THE ECONOMIC SITUATION

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March 2008

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1. Recession???

There is a growing herd of economists and others pronouncing a recession is upon us. And then there are others. I am still one of the others.

On the same February day that Mark Zandi, the much respected leader of Economist.com, announced that the U.S. was in a mild recession, William Poole, retiring president of the St. Louis Fed and widely followed monetary economist, announced just the opposite. Not a recession, according to Poole, just a slow patch. A few days before, Council of Economic Advisors chairman Ed Lazear announced that the CEA was not forecasting a 2008 recession, just a slowing economy.

Drilling down deeper into the matter may help explain the differences of opinions found among the prognosticators.

First off, recessions are defined after the fact by a committee of economists associated with the National Bureau of Economic Research. Here's the NBER's definition: *a recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales.*

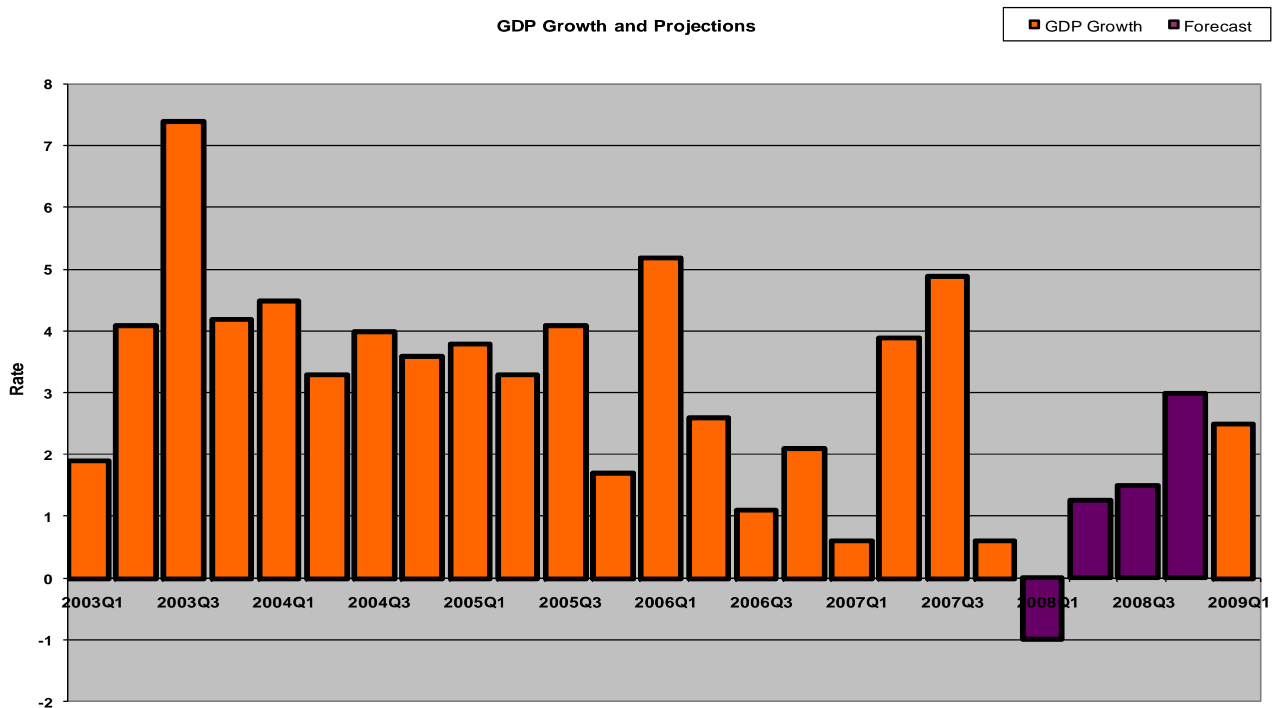
Notice, the NBER does not say a recession is two consecutive quarters of negative GDP growth, even though that may be a shorthand interpretation of their more complete definition. In fact,

each of the 32 recessions recorded by the NBER since 1832 has lasted at least six months. The most recent two—July 1990-March 1991 and March 2001-November 2001—lasted eight months.

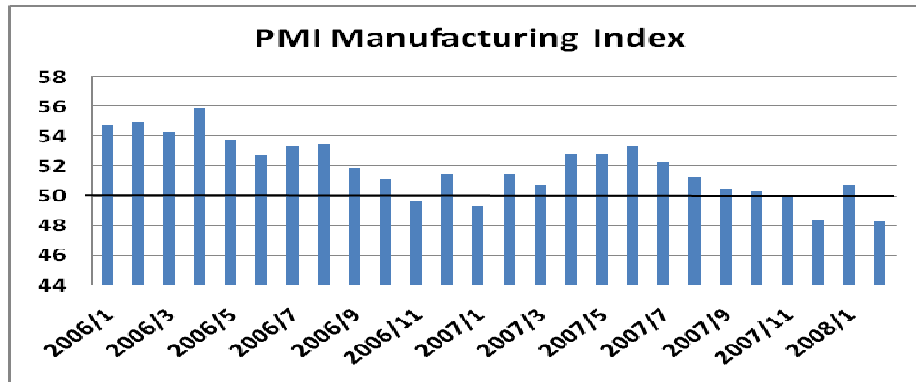
GDP growth and current indicators

What about GDP? Is it declining? Not yet. The two early estimates of 4Q2008 GDP indicate 0.6 percent growth, not quite negative, but surely weak. With this taken into account, I have revised the GDP forecast for 2008. No, there is still no banana on the horizon, recession that is.

