with our $3 billion if it hadn't been channeled to the Clunker program.

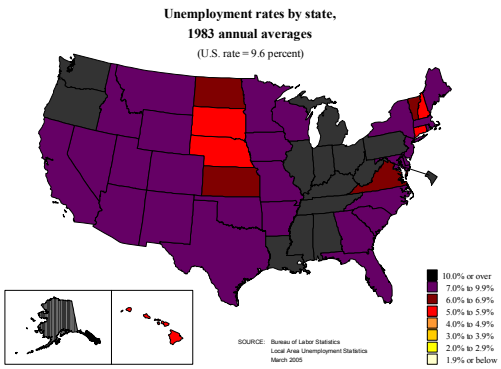
But, alas, we must move on.

How about the states? When will they recover?

The unemployment quilt formed across the 50 states by this recession shows clearly that relative strength continues to hold in the energy states. The greatest relative weakness is seen in the nation's manufacturing belt, which extends from the Midwest to the Southeast. The two maps give a comparison of the current picture with the average for 1983, which was a more severe recession than this one, in terms of unemployment effects, but not nearly as long as this recession.

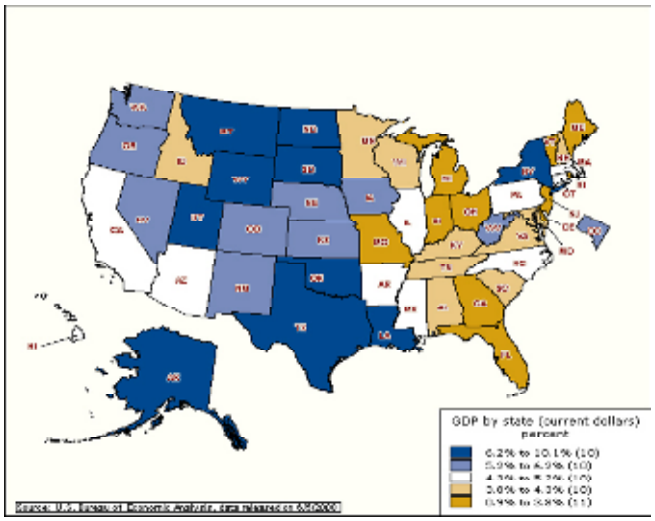
U.S. Recessions, 1983 and 2009



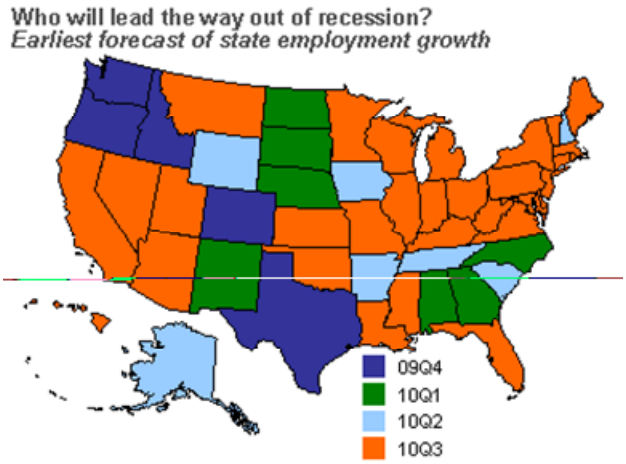


The unemployment pattern translates into nominal GDP growth shown in the next chart. Again, we see a prevailing pattern of strength: Put simply, things are much better west of the Mississippi than in the east.

Nominal GDP Growth: 2005-2008



And all of this translates into a recovery forecast developed by Economist.com and shown in the next map.



What's hot and what's not.

The Great American Bread Machine has a way of producing wealth even in the toughest of times. We understandably focus a lot of attention on unemployed people and resources, and we should. After all, we form communities of people; and community matters. But the economy is constantly adjusting to changing global market conditions, to innovations, recessions and recoveries. Throughout all this, some products gain advantage in the market while others cease to be hot. The Federal Reserve Board's Industrial Production product group indexes provide one way to observe the gainers and losers. I used this data to rank the

top 10 product groups shown in the accompanying table for selected years 1972 through 2009. I have colored the cells to make it easier to observe movement across the years.

