THE ECONOMIC SITUATION

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Bruce Yandle

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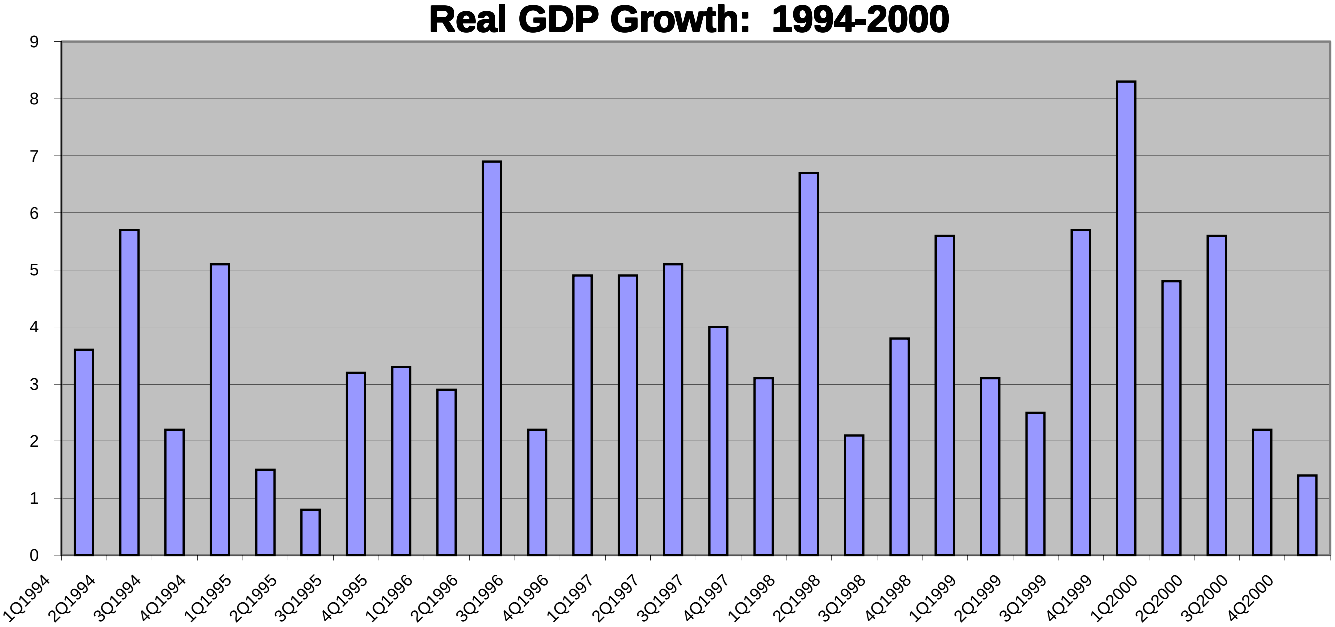
- Recession? How bad? How long?
- What about GDP Growth? What lies ahead?
- Interest rates. Will the Fed cut again?
- Confidence and all that.
- California's toil and trouble: Will it sink us all?
- Kellogg, a hero?

Recession for the Nation?

It is the National Bureau of Economic Research, a private think tank, not a government agency, that tells the nation when a recession has occurred. Generally speaking, we do not get this technical information till long after a recession has begun. Two quarters of declining GDP growth is the dominant ingredient in the recipe used to define a recession. Other ingredients include high general unemployment and sustained lay-offs. By these measures, the economy is definitely not now in a recession; best estimates suggest GDP growth is close to zero. But things are not so good for the factory economy, of which South Carolina is an important part.

Industrial production has been falling for four months, and capacity utilization in the nation's factories now stands at 80%, which is the lower limit of a bright line marking large excess capacity. Employment in manufacturing started falling last June. Within manufacturing, the auto sector began the decline a bit earlier. Weak auto sales hit South Carolina's manufacturing where it hurts. The state's auto specialization includes tires, upholstery fabric, ignition systems, bearings, and autos themselves. The nation's factory slowdown is magnified in South Carolina. This said, is there any good news on the horizon?

Real GDP Growth: 1994-2000



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Good news may be seen in the most recent industrial production data for the nation. Yes, output in manufacturing, mining, and utilities is still declining, but the rate of decline is getting smaller. We must be thankful for little things. There is more than a hint that excess inventories are being worked off rapidly. If so, when will this industrial recession end?

An examination of the tea leaves strongly suggests that we have at least two more months to go before we see the turning point for manufacturing. By June the industrial production recession should be over. At that point, we will be traveling along a flat growth surface that offers the promise of positive growth in the year's second half.

What about GDP?

The February data on fourth quarter 2000 GDP growth left GDP watchers asking for more. Growth for 4Q2000 came in at 1.4%. This gave 5% growth for the year, making 2000 the best year since 1984. In spite of the good overall record, the pattern of growth is troublesome. GDP growth in 2Q2000 was 5.6%. Then came the third quarter's 2.2%, followed by the 1.4%. Fed Chairman Greenspan estimates current GDP growth at zero. But he forecasts this year's growth to be 2.0% to 2.5%. Together, the pieces form an interesting picture for this year. Zero now and 2% to 2.5% for the year implies a rather stronger second half.

