THE ECONOMIC SITUATION

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- Is it a recession or what?
- Industrial production offers a glimmer of hope, but the slows have spread to non-manufacturing.
- Leading indicators and the economic forecasters point to a brighter 2002.
- What about South Carolina and the region?
- Searching for heroes among the saints.

The Latest Recession Reading

We now have GDP growth data for this year's first two quarters, freshly revised and tested. Let's see what the data will tell us about the current economy. Real GDP rose 1.3% in 1Q2001 and a paltry 0.2% in 2Q2001. Indeed, if you plot the data for the last four quarters, you get the feeling we will be below zero in a couple of month. In both quarters, consumer expenditures joined forces with good old Uncle Sam's government expenditures to generate positive growth. If Uncle Sugar hadn't come to the rescue, GDP growth would have been zero or worse. Business investment in capital goods and in inventories are just dead in the water, with not a blip in sight. And purchases of goods from the rest of the world far exceed what we are shipping to them. The rest of the world is suffering from the slows too.

The heavy burden placed on manufacturing by the sagging and dragging economy seems to be getting no lighter. But consumers have not given up. Their purchases of furniture and other household equipment go hand-in-hand with residential construction and sales that are still expanding. Partly fueled by income tax rebates, the surge in consumer demand is also related to mortgage refinancing and capital gains from the sale of homes. Falling interest rates are having a positive effect on the economy.

Sometimes referred to as "pushing on a string," efforts by the Fed to jump-start the economy depend on just this sort of response to lower rates. The push on the string is evident when the large reduction in interest rates is considered. In early September, when dismal employment data were released showing that another 141,000 payroll jobs had disappeared in August, the price of the government's 2-year note spiked upward to yield a post-1972 low of 3.50%. The Fed has already attempted to cut the daily interest rate from 6.50% in January to 3.50% now. After the poor August employment report, the futures market is betting on another 50 basis point cut by November. When these rates are coupled with still very pale inflation numbers, we get a real rate of interest of about one percent, and that's not much to pay for dollar bills.

A Ray of Sunshine in Manufacturing

Industrial Production has now contracted for 10 consecutive months. The fact that the monthly declines are finally getting smaller is about the only comfort found in the data. With negative growth rates reaching back to

Industrial Production and Capacity Utilization

	Jul	Jun	May	Apr	Mar	Feb	Jan	*Dec*	*Nov*	*Oct*
Production (% change)	-0.1	-0.9	-0.3	-0.3	-0.3	-0.4	-0.9	-0.6	-0.3	-0.2
Utilization (%)	77.0	77.2	78.0	78.2	78.8	79.2	79.7	80.6	81.4	82.0

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last Halloween, the manufacturing sector is still reducing inventories in the face of weak sales. In fact, inventories have been falling for six months. The August National Association of Purchasing Managers survey underlines the positive effects of the inventory adjustment. For the third month, more purchasing managers responded that inventories were too low than too high. Finally, the bottom seems to have emerged in this dusty manufacturing recession.

But the Bottom Isn't There for Everyone

While the old economy sectors seem to be approaching a turn of the corner, the new economy tech sector still has a long way to go. Representing just 10% of the national factory economy, according to Business Week, the tech sector accounts for almost half the contraction in factory orders. As mentioned in this newsletter previously, the tech sector ironically does not seem well equipped to use information management for inventories. Given the inventory overhang, it's safe to bet that technology prices will continue their fall to the basement as the new year rolls in. Lower prices mean expanded demand from consumers and the non-tech sector, which will spur productive improvements in 2002.

When it comes to current shipments, the auto sector is the only major one showing positive growth compared to this time last year; and while positive, it is still weak. Sales from the Big Three are still off significantly, with Honda, Toyota, and Nissan holding steady, and with VW and the Korean brands showing remarkable increases. A hefty part of the improvements of overseas brands comes from the soaring value of the dollar relative to other currencies. In one year, the value of the dollar relative to the Japanese yen has increased 22% and for Germany, 10%. Other things being equal, this gives a pretty attractive price advantage to VWs and Japanese-produced products. Shipments for textiles and steel continue to show substantial declines.

