THE ECONOMIC SITUATION

A Strom Thurmond Institute and
College of Business & Public Affairs Report

Bruce Yandle

VOLUME VIII, NO. 2 | A quarterly report on economic trends. | JUNE 2000

Higher interest rates and a cooler economy.
What about our trading partners and oil prices?
South Carolina: Taking the lead in a slower economy.
Alexander Graham Bell: An American hero.

The Weather is Hotter, but the Economy is Cooler

With six increases in interest rates in the last 12 months, the Federal Reserve Open Market Committee finally achieved its goal. America's highly charged economy—the Great American Bread Machine—is reluctantly slowing down. It had to happen. Even an information-rich new economy must yield to the constraining effects of substantially higher interest rates. But keep in mind, that three of those interest rate increases can be thought of as offsetting three decreases associated with the 1998 Asian meltdown. We are also talking about a slowdown from a very fast pace. First quarter GDP growth registered 7.3%, and second quarter came in at 5.4%. For the sake of perspective, GDP growth for the decade of the 1990s and 1980s was 3.1%. Don't get out the sack cloth and ashes yet.

National data seem to show the beginning of a classic pattern of a Fed-induced slowdown. Those activities most sensitive to the cost of borrowed money take it on the chin first. Then, the slowing effects spread to other sectors until finally the economy moves slower in a higher interest rate world. Just how far this plays out depends on future Fed action.

What are the interest sensitive sectors? Housing; debt-based commercial and industrial investments in capital, inventories, and structures; auto and truck sales; and debt-financed mergers and acquisitions. Higher interest rates also reduce the evaluations of all assets that generate future earnings. All else equal, a dollar to be received one year from now is worth less when the prime interest rate is 9.50% than when the prime is 8.00%. As a reminder, one can put away less money at 9.50% and earn a dollar in 12 months than at the lower rate. The result: Share values fall with higher interest rates unless expectations for corporate profits just happen to improve with the higher interest rates.

These effects are observed nationwide in the decline in housing starts and home sales and in weaker auto and other retail sales. Retail sales nationwide fell in April and May to yield a 4.5% annual growth rate, which compares poorly with the boiling hot 13.6% growth rate for the year's first quarter. The economy's weakness is also seen in employment numbers. Excluding the 357,000 census workers added in May, nonfarm employment fell by 126,000 workers, the first decline in five years. Since con-

Sponsored by the BB&T Scholar's Program at Clemson University

sumer purchases account for two-thirds of GDP, we can be confident that GDP growth in the last half of the year will be lower than in the first half.

This is exactly what the forecasters are telling us. The latest Blue Chip consensus indicates GDP growth will average 3.6% over the next three quarters as compared with the much faster 6% growth in the most recent nine months. They say we will see GDP growth of 4.8% this year and 3.3% for 2001. WEFA Inc. predicts GDP growth of 4.2% for this year and 3.7% for 2001. And Wake Forest's Gary Shoesmith calls for 4.85% growth for 2000 and 3.24% for 2001. When displayed graphically, the plotted growth rates for 1998, 1999, 2000 and 2001 form a not-very-pretty inverted saucer. It is worth noting, and emphasizing, that these weaker expectations if realized would still yield higher GDP growth than the historic average. Still, margins matter most. At the margin, the economy is slowing. What are the prospects of a "soft landing"? Is there an economic parachute out there?

Trading Partners to the Rescue. But what about Oil?

The health of our major trading partners determines one force that might help keep the U.S. economy chugging. While things are slowing down a bit here, the outlook is for stronger growth for our major trading partners: Canada, Mexico, Japan, the United Kingdom, and for the major European economies. In fact, Japan is coming out of a rather long recession. This will yield stronger U.S. export sales. All else being equal, a positive GDP nudge.

What about that high priced oil and gasoline? Are we in for another oil price shock? Not by a long shot. When stated in 1999 dollars, the price of oil peaked in 1980 at about $80 per barrel. Finally, after a long downhill slide, in December 1998, oil was trading at a record low of $11 a barrel. We know the current situation. In recent weeks, the price has risen above $30 and now seems to be headed toward $22-$25, the price that prevailed for most of the 1990s.

