THE ECONOMIC SITUATION

Bruce Yandle

Dean Emeritus, College of Business & Behavioral Science,
Clemson University. Distinguished Adjunct Professor of Economics,
Mercatus Center at George Mason University.

yandle@bellsouth.net

March 1, 2015

- **The U.S. locomotive economy.**
- **More on the energy story.**
- **What's happening to worker pay?**
- **Taking a fresh look at the U.S. Beveridge curve**
- **Paying interest on the national debt.**
- **Drawing on the connected brain.**
- **For the reading table.**

The U.S. Locomotive Economy

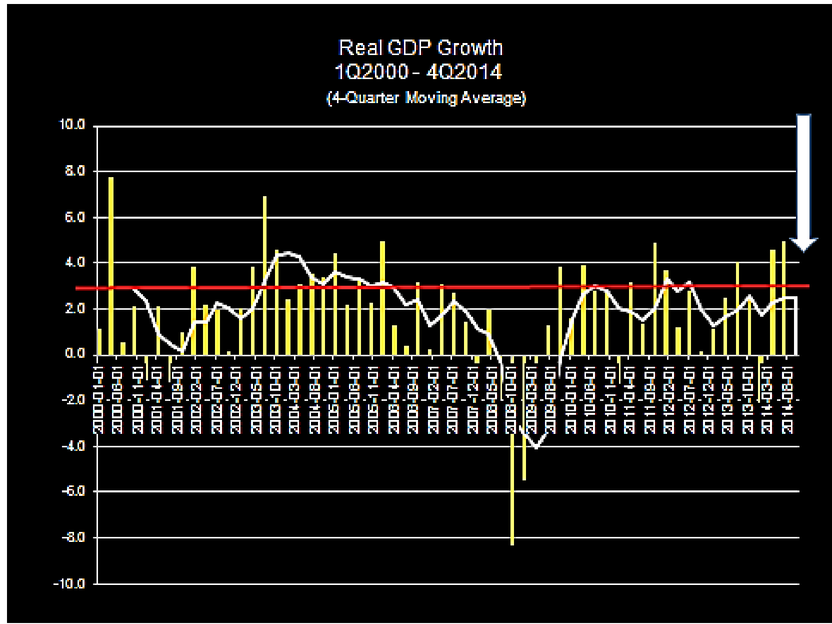
Has the U.S. economy kicked off third quarter's running cleats and slipped on bedroom shoes with very soft soles? The running pace has changed abruptly. As the accompanying chart tells us, the second estimate for 4Q2014 growth fell to 2.2 percent from 3Q2014's hair-raising 5.0 percent. Is this the economic engine that is pulling the world economy?

Yes, it's the best engine the system has. So why the sudden shift to second gear?

Weakness in the rest of the world is the major part of the story. Still seeking higher ground, Europe is slowly lifting off the edge of recession. China is running in third gear with growth hitting 7 percent instead of the "normal" 10 percent. Canada and Mexico are moving along at 2.5 percent growth. And Japan's is launched again, but just beginning to sail. It's a mixed bag, but still a decidedly weak one.

Meanwhile, with the dollar getting good as gold, while others cut interest rates in the hope of stimulating growth, U.S. exports are falling, and imports have surged.

The chart's white 4-quarter moving average shows real GDP growth is averaging about 2.6 percent for the year. The gap between current growth and the 3.14 percent long-term average may look like a permanent feature of the data landscape, but most forecasters are betting the gap will be closed as 2015 progresses. As always, there are some special considerations. This time, it is energy. And this time, the net effect is positive.



More on the energy story

The effects of the better than 50 percent decline in crude prices since June 2014 are now working their way through the economy. U.S. commentators cheered the explosive growth of shale oil production that triggered the price decline, and they should have. As will be shown later, it was growth in the shale oil states that propelled the U.S. economy as it sailed out of the recession. But folks on the other side of the pond—OPEC and its leader, Saudi Arabia—somehow felt differently about the matter. Let's face it, when prices fall, it matters whether you are a buyer or seller, a producer or a consumer, and folks who have dominated a product market for

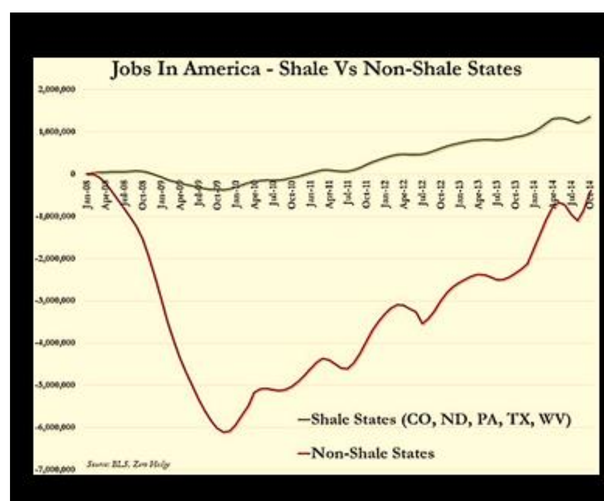
decades just don't go quietly into the night. On balance, of course, the U.S. is a consumer. Lower energy prices are a boon to the economy, maybe adding as much as 0.50 percentage points to GDP growth.