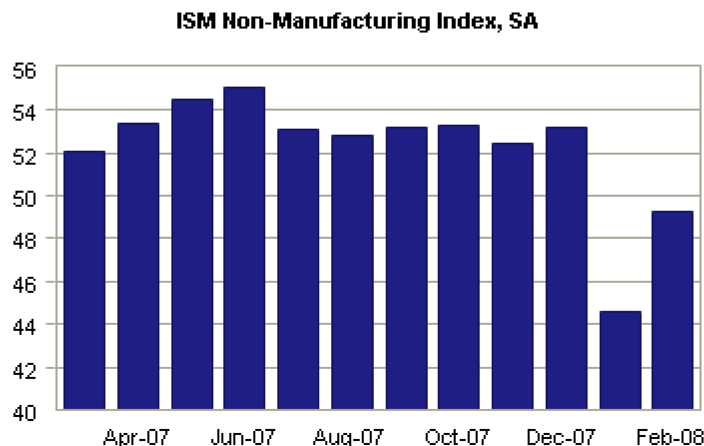
As noted below, my forecast still calls for one negative quarter, which is the one we are in right now. Then, the remaining three quarters for 2008 show positive, though weaker growth. Taken together, the four quarters generate an annual growth of slightly better than 1.0 percent.



While it will be several weeks, if not months, before we have data on which to draw conclusions about the first quarter's overall performance, we do have some early indicators to consider. The next chart shows the Supply Chain Institute's PMI Manufacturing Index, where a value of 50 indicates neutral growth. As indicated, the value for January is just above 48. A scan back to May, 2007, reveals a local high point. Things are more or less downhill from there.



The service sector now accounts for some 40 percent of the U.S. economy. The next chart shows the service economy index. Once again, 50 is the magic number for neutral growth. Here we see a dramatic decline in January that brought a major market sell-off when it was announced. Too bad the market did not know that the January reading was the first observation generated by a new measuring technique. February's number came in at a much more comfortable 49.3.



When economic troubles arrive, some states and regions are better situated than others to ride out the storm. Some U.S. regions were going through severe adjustments long before sub-prime was part of the daily vocabulary. The sub-prime shocks just make things worse. The next chart shows growth in state GDP for 2005-2006. Here we see the heavy industrial states of

Michigan, Wisconsin, Ohio and W. Virginia lagging the nation, while states in the far west are racing ahead.