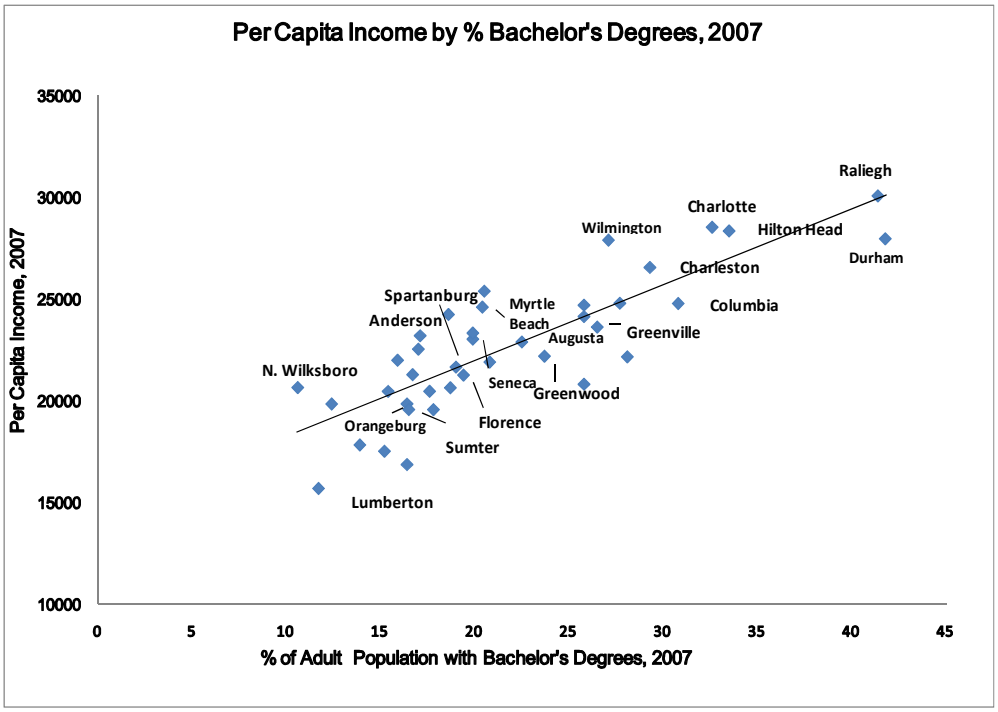
Production Rated Industry Rankings: What's Hot and What's Not

1972	1980	1990	2000	2004	2006	2009
Iron/Steel	Iron/Steel	Printing	Comp/El	Comp/El	Comp/El	Comp/El
Apparel	Apparel	Apparel	Autos	Autos	Machinery	Aircraft
Machinery	Machinery	Paper	Food	Food	Aircraft	Tobacco
Food	Fab, Met	Food	Fab. Met	Chemicals	Pet/Coal	Pet/Coal
Paper	Paper	Chemicals	Machinery	Iron/Steel	Food	Chemicals
Fab.Met	Food	Iron/Steel	Plas/Rub	Plas/Rub	Chemicals	Elec. Eqt.
Chemicals	Chemicals	Fab. Metal	Chemicals	Machinery	Fab.Met	Fab. Met
Autos	Printing	Machinery	Printing	Fab.Met	Minerals	Plas/Rub
Printing	Autos	Plas/Rub	Paper	Paper	Elec.Eqt.	Machinery
Plas/Rub	Plas/Rub	Autos	Iron/Steel	Printing	Iron/Steel	Minerals

It is interesting to see that Computer and Electronics has been the top product group since 2000 and that Aircraft has made a rapid upward move in just the last three years. It is also noteworthy that Chemicals has maintained a middle position in the rankings for the last 37 years. This seems to say a lot about that industry's comparative advantage in international trade. Movement across the cells gives hints about the U.S. industrial powerhouse, which in spite of speeches heard to the contrary, still leads the world in manufacturing output.