The decline in crude oil prices came when the Saudis targeted the U.S. and Asia with a price cut, raised their price to Europe, and opened up the valves for more oil production. When the price plummeted from $100 a barrel to $45, the Saudis responded with a smile. They are the world low-cost producer, and have lots of loot in their sovereign fund for weathering a long price war. Holding market share seems to be their current strategy.

While consumers overall can enjoy large savings in transportation cost, something on the order of $750 a year for the average family, just where they live and work puts a different spin on that, too.

The shale oil state boom

As seen here, the oil-shale states have led the way in job growth since 2008. Of course, not all that job growth was driven by expanded shale oil production, but lots of it was. The growth isn't over by a long shot, but the pace of growth is definitely slowing. In a real sense, energy production pulled the economy out of the jaws of the recession.



Shale oil and gas production was the stimulus program that finally worked. And it did not originate in Washington. But Washington was happy to see the result.

President Obama trumpeted the significance of the oil revolution in his 2015 State of the Union Address and attributed the success to our collective belief, a kind of celebration of *The Little Engine that Could*—"I think I can" effect:

"We believed we could reduce our dependence on foreign oil and protect our planet. And today, America is number one in oil and gas. America is number one in wind power. Every three weeks, we bring online as much solar power as we did in all of 2008. And thanks to lower gas prices and higher fuel standards, the typical family this year

should save about $750 at the pump."

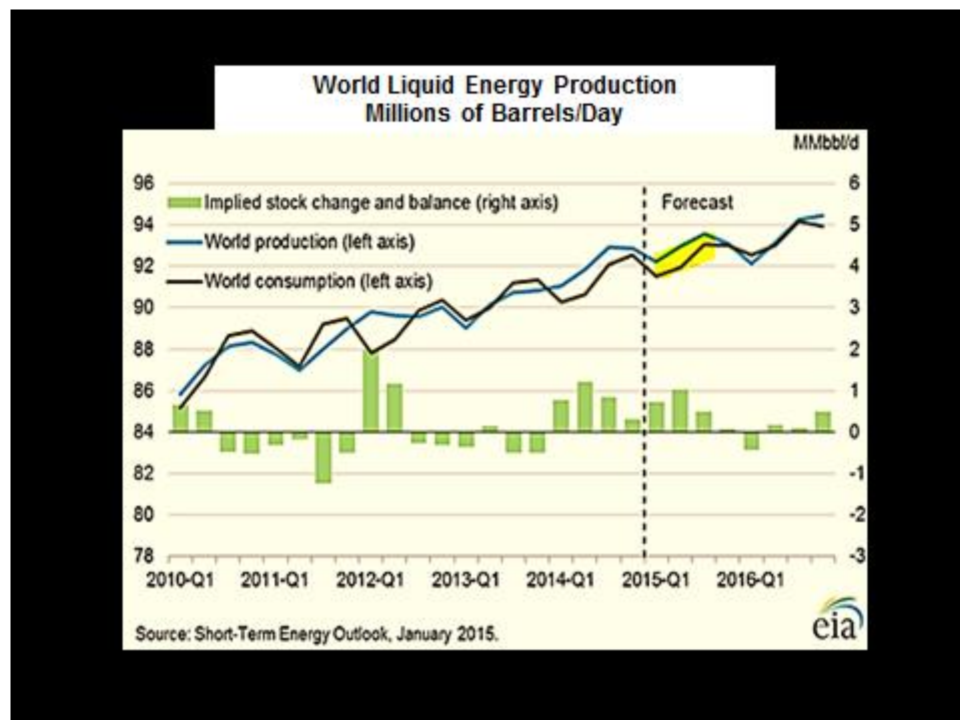
Those who were drilling, pumping, and carrying the shale oil product could probably point to lots of strands of regulatory barbed wire that stood in their way.

But the pendulum is swinging the other way for the shale states. According to *The Wall Street Journal*, Houston, for example, the epi-center of the boom buildup, had experienced an office space construction boom that accounts for one-sixth of all office space being built in the United States. At the end of 2014, there was about 18 million square feet of office space under construction, and that was based on $100 oil. *The Journal* reported that Halliburton, Baker Hughes, and BP had announced cuts of 23,000 jobs in association with the shale boom slowdown. Many of those were housed in Houston offices. The brakes are on.