The Production Slowdown

Sector	4Q2000	1Q2001	2Q2001
	(Quarterly % Change)		
Manufacturing	-1.6	-7.9	-5.4
Consumer Goods	-2.4	-1.8	-3.0
Motor Vehicles	-23.6	-27.2	29.2
Business Eq't.	5.2	-7.3	-7.5
High Tech Mchy.	25.2	-5.7	-14.0
Materials	-1.6	-10.6	-5.6

Source: Business Week.

Although the purchasing managers survey offered a bit of hope for the manufacturing economy, that group's August non-manufacturing index indicates the slowing economy is spreading. The August index fell sharply from July's still weak reading. The weakness was concentrated in real estate, construction, and communications.

Will the Tax Rebates Help?

There are at least two readings on the effect of $55 billion in tax rebates circulating through the economy. Mr. Greenspan focuses on the permanent income hypothesis, most often associated with economist Milton Friedman. This theory says that most consumers pattern their purchases on the basis of their permanent income, not on the basis of windfalls and transitory changes in income. Accordingly, the $300 to $600 check received by many households will be split between savings and paying bills; not on a lot of new spending. Indeed, a recent Gallup poll on the question showed that 45% responded saying they would pay off some debt; 17% said they would go shopping, and some 32% said they would save the windfall. Hardly any of those polled said they would give their rebate to charity. If consumers follow this tack, the rebates will not generate a lot of new production.

Economists at Dismal.com give another interpretation. They focus on what consumers are doing now and base their forecast on the observed pattern. And what are consumers doing now? They are spending every dollar they can get their hands on. Savings has plummeted. So, even if consumers pay off debt, Dismal bets they will run up debt again, and soon. If this reading is the more accurate interpretation, the tax rebate will have a substantial effect on economic activity, adding about 0.7% in GDP growth across the last six months of the year.

Leading Indicators and Forecasters: What Are They Saying?

Leading indicators maintained by the Conference Board, the Economic Cycle Research Institute (ECRI), and Economy.com help to predict key turning points in the economy. All three of these signaled the current slowdown when it was first a flimmer in the fall of 2000. What are they saying?

Economy.com's recession predictor is reading slightly less than 0.50, which is a probability reading. That's far better than the reading in March, when the indicator hit 0.63. The Conference Board's indicator has been rising for four months, which implies a recovery in growth by the last quarter of this year. The ECRI index, which is produced weekly, shows little improvement in the economy, suggesting that the recovery is still months away. In sum, the indicators point to a brighter light at the end of the tunnel, and suggest the tunnel opening will arrive this winter, not next month.

Two recent regional forecasters are not quite speaking with one voice, but either way we take it, the news is not filled with cheer. In his September 2001 report on the national economy, Wake Forest's Gary Shoesmith calls for 1.7% real GDP growth this year, with continued improvement for 2002. This says that we should see GDP growth of 2.5% for the last six months of this year with a bit more volatility in the year ahead. In an earlier report, the University of South Carolina's forecasting service was more pessimistic than Shoesmith. The USC forecast indicated real GDP growth for 2Q2001 and 3Q2001 of 0.8 to 0.7% with a year-end recovery bringing 1.5% growth for the year. Of the two reports, I think USC's may end up being the more accurate one. Mark one for the Gamecocks!

In the face of the national slowdown and wide variation across the Southeast region, the outlook for South Carolina is relatively bright. Please note the word "relatively." Consider job growth during the last few quarters.

Within the region, Florida and Georgia are the two 900-pound economic gorillas. Indeed, Florida may be a 2000-pound gorilla. Even the current slowdown seems to have little impact on the Sunshine State. But relative to the rest of pack, South Carolina is doing fairly well.The manufacturing slump has clearly hurt state employment growth, but nothing like the pain imposed in Alabama, West Virginia, and Virginia. The state's relative resistance to the manufacturing recession gives a stronger platform for generating next year's growth. But when you don't zig very much, you don't zag a lot either.

Employment Growth

	1999	2000	1Q2001	2Q2001	2001	2002
United States	2.43	2.22	0.90	-0.22	0.07	1.70
Southeast	2.63	2.64	1.75	1.17	1.73	2.01
South Carolina	**2.64**	**2.63**	**0.28**	**1.66**	**1.46**	**1.92**
North Carolina	2.56	2.07	0.56	0.42	0.85	1.44
Alabama	1.13	0.79	-0.49	-2.43	-0.43	0.45
Florida	2.89	3.63	3.36	3.21	3.24	3.28
Georgia	3.80	2.83	2.55	0.80	1.72	1.98
Tennessee	1.79	2.06	0.00	1.03	0.84	1.58
Virginia	2.79	2.84	2.30	0.57	1.79	1.83
W. Virginia	0.94	1.37	1.93	-0.79	0.61	0.83

Source: Gary Shoesmith, Wake Forest Center for Economic Studies, *Quarterly Review*, Fall 2001.