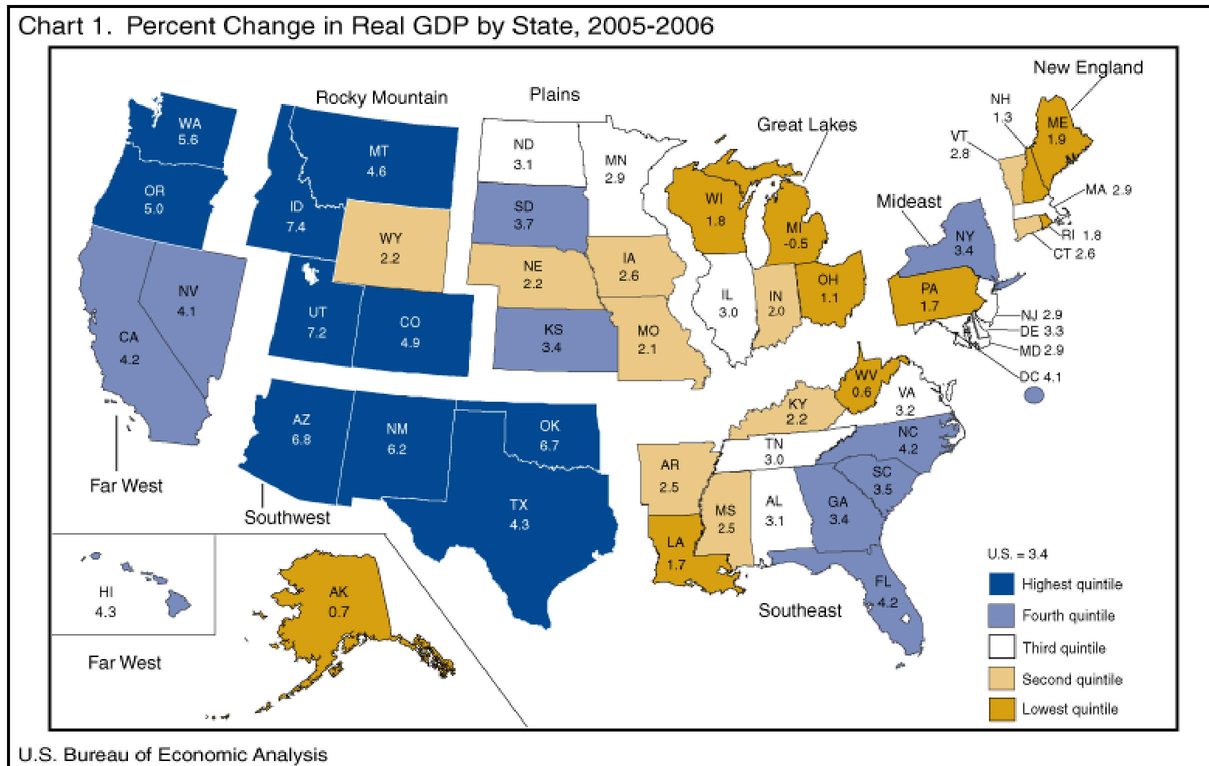


Chart 1. Percent Change in Real GDP by State, 2005-2006

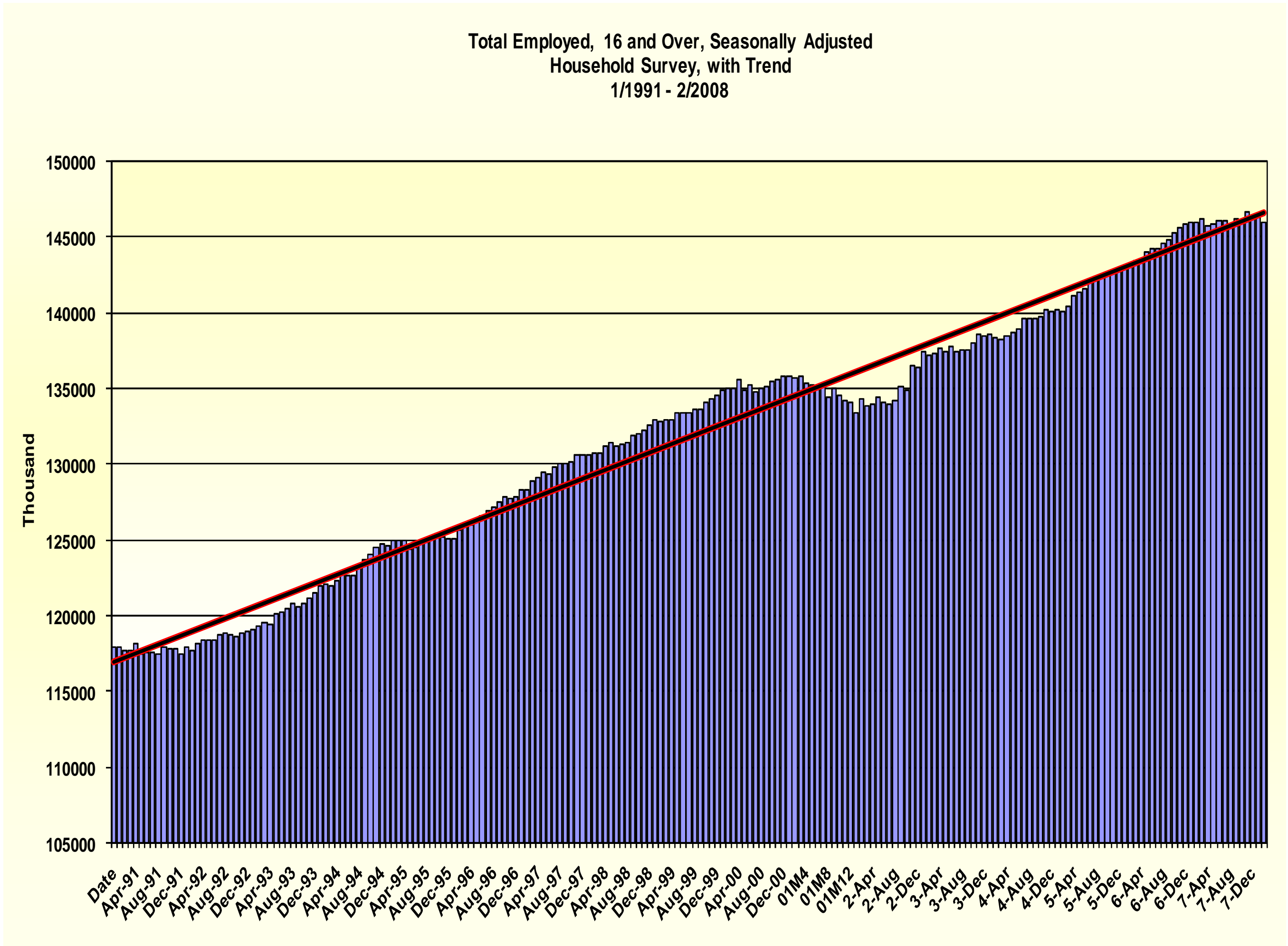
U.S. Bureau of Economic Analysis

2. Sizing up a recession with four Ds

When dealing with the recession question, economist Don Ratajczak suggests we use a 4-D test. The Ds are Decline, Diffusion, Duration, and Despair. And every D must be satisfied. Decline relates to the depth of the economic decline. When the U.S. unemployment rate in December jumped suddenly from 4.7 percent to 5.0 percent, Merrill Lynch and others announced the start of a recession. But a sharp decline in employment is not enough. What about the degree to which employment growth or decline is occurring across the economy? Diffusion of employment growth is the second measure. But there is more. What about duration. Notice the NBER says a recession requires a span of a few months. January may have qualified as a recession month, but that is not enough to define a recession. And then there is despair. This D is measured by such things as the Consumer Confidence Index produced by the Conference Board. In January Consumer Confidence fell into a troublesome zone. Perhaps three of the Recession Ds are in place. But if a recession has started, we have only just begun.

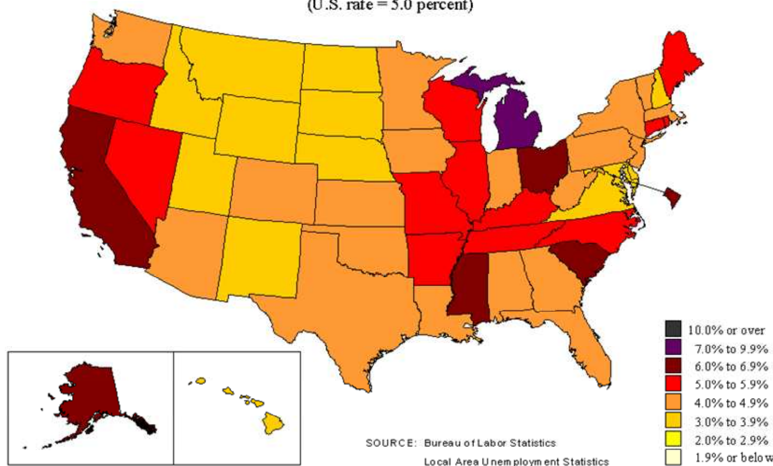
Let's consider the first D: Depth.