The consumer response

But then there are consumers! Cheap gas has generated an interesting consumer response. Yes, gasoline sales have skyrocketed, but not much else has fired off in the retail sector. Consumers are apparently playing their cards close to the vest. They don't know how long this picnic will last. And no else does, either.

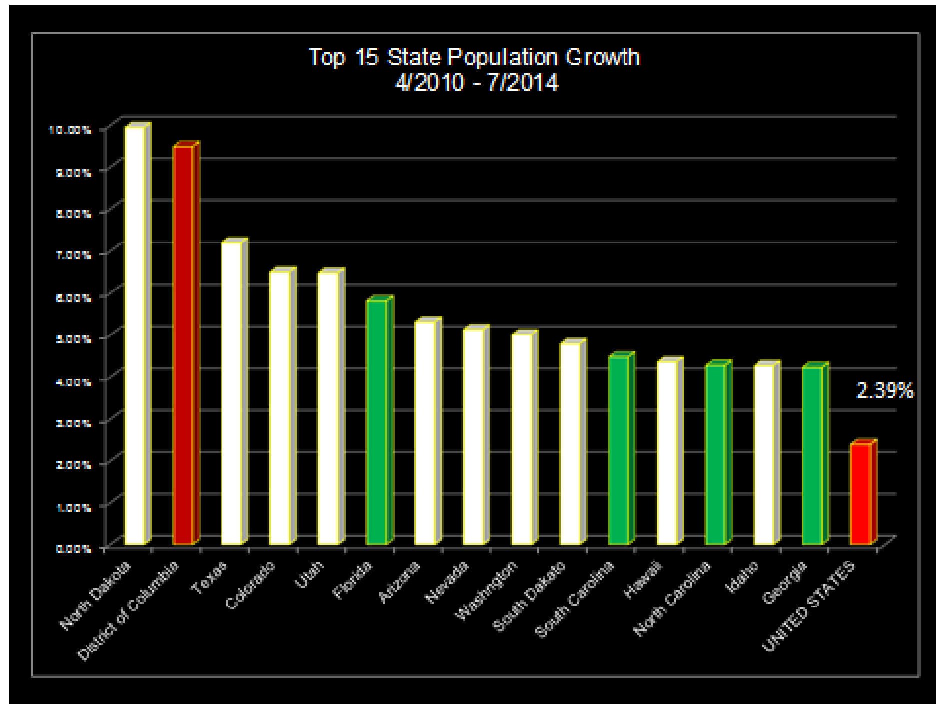
The Department of Energy provides data and a forecast for liquid energy production and consumption. Notice how production is well above consumption in the current period. According to the estimates, we can expect to see production outstripping consumption until 1Q2016, with supply and demand in balance after that.



But remember. We are not dealing with a competitive market where bottom line forces tend to dictate outcomes. More than 80 percent of world crude comes from government owned sources. A multiplicity of political goals affects the pricing and production process.

What about population growth?

Across the years 2010 through 2014, Western states, including petroleum producers Texas and North Dakota and some southeastern states, led U.S. population growth.

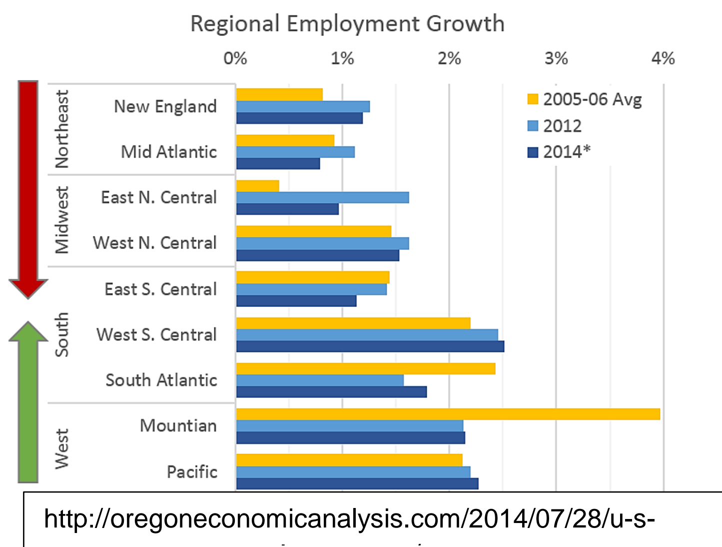


It is interesting that the top 15 includes just one “state” in the nation’s northeastern quadrant, and that’s the District of Columbia. The other 14 are either Western or Southeastern.

What’s happening to worker pay?

There has been understandable concern expressed for the lack of growth in worker wages. Time and again, we hear that wages are barely keeping up with inflation, if at all. Like most economic outcomes we observe, there are lots of moving parts to an explanation as to what is going on.