How does this square with measures of consumer confidence? The January Consumer Confidence Index maintained by the Conference Board fell for the fourth consecutive month, hitting 114.4, which is about where it stood in December 1996. In short, confidence is still high, even though falling. This measure of consumer thinking, which results from a survey of 5,000 households, shows weak expectations for the future as well. Although not predicting an approaching recession, the low and falling index does translate into reduced consumer spending. Even so, consumers nationwide continue to lift retail sales. January's numbers were higher than expected, indeed the highest in four months.

The change in composition of spending caused by energy price increases also affects consumer purchases of other goods and services. On average across the U.S., energy prices have tripled. Consumers are spending at the rate of $300 billion annually, instead of $100 billion. That leaves $200 billion not spent on other things. And that ain't hay.

The shift in consumption patterns also affects state revenues. Most states do not impose sales taxes on energy. Given the realities of family budgets, allocations to higher priced energy mean less tax revenue for state governments. Even though the economy is clearly not in the tank, some states are facing revenue shortfalls. Should we call it an energy-based fiscal recession? Maybe so.

What are the Prospects for Interest Rates?

Past actions by the Fed to slow the economy worked wonderfully well. Too well! Now, what are the prospects for turning this battleship around?

January's two large half-point interest rate cuts are already having an effect. Subdivision plans are being taken off the shelf. Houses are moving. Purchases of more expensive consumer goods are once again a twinkle in the eye. But will the cuts continue?

Interest future markets say yes. The action of world investors in futures contracts tells us there is an almost certain bet that by June Fed controlled rates will fall by another half point. When this happens, the Prime Rate will be where it stood in July of 1999. The Fed will have wiped out nine previous rate increases. Even that will not be enough, however. To accelerate the economy, we will need to see another quarter to one-half percentage point cut in rates. With that, we will be back where we were in the first half of 1999.

Talk of interest rates leads logically to thoughts on inflation, Mr. Greenspan's archenemy. What is the picture? Does the February PPI spike predict another round of inflation? Hardly. Natural gas prices were the culprit in the February PPI run-up. And that's not a general price level increase. Winter is passing. Higher petroleum prices are leading to more exploration and, with that, discovery of natural gas. The growing excess capacity in the economy and rising productivity combine to reduce inflationary heat. In a word, things look rather cool right now.

California's Energy Problem

By now, we are all familiar with the unhappy details of California's energy problems. An energy sector restructuring placed caps on consumer prices, but left the prices paid by energy distributors unconstrained. Rising incomes and population growth caused demand to increase. No new power plants were built. Older ones were closed for environmental reasons. Droughts reduced the flow of rivers providing hydropower. Environmental rules made natural gas the preferred energy source nationwide. California energy providers faced rapidly rising energy prices when attempting to supply California needs. All the constraints began to bind at the same time. California, the nation's largest state economy and primary provider of vegetable and diary products stumbled and began to get a bad case of the slows.

What about the rest of us? Will the California disease spread to the nation?

According to *The Dismal Scientist*, that wonderful web-based provider of information, California accounts for 14% of U.S. GDP and contributes 20% to U.S. GDP growth. As the nation's leading high tech economy, California employs 18% of all high-tech workers nationwide and produces 25% of the high tech value added. California's economy expanded 9.5% in 2000, while the country's economy was growing 5%. The U.S. economy is predicted to growth by roughly 2.5% this year. If California falls to zero growth, the U.S. growth will fall to 2%.

We will definitely feel some of California's pain.

What can we learn from the California experience? First and foremost we have learned that how energy markets are deregulated matters. If California had left consumer prices unconstrained, and if California had allowed new generating capacity to come on line, then the picture would have been very different. Pennsylvania did this when they deregulated electricity markets. No one has heard about a Pennsylvania energy crisis. There is none. The market has responded to growing energy demands in the Keystone state.

W.K. Kellogg, an American Hero

Our regular newsletter readers will recall my hero project. I search for people who did well by doing good. Along the way, I have reported on such notables at Mary McLeod Bethune and Alexander Graham Bell. But what about Will Keith Kellogg, the inventor of grain-based breakfast foods? Does he count in the hero contest?

Consider how it happened. The year was 1894. The place, Battle Creek, Michigan. Will Keith Kellogg was working with his brother, Dr. John Harvey Kellogg, who operated the Battle Creek Sanitarium. John Kellogg was a Seven Day Adventist vegetarian. He believed proper diet held great promise for good health. He and W.K. were trying to find a better recipe for the wheat rolls served in the sanitarium. Working in the kitchen together, they rolled out different mixes of whole grain wheat and other ingredients.

On one occasion, they left a roll of dough that had been spread before going to the oven. Upon returning the next day, they found that flake-like wheat kernels had separated from the dough. They baked the dough to see what would happen. The roasted wheat flakes emerged separately from the oven. With more experimentation, W.K. developed a wholesome breakfast cereal that he served at the sanitarium. With more work, he developed corn flakes. Showing an unusual flair for marketing, W.K. created a national market for his new wholesome food.

Some might say, the rest is history, but it's not. There was an impoverished patient at the sanitarium named Charles Post. While there he enjoyed the nutritious foods and bran served by the Kellogg brothers. Not responding to treatment, he was placed in a Christian Scientist's home for treatment. Remarkably, he recovered. Perhaps inspired by the benefits of good diet, Post went on to invent Postum, the grain-based coffee substitute, and, you guessed it, Grape Nuts and other famous Post brands.

W.K. Kellogg did well by doing good, and he attracted a strong competitor in the process. The Great American Bread Machine produced two heroes for the price of one.

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

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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.

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