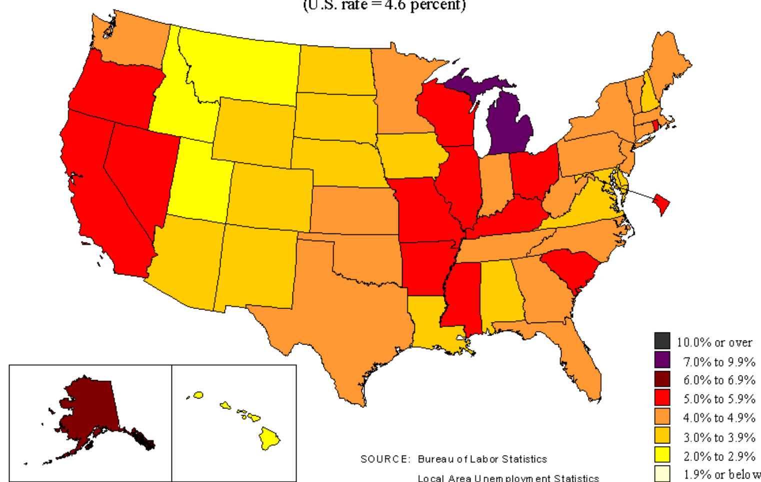
When total employment turns down, we have one important depth element. The next chart shows total U.S. employment with a bit of light between the February bar and the trend line. Yes, February came in with lower total employment.



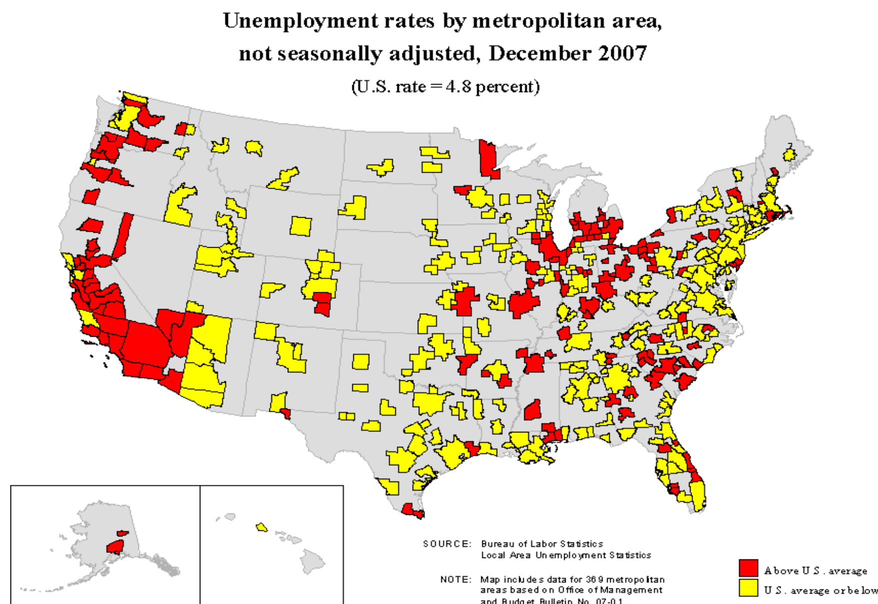
Mapping to the states and metro areas

The imprint of the slowing economy is seen vividly when state unemployment outline maps for December 2007 and August 2007 are compared. In December, the number of states with greater than 6.0 percent unemployment increased. The count includes Alaska, California, Michigan, Mississippi, Ohio, and South Carolina, with California's slowdown explained primarily the demise of the housing market.



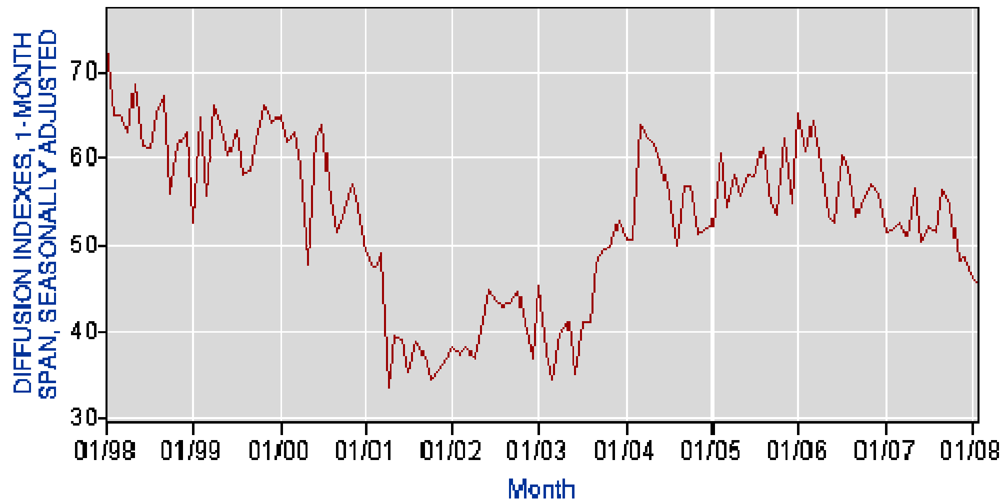


Of course, employment weakness among the nation's metro areas follows the pattern of the states.



The second D: Diffusion.

A slowing economy can be suffering from a contraction that just affects a few sectors, like housing, or experiencing a contraction that is spreading across a large number of industries. The Bureau of Labor Statistics employment diffusion index covers 274 industries and asks this question: What share of the industries are enjoying an employment expansion or experiencing a contraction? A reading of 50 indicates exact balance. Values below 50 indicate contraction. The next chart reports data through February 2008. The January value is 46.2. February is 45.6. Both are preliminary numbers, but both show a contracting economy. Notice that the trend toward contraction began in January 2006.



The Fourth D: Despair

The extent to which consumers taken together are downhearted forms the basis for the fourth recession indicator. The next two charts show two indicators of consumer confidence. One is the Conference Board's indicator; the other is based on an ABC News poll. Both charts yield a similar picture of declining confidence in the economy. The Conference Board indicates that January's reading is the lowest since just before the Iraq war in 2003. These low confidence ratings are reflected in weak retail sales. When adjusted for inflation, retail sales were flat in both December 2007 and January 2008. With the exception of the Katrina period, to observe such weakness, one must travel back to December 2001 to find similar data. This was when the U.S. was clawing its way out of a recession.