Industry mix matters. If lower paying industries are growing faster than higher paying ones, then average



http://oregoneconomicanalysis.com/2014/07/28/u-s-

wage grows less. In recent years, lower paying industries—leisure and tourism, education and health-care services--have grown faster. The extent of experience and skill matters, too, as does experience on the job. Right now, the average of age of workers is rising, with lots of over-65 workers remaining in the workforce. This implies more skill, but also a slowing down that comes with older age. During the recession, layoffs and employment instability caused the average tenure—the number of years on the job—to fall. In 2012, median tenure was just 4.6 years, and that reduces on-the-job skill levels.

Just where geographically employment is growing also matters. If growth is occurring in lower cost of living states, then average wages are correspondingly lower. If suddenly all the growth shifted to high cost of living states, wages would rise. But would the results make people better off?

Generally speaking, living costs are lower in the Southeast, and West. And that's where employment growth is higher.

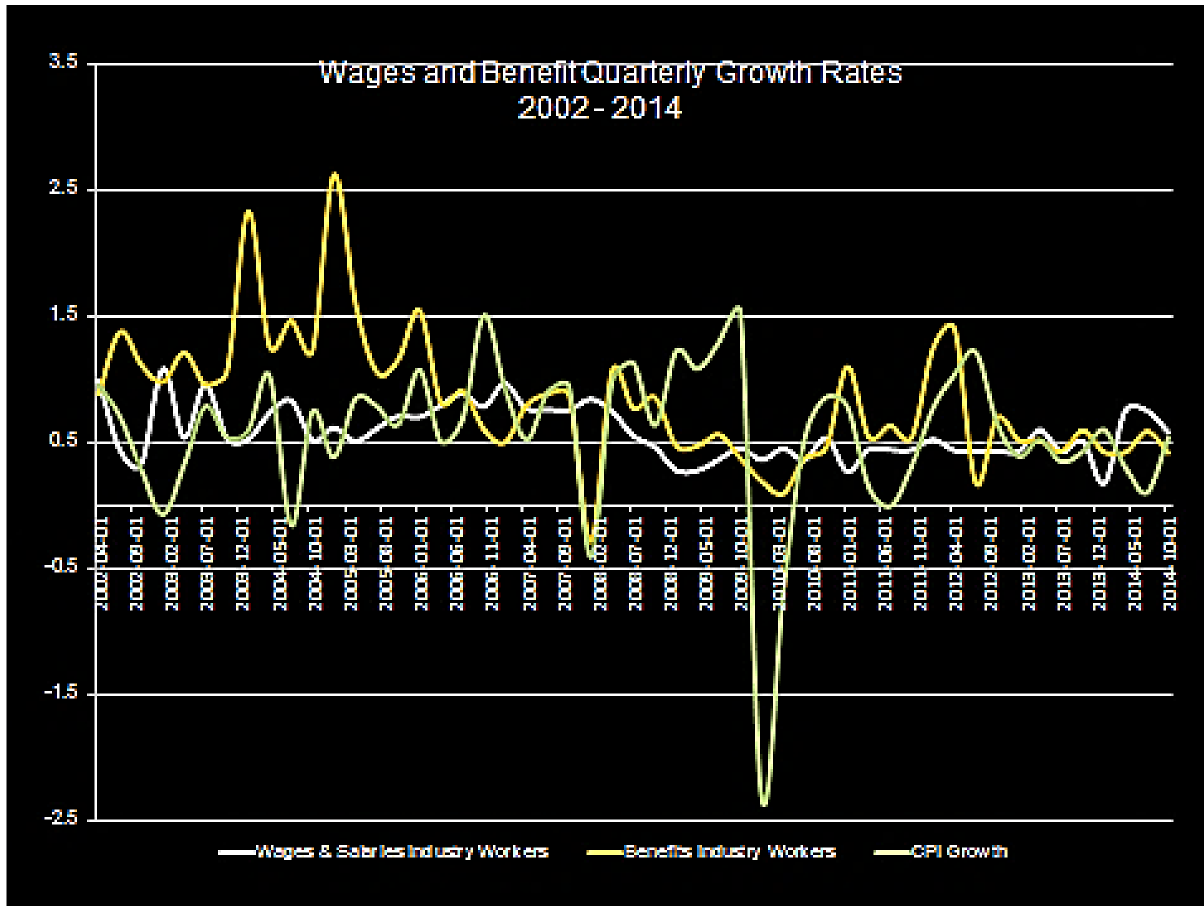
When these factors are considered, there is still another key consideration that has to be made. How much have fringe benefits increased? After all, workers are paid with a two-part package: before tax, take-home pay, and fringe benefits. Rising fringe benefits can combine with frozen wages to yield higher compensation, but with nothing to show for it in the pay envelope.