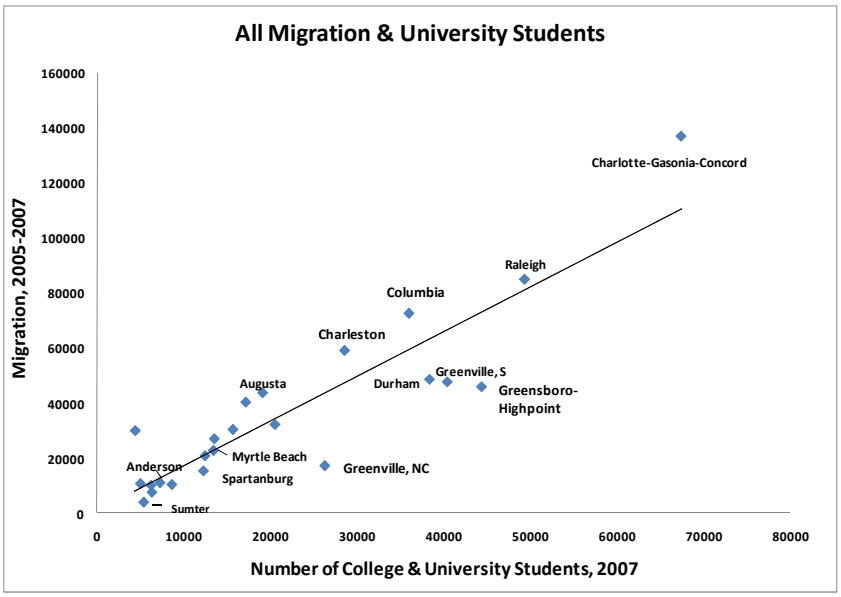
Brains and income go together.

For more than two years, the South Carolina Research Authority has supported the work of Clemson graduate students who worked with me in a study of the knowledge economy. We built knowledge economy indexes for the 50 states and for more than 100 southern metropolitan areas. Our indexes enabled us to rank the relative positions of these units and then to study the determinants of the rankings. In one of our investigations, Kristine Koutout and I ranked the top 50 southern metro areas and then looked at metro rankings for the combined states of North Carolina, South Carolina, and Georgia. (I reported those rankings in the June *Economic Situation* report.) We also examined the relationship between income and educational attainment for a sample of North Carolina and South Carolina cities. This is shown in the next chart.



As we studied the rankings, we realized that most of the high ranking cities contained major research universities and/or medical research universities. This observation sent us on a research mission to determine the role of universities in attracting people as they relocate across cities and regions. We studied migration patterns for different demographic groups. We built statistical models in effort to explain the migration determinants for more than 120 cities. To account for the presence of universities, we included the number of college and university students located in each city. This made it possible for us to capture a scale effect. Our results were robust. The number of students was a highly significant and positive variable in explaining migration for people in the 25-39 age group; the variable was not significant in explaining migration for the 40-54 age group.

Now we do not claim to understand how all this works. But findings from a large number of statistical models tell us that students matter in attracting the age group that will form the future economy. We doubt that it is just students; we think that the number of students proxies for a cultural environment that includes the arts, dynamic downtown areas, and intellectual activities. In our work, we focused on some very recent periods. The next chart shows a mapping for all-age migration across North Carolina and South Carolina cities based on the number of college and university students located in those cities.



A few cheers for capitalism.

There are few who can top Arthur Selden's ability to describe and defend capitalism. At a time when capitalism is again under attack, we may need to be reminded that this social system, even with its flaws, generates wealth and opportunity like none other under the sun. When discussing how capitalism has rebounded from human and natural disaster, precarious political institutions, war and recessions, Selden put it this way:

> The historic recuperative strength of capitalism lies in seven pillars: the human ability to recover after adversity that it liberates, the family it fortifies by refraining from paternalism, the private property it strengthens by law, the ferment of new thought and ideas that it promotes by political liberty, the encouragement of scientific discovery it creates by the prospect of individual gain, the generosity in giving it promotes by low taxation and the ethical teaching that a man's worth shall be judged by his contribution to wealth as valued by his fellows in the market rather than by his political/cultural influences. This is the glory of capitalism we should celebrate.

Arthur Selden. *The Virtues of Capitalism*. The Collected Works of Arthur Selden. Indianapolis: Liberty Fund Inc., 2004: 275-76.

Pass it on!