D-4: Despair

A four-D summary

I summarize the result of the 4-D scan in the accompanying table. As indicated, there is evidence that points north and south. Some of the data quality for an early forecast that recession is on the way. Other data say not yet.

At this point, we have two recessionary months. I am still holding to the position that the U.S. will dodge the recession bullet, but I also say the bullet is getting closer to the target.

Recession Watch: The Four Ds

D1: Depth	D2: Diffusion	D3: Duration	D4: Despair
January employment data showed decline for payroll data. February showed a sharp decline for payroll and household data. December and January retail sales data are flat. But, January industrial production growth was positive. January and February look like recession months.	Diffusion index is 47 for January. 45.6 for February. Job losses are spreading across industries. Supply Chain Managers index for services economy turns negative. January and February qualify as recession months.	Too early to tell.	Sharp decline in various January consumer confidence indexes. February remains low. Compares with previous recession periods. January and February qualify as recession months.

3. A whole lot of hurt'n going on.

Whether the nation is in a recession or not, one thing is clear, there is a lot of hurt'n going on. At the same time, there are vast areas of the country where things look pretty good. The question, of course, is how much and for how long the sicker regions will weaken the stronger ones.

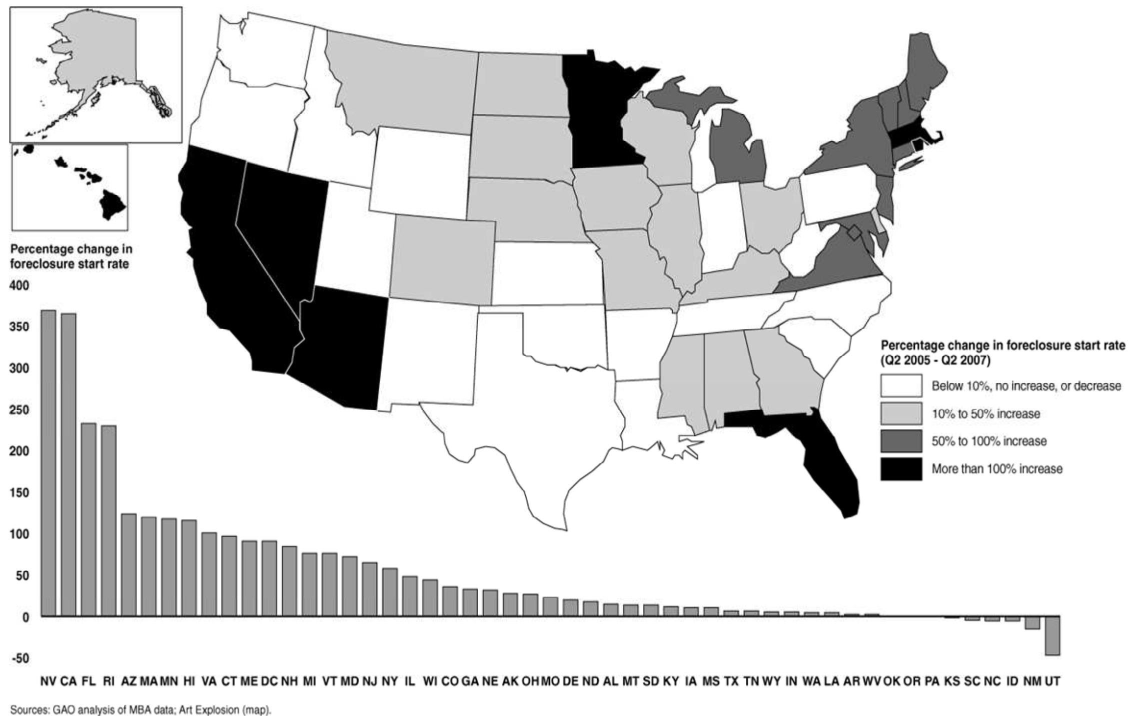
Searching for remedies: Pulling the monetary lever.

The last few months have witnessed an all-out effort by government leaders to take actions that might counter the slowing economy. On the monetary side, we have seen the Federal Reserve Board cut short-term rates between meetings, which is a rather rare event, and then cut some more. Short term rates have fallen by 2.25 percentage points. To encourage bank borrowing, the Fed has cut the discount rate, and since that didn't seem to do the trick, the central bank invented a new fund auction so that banks could bid for cash. All this has been a frustrated effort to encourage commercial bank lending. So far, the commercial banking system has not responded. Through the end of February, M1, a traditional measure of the money supply, shows no increase. Money supply grows when banks lend money. Supply contracts when loans are paid down or defaults occur. The banks are not eager lenders, and borrowers are laying low.

Part of the lack of lending relates to the weakened reserve position many large banks are experiencing from loan defaults and write downs. A second reason for cutting back relates to the deteriorating quality of real estate collateral that might be used as a basis for borrowing. An optimistic reading of all this suggests that by third quarter, these problems will be much smaller. Reserves will build back, real estate prices will begin to stabilize and increase again, and bank regulators will be able to relax a bit. Of course, it must be noted that all of the country is not experiencing declining real estate values, and all banks are not facing weaker reserve positions.

Consider the next chart, which shows an outline map of loan defaults. The chart shows the percentage change in defaults and foreclosures across 2Q2005 to 2Q2007. There are two categories of hard-hit states. States like Michigan and Ohio are suffering from structural changes in their economies. Others, like California, Arizona, and Florida, experienced unsupportable housing booms and are now readjusting. The bars at the bottom of the chart show how the individual states stack up.

Default and Foreclosure Trends



Sources: GAO analysis of MBA data; Art Explosion (map).

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Trying the fiscal policy accelerator

While Fed action borders on a display of panic, politicians of all stripes seem to be racing to see which party—Democrat or Republican—and which branch—legislative or executive—can put the largest checks in the mail to American consumers. While the political race was on, we heard about the three Ts, that payments should be targeted (read not for rich people), that they should be timely (before the onslaught of the recession, but in time to influence some state primaries), and temporary (end when the recession and election are over). The whole debate brought back memory of a politburo argument of how to engineer an economy.