Enough talk, let's look at some data.

The next chart for U.S. industry workers shows growth in salaries and wages, growth in fringe benefits, and the growth rate of the CPI. The yellow line tracks fringe benefit growth. The white is for wage/salary growth, and the light green line is for CPI growth. Close examination of the three series enables us to speak to the questions: Are workers getting better off, when both components of pay are considered? And are workers getting ahead of the cost of living, as measured by the CPI.

I call attention to the chart's earlier years—2002-2005-- when fringe benefit growth was far outpacing wage and CPI growth. Workers were clearly getting ahead of the game, but primarily because of fringe benefits, not money in the pay envelope. Things

become chaotic from 2006 through 2012. Fringe benefit growth is swinging wildly, but wage growth is flat, and generally below CPI growth. Finally, during 2013 to 2014, wage growth rises above fringe benefits, which are also growing at a positive rate and CPI growth exceeds fringe growth.

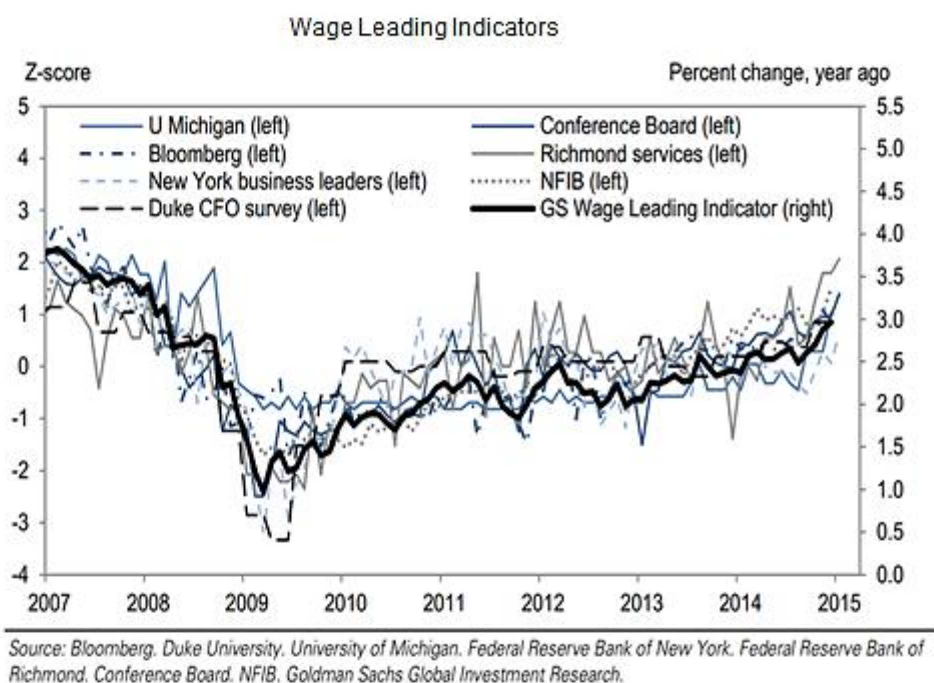


To get a better handle on this, I added the quarterly growth rates of wages and fringe benefits to get a total growth rate and then subtracted CPI growth from the total wage/fringe package. The number remaining is positive for all but five of 48 quarters. The average quarterly rate of growth in pay plus fringes over cost of living growth is 0.9 percent. Of this, the average growth for benefits is 0.8 percent, which leaves a tiny 0.1 percent for wage and salary gains. The total gain, after inflation, across the 12 years examined is 10.8 percent. Fringe benefit cost increases accounted for 9.6 percent of the total gained.

Are industry workers gaining on inflation? Yes, they are gaining on inflation when fringe benefits and regular compensation are considered. But it’s hard for them to know it.

Outlook for higher wages

On that not so optimistic note, let's take a look at some forecasts for what lies ahead for wage and salary growth. The next chart shows eight leading indicators. The consensus is clearly positive.



Source: Bloomberg, Duke University, University of Michigan, Federal Reserve Bank of New York, Federal Reserve Bank of Richmond, Conference Board, NFIB, Goldman Sachs Global Investment Research.