The Bottom Line: Is It a Recession or What?

This is not a recession…, yet. It is a what. So far, the U.S. services and construction economy have performed well enough to keep growth on a positive plane. Plant closing and layoffs are now taking their toll, however. We are getting closer to negative GDP growth. I am still betting that we will miss having a conventionally measured recession, which means at least two consecutive quarters of negative GDP growth. But saying this doesn't minimize the pain being felt by those in manufacturing who are bearing the brunt of this slowdown. As far as they are concerned, this is a recession, and not a mild one.

No recession. Recovery of meaningful growth will be seen in this year's fourth quarter.

Looking For Heroes Among the Saints

I was reminded recently of Augustine of Hippo (354-420) in an address delivered at Spartanburg Methodist College by the Reverend Dr. Clay Turner, Rector of the Spartanburg's Episcopal Church of the Advent. Dr. Turner told of Augustine's interpretation of hope, a topic that might be worthy of thought as we consider some of the difficulties posed by the current manufacturing recession. After all, there are one million fewer workers employed in manufacturing today than a year ago. And each job lost and plant closed represents a lot of grief.

Augustine, we are told, talked about hope. He said that hope has two daughters. One is anger. The other, courage. Hope is born when we become angry about a situation we face and have the courage to do something about it. Loss of a good job, the closing of a plant, the loss of good customers are things that make us angry. Courage to search for another job, even in another field, courage to find lower costs so that plants can be opened, and the courage to keep knocking on doors when our good customers are long gone, these are things that bring hope.

Fortunately for us, Augustine's hope stands largest where freedom to act beneficially is least constrained. America's enterprise system still offers loads of hope to boatloads of people.

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Special Addendum to

THE FALL 2001
ECONOMIC SITUATION REPORT
The Effect of the Terrorists' Attack

The September 11 terrorists' attack occurred shortly after the Fall Economic Situation Report had been put to bed and posted on the Thurmond Institute web site. What can we say about the effects of the attack on the economy? And what might government do to hasten a recovery? This special addendum provides some quickly developed comments on the new situation.

The Effects of the Attacks

There are many economic effects flowing from the attacks, but let us consider three. First, there is an enormous loss in the ultimate resource—precious human life. Then, there is the disruption of the nation's economy, especially the transportation and financial sectors. Finally, there are income-producing flows associated with assisting, rebuilding, and changing the way we live. The first of these effects—the human loss—is especially severe. The losses are concentrated on working people in the prime of their careers. The second is brief—perhaps three days long—but extensive. It involves the entire economy and part of the international world. And the third effect is large, but nothing to compare with the first two effects.

Of the three effects, the interruption in economic life is the largest and easiest to assess. A three-day loss in economic activity represents about 1% of GDP. With 0.2% second quarter GDP growth, the U.S. economy was teetering on the brink of negative economic growth prior to September 11. The economy is undoubtedly in negative growth territory now and will remain so until early 2002. Forecasts for 2002 had called for 3-3.5% GDP growth for the year. Those estimates will be cut to 2.5%-3% growth. The slower economy will take a toll on all phases of economic life.

South Carolina's economy will suffer from the events about like the nation's. With the dollar made weaker by events, export activity will increase a bit and manufacturing will get a small positive stimulus. Recall that South Carolina's economy is growing more rapidly than the nation's economy. The negative effects of the terrorists' actions will on balance reduce but not stop South Carolina's economic growth.

Government Policy to Hasten Recovery

The federal government plays a crucial role in supporting the recovery of normal economic life. First and foremost, the federal government must protect nation, life and limb. That, after all, is the fundamental purpose of the national government. It is obvious that governments at every level must provide assistance to the victims of the terrorism. Second, fear and uncertainty must be minimized. All regulatory changes that affect air movement of people and goods must be implemented quickly and effectively. Time is the essence of value. Then, the federal banking system must accommodate the flow of needed credit, and the Securities and Exchange Commission and other agencies that regulate markets must move quickly to accommodate the reopening of markets.

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