When the House leadership called out a number, President Bush claimed it not enough. Eventually, all agreed on a fiscal stimulus estimated at one percent of the nation's GDP, with

checks going in the mail around mid-year. Somehow the White House engineers had calculated the exact size of the needed remedy. It was about then that one of the presidential candidates said that we needed a president who could manage the economy, and another candidate said he did not know anything about the economy.

We have choices.

In all this, we witness a classic Keynesian effort. Forgotten lessons from the past tell us that dollars shipped to happy recipients have to come from somewhere if they are to have any value. And from whence might they come? Just two places. Either from immediate tax revenues or from funds borrowed from U.S. taxpayers and foreign people. Ultimately, of course, U.S. taxpayers bear the burden of paying off the debt and interest. In that sense, there is a rough equivalency between paying now with taxes or paying later with taxes and interest. By the way, this is called Ricardian Equivalency. It was discovered a long time ago by economist David Ricardo (1772-1823).

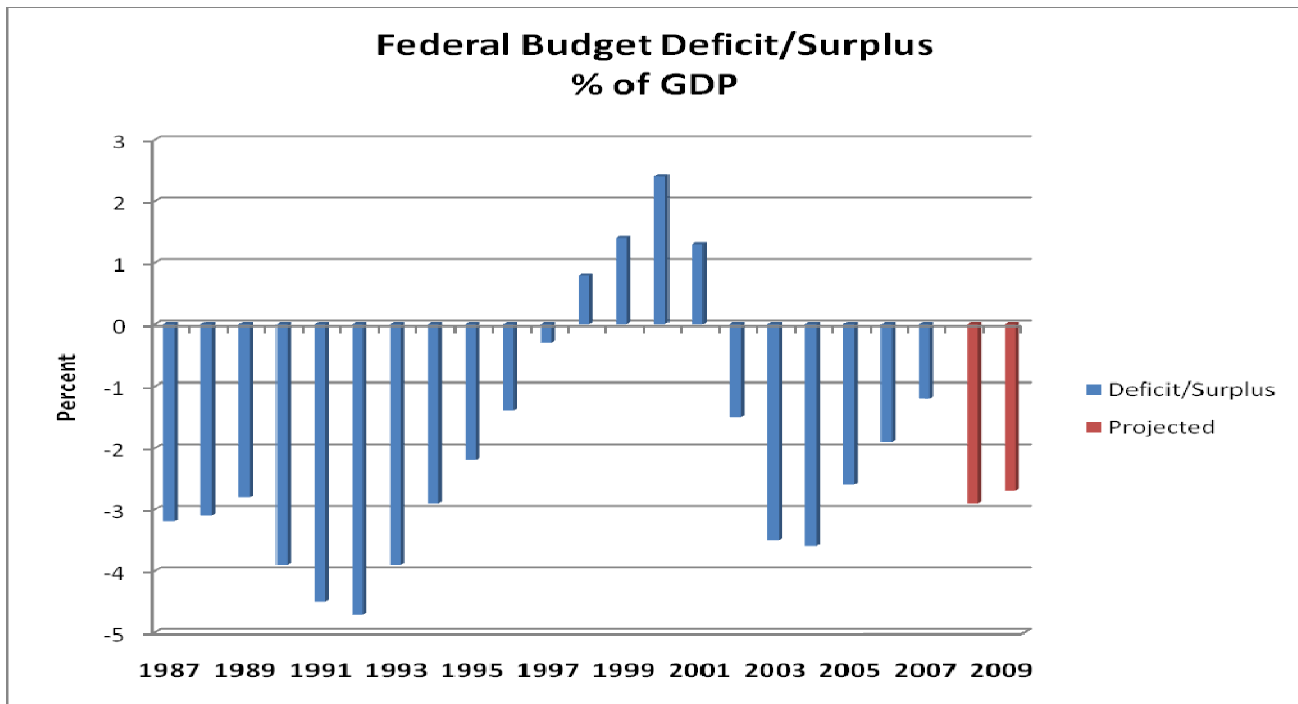
Is there a multiplier effect from all this? Does pump priming work? It is not clear. Multiplying spending on one side of the ledger is offset by contracted spending on the other side.

The picture becomes clearer when we think of one household representing the economy. A $600 government check arrives in the mail. The stimulus has arrived. Included in the mail that day is a note from the IRS indicating that taxes have increased. By how much? $600.

Of course, it is not quite this simple. People and governments worldwide can buy our debt. But eventually the chickens come home to roost. The debt has to be paid off…., by whom? You guessed it.

The next chart gives data on the federal government’s spending habits. Included here are Mr. Bush’s budget proposals for the coming year. And this was before the fiscal stimulus was added it.

There’s a whole lot of debt being generated.



Well, there is one more way to raise the money. Print it.

Of course, there is one more to raise the money that will be stuffed in envelopes and delivered to happy taxpayers. It can be printed. Inflation is way to collect the loot. Wages rise in nominal terms, and tax revenues rise with inflation. On that score, the record shows the U.S. is getting good exercise in inflation. CPI inflation is now running at a rate that exceeds 7.0 percent annually. Of course, if you can skip meals and forego gasoline and other energy, you can operate on "core inflation." It is just running a bit higher than 4.0 percent. As a consequence, the dollar is falling, and oil and other import commodities are getting more expensive. It may be more fun to blame all this on the Arabs and other foreign suppliers of things we want, but the real problem is here. We are printing the money. They are running the pumps.

Along these lines, Gisele Bundchen, Brazilian model friend of Boston Patriots star Tom Brady, is requiring payment for services in euros. It also turns out that the only decent investment I have made in the last year is in the 500 euros I held on to after a July stay in Europe.