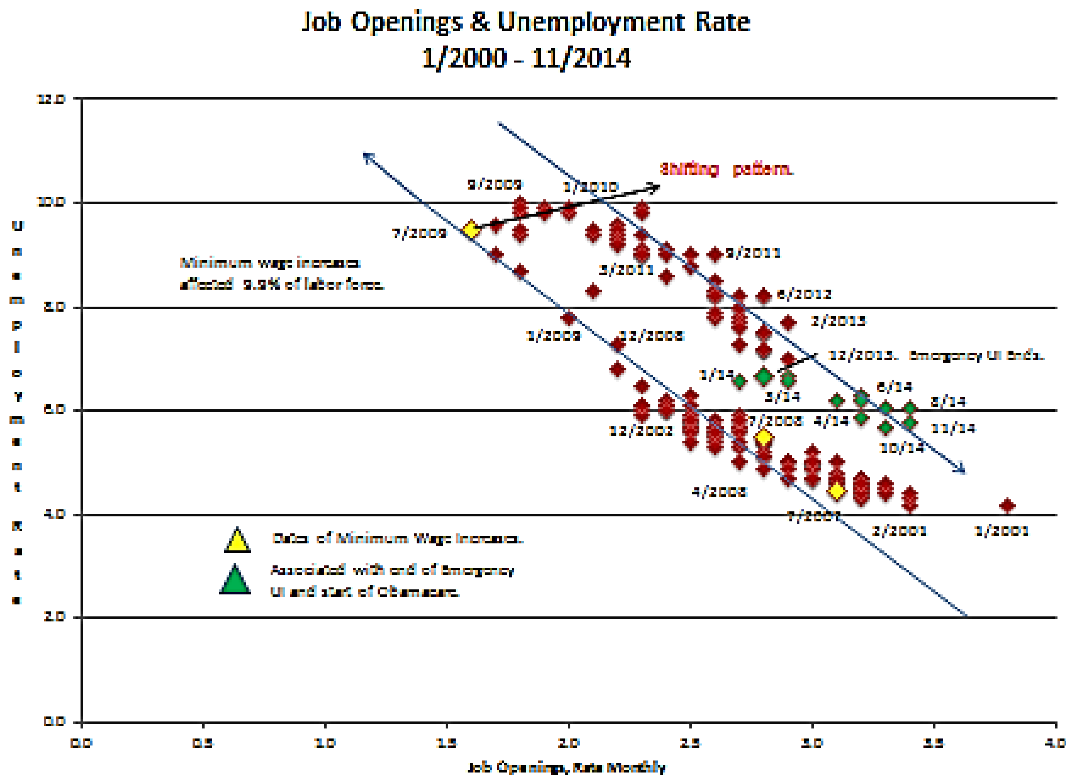
Taking a fresh look at the U.S. Beveridge curve

Readers with good memory will recall that in December 2013, I discussed a relationship between growth in job openings and the monthly unemployment rate. The data mapping is named for Beveridge, the British economist who thought the two phenomena should be linked. Common sense suggests that when the job openings grow faster, the unemployment rate should fall.

The Beveridge curve using the most recent data is provided next. I provide some vectors that show movement of the data points. The chart's distinctive two-part pattern indicates that the relationship changed fundamentally toward the end of 2009, which was when the last minimum wage increase fell into place. From that point on, the unemployment rate is higher for the same job opening rate when compared with the pre-2009 period.

The chart also marks December 2013, the date when emergency unemployment benefits ended. The loss of unemployment benefits caused some workers to reenter

the labor force, perhaps accepting a less desirable job than they might hope for. That date also coincides with Obamacare employment mandates, which can also reduce full-time hiring. The new labor market rules seem to have formed a web of work incentives that cause the nation's unemployment rate to levitate at a higher level.