Those 1998 prices spoiled us. As St. Louis Fed economist James Bullard puts it: "[T]he recent run-up in the price of oil reflects not so much a high price today as a shockingly low price during the fall of 1998." Our memories are short. In any case, higher priced energy has a smaller effect on the national economy now than in the past. The percent of oil and energy expenditures in GDP has fallen from a 1980 high of 3.5% to a bit more than 1.5%. Bottom line: Gasoline sticker shock hurts the family budget and takes a big bite when filling the SUVs, but will not generate a shock to the national economy.

South Carolina Not as Hot as it Used to Be

In recent years, the South Carolina economy has been a bit ahead of the nation in registering the effects of a slowdown and also in generating evidence of recovery. The state's manufacturing and auto specialization is part of the explanation. The linkage from textiles to home furnishings is another part of the puzzle. The housing and auto sectors feel the first pain when the fed tightens credit. Fewer car sales mean fewer BMWs, and Hondas, as well as fewer Michelin and Firestone/Bridgestone tires and auto upholstery. Fewer new homes mean less carpet, drapes, and other textile-based home furnishings. Our state specializes in leading edge manufacturing.

Evidence of the linkage has been showing up for several months. There is no growth in manufacturing employment, and services employment growth has slowed substantially since January. New residential building permits issued in the state are running 15% below last year's numbers. New home sales are off as well. State retail sales since January have been growing at less than 3% a month, as compared with the nation's 4.1%. Relative to the

nation, the state is still expected to have faster growth in personal income and employment this year and next, but the differential between the state and nation is narrowing.

WEFA, a leading economic consulting firm, has just published a ranking of 1999 employment growth for national metropolitan areas in the 300,000 to one million population category. Charleston, SC, is second in the nation, just behind Tucson, AZ, the nations fastest growing urban area. Columbia ranks 15th, and Augusta-Aiken is 39th. Greenville-Spartanburg comes in at 48th. Charleston was 9th in income growth, while Columbia was 29th, and Greenville-Spartanburg was 25th. Augusta-Aiken came in at 62nd.

A comparison of housing permit data for the state's three largest metro areas shows a similar pattern. For 1993 through 1996, Greenville-Spartanburg was the state's most vital housing market. Charleston and Columbia were substantially less active, with Columbia taking the lead. In early 1997, Charleston pulled away from the other two cities and has been the housing leader ever since. Columbia and Greenville-Spartanburg are now in lock step running a distant second to Charleston.

Looking for Heroes: Alexander Graham Bell

For some time now, I have been looking for a particular kind of hero—the person who does well by doing good. A while back, I wrote a short note about Mary McLeod Bethune and Charles Kettering. Bethune, child of former slaves, built a successful career in higher education and founded a college that has prospered. She did well by doing good. Kettering was inspired to invent the electric automobile starter after a close friend was killed when trying to start his car with a hand crank. He also did well by doing good.

Clemson students have assisted me in my search for heroes. This spring Sammy Little, an economics major from Pickens, did some research on Alexander Graham Bell. At the outset, we thought he might be a hero, but we weren't sure. We knew he had an interest in helping deaf people, did wonders with the telephone and built a massive enterprise, but we didn't know much more. It turns out that Bell was indeed dedicated to helping the deaf. His mother was deaf. His father specialized in teaching deaf people. Bell was a respected specialist in working with the hearing impaired. His wife was deaf. His interest in hearing led him to invent the telephone, something that would help all people hear messages from greater distances. As his phone company prospered, Bell put more and more resources into assisting the hearing impaired. He also was one of the founders of National Geographic Magazine and the respected journal Science.

What's wonderful about America? It is possible for a Scottish borne scientist like Bell to pursue a dream to success or failure. The market economy makes it possible for people to do well while doing good.

THE ECONOMIC SITUATION
The Strom Thurmond Institute
Clemson University
Perimeter Road
Clemson, SC 29634-0125

The Economic Situation is printed quarterly by the Strom Thurmond Institute of Government and Public Affairs at Clemson University and the College of Business and Public Affairs. For more information contact the Strom Thurmond Institute at:
Telephone—(864)656-0215;
FAX— (864)656-4780;
e-mail—**publications@strom.clemson.edu**

Bruce Yandle is a Senior Fellow in the Strom Thurmond Institute of Government and Public Affairs at Clemson University. He is also a Professor of Economics Emeritus.

CLEMSON®
UNIVERSITY

Printed on
recycled paper.