4. Rogue traders and collapsing markets…one more time

In late January in midst of sub-prime chaos, titanic trading losses generated by a young misguided trader wiped out the net worth of French bank Societe General, one of Europe's most prestigious financial institutions. By the time the dust cleared, the losses summed to more than $6 billion. Financial markets were stunned when bank officials admitted that young trader Jerome Kerviel had found a way to hide his losses. Then, while European and U.S. central bankers were apparently unaware of the cause, world equity markets rocked and rolled as the

French bank opened its books and began the tedious task of unwinding previously hidden contracts.

With evidence of market meltdowns coming from all directions, on January 22, U.S. Federal Reserve Bank Chairman Ben Bernanke pulled the plug and cut overnight lending rates by 75 percentage points to 3.50 percent, this after consulting in emergency session with members of the Fed's Open Market Committee. The cut was the largest in 24 years. It followed a 50 percentage point cut that had been made just one week earlier. Then, on January 31, the Fed lopped another 50 percentage points of the overnight lending rate, bringing the rate to 3.00 percent. Even the best data sifter will have a hard time proving that the Fed may have been falsely inspired to take the unexpected emergency action. Whatever the case, world equity markets settled and central bankers worldwide began to assess the damage.

This was not the first time that problems of financial securities fraud contributed to major equity market meltdowns. Indeed, in that most famous case of all, the 1929 U.S. stock market collapse, a London securities and industrial firm, Hatry Group, played the role of rogue trader. But instead of being orchestrated by a relatively minor official in the firm, this collapse was triggered by Clarence Hatry himself. Hatry served nine years in jail after being found guilty of forgery and fraud. He had used forged municipal debt instruments as collateral for a one million dollar loan. This and other forgeries led to Hatry's demise. Investors were estimated to have lost $30,000,000 to $100,000,000. And that was in 1929 dollars. When converted to 2008 values, the losses were $360,000,000 to $1.1 billion.

Unlike 2008, central banks in1929 were not all that well equipped with knowledge and technology to take offsetting action. The Hatry collapse caused investors worldwide to question the validity of shares held by brokers. Markets were flooded with sell orders. Indexes headed south. The famous 1929 collapse was on its way. Of course, the industrial world became caught in other more fundamental financial problems, but Clarence Hatry in 1929, like Jerome Kerviel in 2008, was the rogue trader who triggered a major collapse.

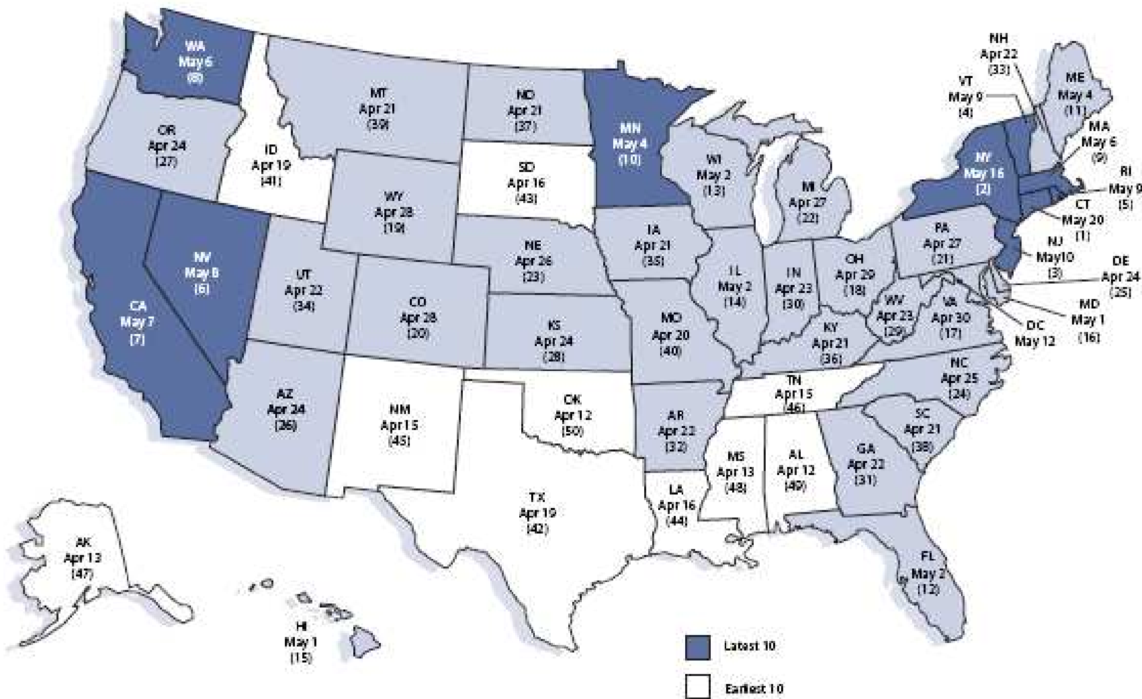
5. South Carolina Digest

South Carolina's economy has thus far avoided some of the tougher aspects of the sub-prime mess. The reason for this has two components. First off, the state did not experience the go-go days that caused housing prices to rise annually at double-digit rates. Yes, there were some hot spots, but not enough to put the state economy at risk. The second reason for dodging the bullet relates to the relatively solid performance of the economy and thus its ability to shake off some of the sub-prime repercussions. While the state is still adjusting from heavy concentration in textile manufacturing, growth in services and other sectors has softened the blow. In a word, the state economy is relatively healthy. It can handle some tough blows.