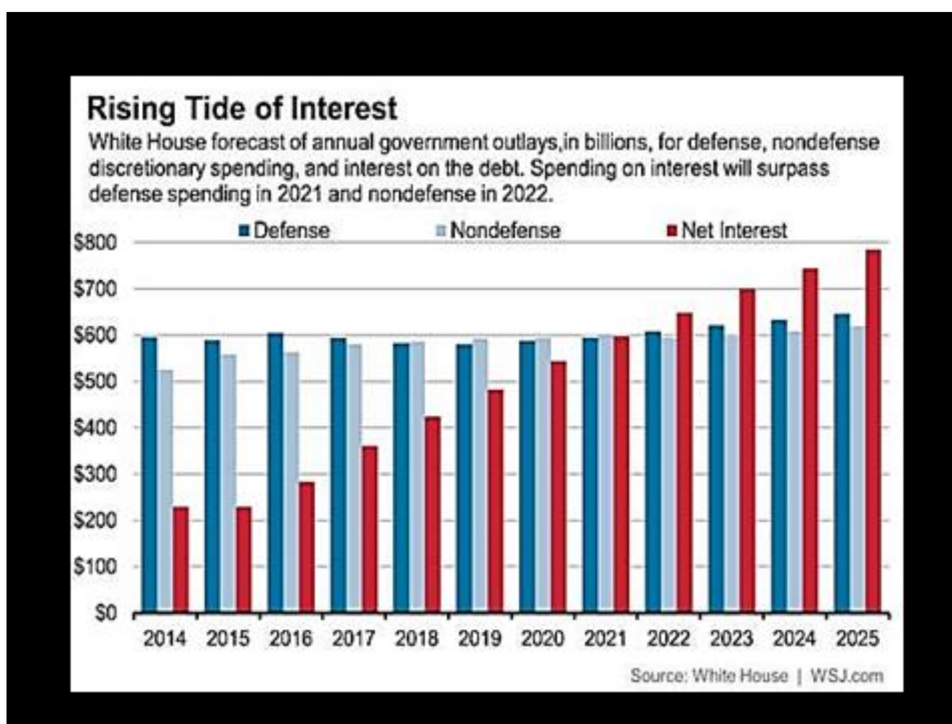


Paying interest on the nation's debt

President Obama's 2016 budget request asks Congress to approve spending $3.999 trillion, up from $3.720 billion this year. (Only the angels know why they didn't round to $4.0 trillion.) There's plenty there to debate on the basis of relative merits, but one budget part is not debatable. Net interest to be paid on government debt is scheduled to rise to $283 billion or 7.0 percent of all spending, and it will be paid. The interest rate on the debt is expected to rise to 3.28 percent from the current 2.68 percent.

To put the $283 billion interest cost in perspective, the new budget calls for $365 billion for Medicaid and children's health insurance; by comparison, just $44 billion for all natural resource and environmental activities, and $98 billion for all transportation spending. Paying $283 billion in interest on a $16 trillion deficit carries a high opportunity cost.

But it gets worse. Projections ahead tell us the federal debt will yawn larger as scheduled mandatory spending increases hit the federal purse. By 2024, instead of shelling out 7 percent of the budget for interest payments, the level will rise to 13.8 percent. As a result, that category of spending called "discretionary" will become ever smaller. Those who are care about natural resources, the environment, highways, bridges, and a host of other government services will have to make do with a lot less. Those who get their kicks from paying interest will think they've died and gone to heaven!



Our federal debt is now equal to 100 percent of GDP. If borrowing cost is 3.28 percent and GDP growth is 3.5 percent, which is the optimistic current forecast, then we make a wee bit of headway if government revenues grow apace with the economy, and non-interest expenditures grow no faster than the economy. But the margin is thin, and 3.5 percent GDP growth has been scarce as hens' teeth.

Common sense tells us that it makes sense to borrow when the invested funds lead to higher future income, so that we can pay off debt and gain future benefits. Investing in highways and other infrastructure, caring for and managing natural resources—fisheries and timberlands—may fall into this category. Investing in early childhood education may also fall into this category. But borrowing to consume doesn't make sense in the same way. Unless somehow the increased consumption makes for a more productive

community. Right now, productivity is stagnant, GDP growth is pale, and the debt burden is getting heavier.

But there could be brighter days ahead. Let's take a look at the possibility.

The interconnected brain of mankind

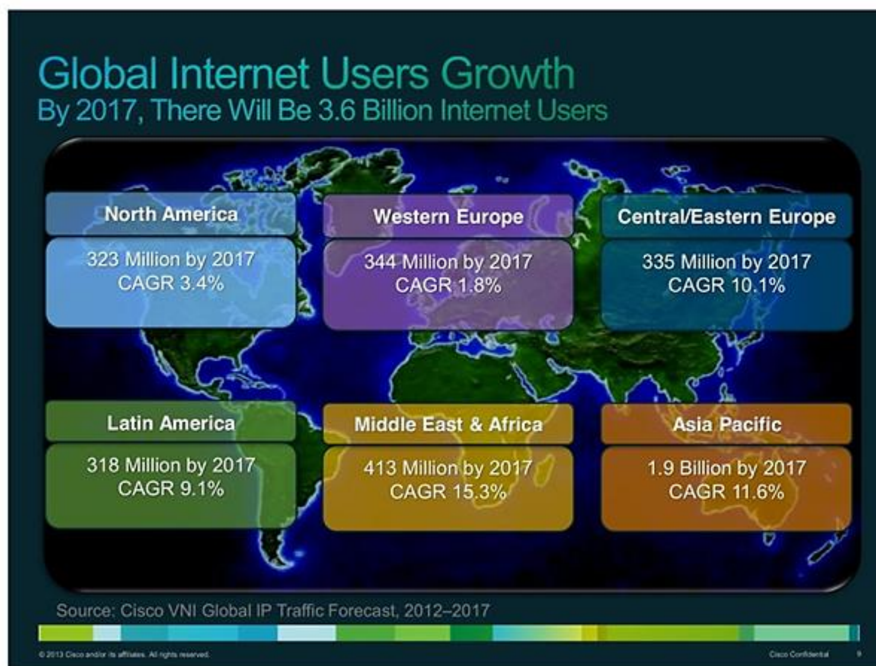
Writing in 2010, in his outstanding book, *The Rational Optimist* (Harper/Harper Collins) Matt Ridley rests his case for optimism on the fact that the collective brain of humankind is progressively becoming more fully connected. He reminds us that finding ways to draw on dispersed bits of specialized knowledge when addressing scarcity of all forms is the fundamental human challenge. This means getting ideas, data, and understanding connected so, as Ridley puts it, the ideas can have sex and produce spinoff knowledge.

Innovation. Novels. Poems. New forms of music. Dreams more likely become reality when the human community gets connected. Of course, there's another side to this story. Direct communication links between people with similar purposes and desires that may connect remote specialized suppliers with otherwise unknown consumers can threaten long-standing institutions that emerged to solve the communication problem. Governments, religions, even traditional family functions may be undermined.

A recent CISCO analysis provides a brain connection forecast that gives perspective to Ridley's point. The data here tell us that by 2017, there will be 3.6 billion internet users on the globe. The chart identifies their locations and the compounded annual growth rate (CAGR) for each region of the world. Asia Pacific will have the greatest number hooked to the collective brain and the second highest growth rate. Middle East & Africa the second largest number and the highest rate of growth.

A few moments' reflection on all this leaves a single thought: There is no way to forecast what may happen when these 3.9 billion brains interact.

We ain't seen nothing yet!



For the reading table

Niall Ferguson. *The Great Degeneration* (Penguin, 2014). Just 153 pages long, Harvard historian Ferguson's latest book offers a powerful explanation of why the U.S. economy seems to be stagnating. Ferguson's clear prose is loaded with data that compares today's economic performance with past decades and with the performance of other western nations. In building his story, he draws on arguments laid out by Adam Smith in *Wealth of Nations* and on commentary found in Toqueville 's *Democracy in America.* In one word, Ferguson's focus is on institutions, the rules, laws, and customs developed to generate order in a chaotic world. And stated in a few words, the problem America now faces, in Ferguson' opinion, comes from two disturbing political habits. The first is the political tendency to impose ever more complex top-down, command-and-control regulations that constrain the ability of ordinary people to create and share new wealth. The second relates to the erosion of social capital—past community investment in civic and religious institutions—that effectively but never perfectly addressed community welfare problems. High specialized local social capital is being replaced with centralized welfare programs that tend to impose a one-suit-fits-all solution to a geographically and culturally rich set of social problems. Ferguson

does more than provide discussion fodder for wearers of sackcloth and ashes who love stories about the demise of the welfare state. He offers institutional alternatives that may be considerd as models for improving the nation's future rules and laws.

Marshall Jevons. *The Mystery of the Invisible Hand*. (Princeton University Press, 2014). Only the very lucky ones have daughters who give books for Christmas. My daughter Kathryn can read my mind—well, at least parts of it. She gave me University of Virginia economist Ken Elzinga's fourth delightful Henry Spearman mystery. Writing under the Marshall Jevons pen name—easily recognized as a composite of the last names of two great English economists, Elzinga's mystery revolves around a faculty member murder that occurred on a small liberal arts university campus just at the time that economics Professor Henry Spearman arrives as a visiting distinguished professor. Readers of Elzinga's past mysteries, coauthored with the late William Breit, know that Spearman is the fictional embodiment of Nobel Laureate Milton Friedman. And just as Professor Friedman viewed any problems posed to him through the lens of economic logic, Spearman uses economic theory to solve the mystery. If you are looking for a good weekend read, I recommend getting your hands on the latest Marshall Jevons book.

Bob Woodward. *The Agenda* (Simon and Schuster. 1994). An oldie, but goodie and perhaps timely given Hillary Clinton's presidential aspirations, *The Agenda* also came into hands at Christmas. (Yes, I finally got around to reading it.) Displaying Bob Woodward's renowned investigative reporting and writing skills, the book focuses on a major and almost desperate struggle in President Bill Clinton's first term—trying to make good on campaign promises to reduce government spending while expanding some government programs. The book gives an almost blow-by-blow account of a yet-to-be organized and still chaotic White House trying to figure Washington's ways while trading political promises for votes with reluctant congressional Democrats. The story is an amazing reminder that there was a time when New Democrats, as they termed themselves, were working to cut back on the federal government's scope while, like Calvin Coolidge of yore, struggling to eliminate the federal government deficit and debt. Of course, what is even more amazing is that Bill Clinton almost brought the nation to the point of being debt free. In fact, it was during his second term that questions were raised as to whether 30-year Treasury bonds would be needed in the future. All this is hard to believe now, which makes Woodward's 1994 account all the more interesting.