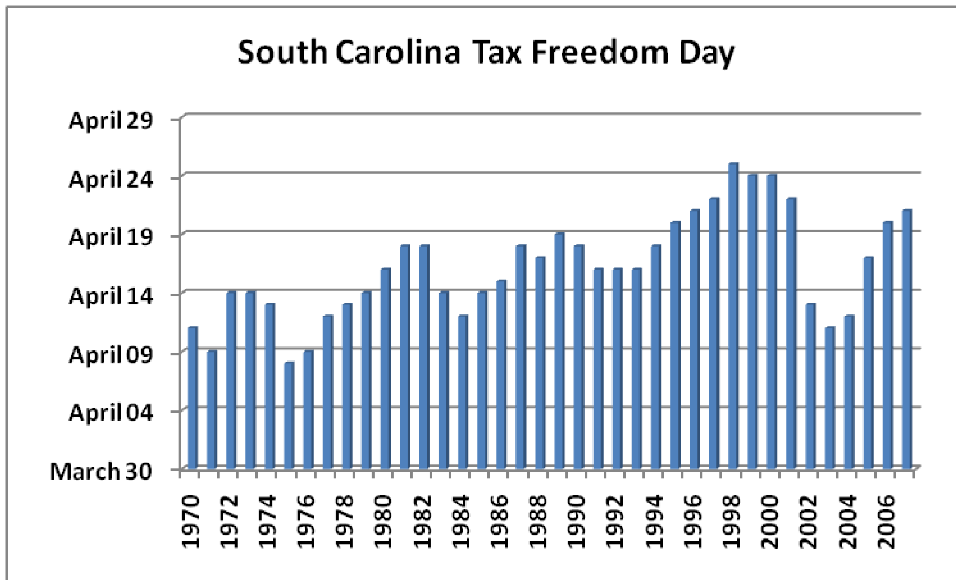
But while the state is not bogged down with large inventories of unsold homes, the slowing economy has still generated real problems for a good number of people. In early March, the Mortgage Bankers Association reported that in 4Q2007 1.86 percent of mortgages in the state were in foreclosure. This was up from 1.68 percent in 3Q2007 and the most in three years. The final quarter average for the nation was 2.04 percent; for Michigan it was 3.38 percent. South Carolina ranks 20th from the top among the 50 states in share foreclosed.

The extent to which residential real estate prices are softening is another indicator of housing market distress. When buyers pull to the side and the lenders cut back because of uncertainty, sellers of new and existing homes have to start cutting prices. The U.S. Office of Federal Housing Oversight publishes quarterly data on changes in the average price of homes sold across the U.S. Prices for the nation rose 0.8 percent across 2007. (Prices for the nation were down 1.3 percent when 4Q2007 is compared with 3Q2007.) Prices in South Carolina rose 3.7 percent for the year. Prices were up 3.0 percent for the Anderson MSA, 1.9 percent for Charleston, 2.9 percent for Columbia, and 5.25 percent in the Greenville MSA. By comparison, prices for the year were down 6.7 percent in California and down 4.7 percent in Michigan.

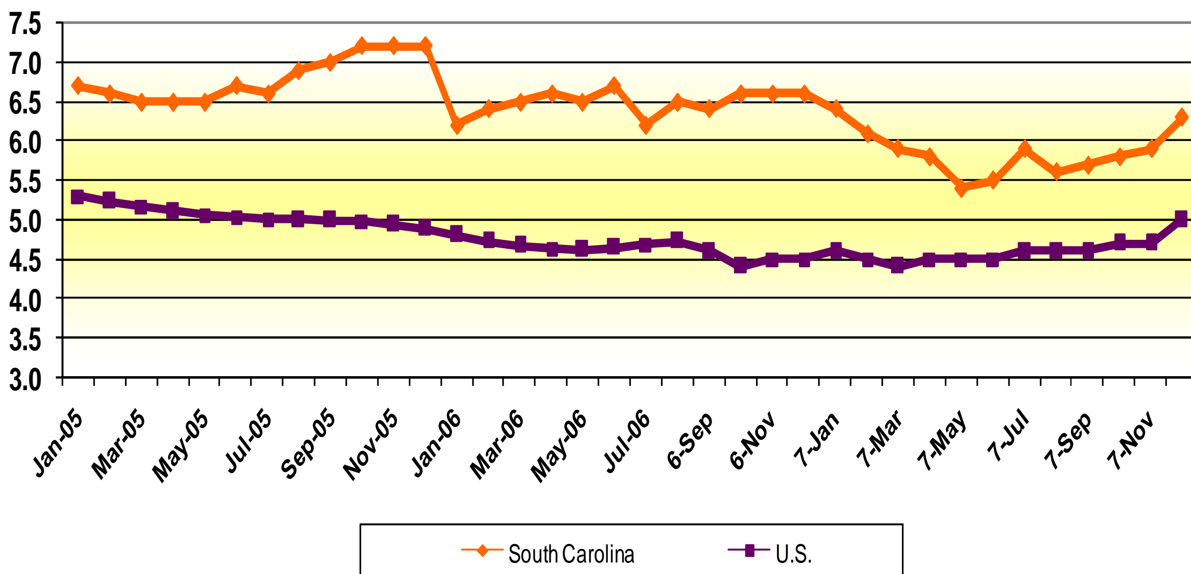
Though much stronger overall, South Carolina shares some traits with troubled Michigan. Both states have unemployment rates above 6.0 percent. What about taxes? As indicated in the next map, South Carolina citizens reached tax freedom day in 2007 on April 21. This is that hypothetical day when the average citizen, based on earnings, stops working for government of all kinds and begins working for himself or herself. Notice that the good folk in Michigan make the transition six days later on April 27. Michigan is a heavier tax state.



From the way things looked in 1996-2000, higher tax burdens are nothing new in South Carolina. As indicated in the next chart, tax freedom day has been creeping up since 2003.



The South Carolina economy marches to its own beat but also responds to the national economy. The next chart compares the state's unemployment rate with that of the nation. There is a persistent gap between the two but it has narrowed somewhat since April 2007.



There is another important linkage that connects the state to the nation. National industrial production data do a good job of predicting state total personal income. The strong relationship is seen in the last chart.

Through January, industrial production is just barely on a positive track. That means South Carolina total personal income should still be growing at a positive rate.

Pass the word!