

THE ECONOMIC SITUATION

Bruce Yandle

***Professor of Economics Emeritus, Clemson University
Director, Strom Thurmond Institute Economic Outlook Project***

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It's a Forrest Gump economy. We don't know what we will get.

War and the economy. Two possible outcomes.

Oil prices: the critical variable.

Are there any new jobs in this economy?

Mr. Greenspan: A friend in time of trouble?

South Carolina? What about the jobs here?

Forrest Gump one more time.

Fans of the fabulous Forrest Gump movie will recall the line about life being like a box of chocolates. You never know what you will get. To a larger extent than usual, this is the case for the U.S. economy. As this is being written on March 12, 2003, there is a huge level of uncertainty clouding if not completely disguising the real U.S. economy, wherever it might be. There is uncertainty about war. The Bush administration is pushing for a March 17 D-day, or thereabouts. War uncertainty brings added uncertainty about the supply and price of crude oil, which has already been confused by the Venezuelan oil revolution. And uncertainty about oil prices raise the probability of a 2003 recession.

The degree of uncertainty is seen in the amount of funds socked away in checking, money market, and savings accounts. On February 17, the total in those zero or low interest bearing accounts (and what isn't low these days?) was peaking at \$6.2 trillion dollars, a number that has been rising rapidly for two years. Just to put this in perspective, consider this. The dollar value of all equities on the stock exchanges, all of them, is \$10 trillion. Put differently, there is 62 cents in cash for every dollar in equities. People with good sense don't sit on cash when profit-making opportunities exist that have some range of estimated risk associated with them. Right now, it is impossible to estimate risks. What we have is uncertainty.

As Gump suggested, pick a chocolate, and hope that you get the one with a favorite center. Unfortunately, the box of chocolates now being considered is not filled completely with tasty chocolates, even though all are not favorites. Some of them have castor oil centers!

War and the economy

By the time this report is being read and digested, our country may be at war in Iraq. There are profound issues associated with war, issues that go deeper and far beyond war's impact on the economy. But this is an economic situation report and how this war progresses will have a major bearing on the U.S. economy. Oversimplification is the only way to get at a forecast, and doing so now suggests two possibilities. The first hinges on a short war, one that is concluded in weeks, not months, and one that is decisive and free from acts of domestic terrorism. The other possibility is generated by a longer war, one associated with major disruptions in oil supply and expenditures that go far beyond the estimates provided earlier by national leaders. But before giving a summary of outcomes, we should first consider the launching pad. What is the state of the economy at the outset?

In mid-March, the U.S. economy was on the edge of entering a recession. No, the economy was not entering a recession; it was on the edge of an entry. The year 2002 had turned out pretty well. Real GDP growth registered 2.4%, not bad after 2001's 0.3%, and not nearly as good at 2000's 3.8%. But here's the really bad news. Real GDP growth in the fourth quarter of 2002 was 0.7% and headed south. Growing uncertainty, bad winter weather, and higher oil prices all contributed to a bad case of the slows. Then, in early March when crude oil prices spiked to \$40 a barrel, the betting line for a recession moved north. In early March, forecasters assigned a 30% probability of recession in this year, even before evaluating the effects of war, which we will do now.

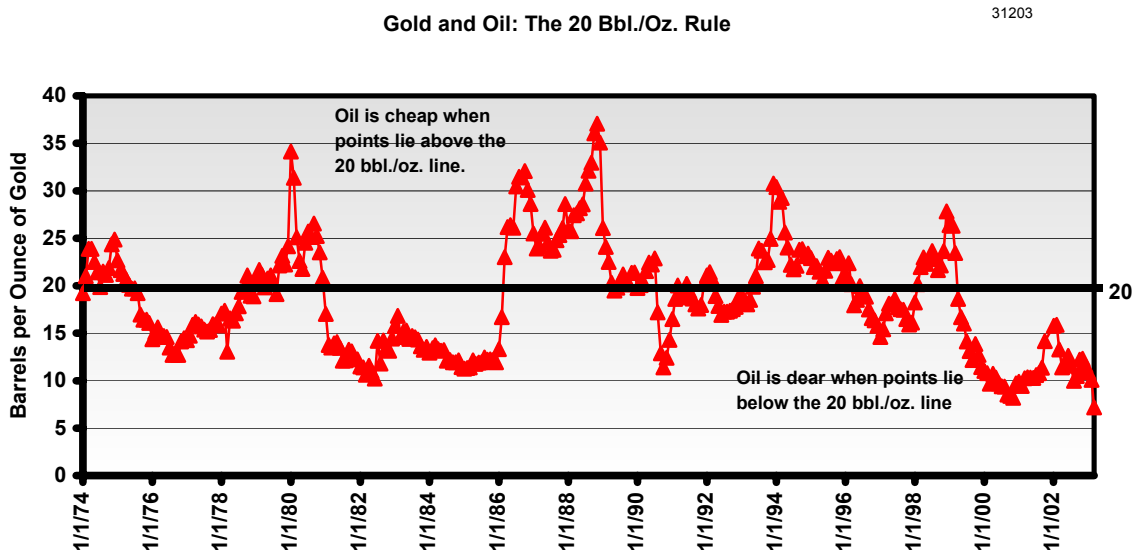
The happier of two forecasts comes with a short war, oil prices that may spike upward to \$50 for a brief period, but then fall rather quickly. The price of regular gasoline at the pump hits \$1.60 a gallon and then falls. By January 2004, the price of oil is \$29 a barrel and gasoline is selling for \$1.25. GDP growth brightens. By this year's last quarter, the economy is pumping real GDP at 3.5%. The Dow moves above 10,000. (By the way, the current oil futures market is consistent with this forecast. Short war, mild supply interruptions, and back to normal growth again.)

The darker forecast is based on a long and troublesome war, one in which crude oil prices jump to \$60 a barrel and stay there. The U.S. economy moves quickly into a recession that lasts at least two quarters. GDP growth for the year is less than one percent. The Dow falls 1000 points.

The emphasis here is on the price of oil, which becomes the main driver in hammering or improving the performance of the U.S. economy. For reasons not very well understood, every spike in oil prices in the last 40 years has been followed by a recession, which in some cases, was brief. It would not be wise to bet against the relationship holding one more time.

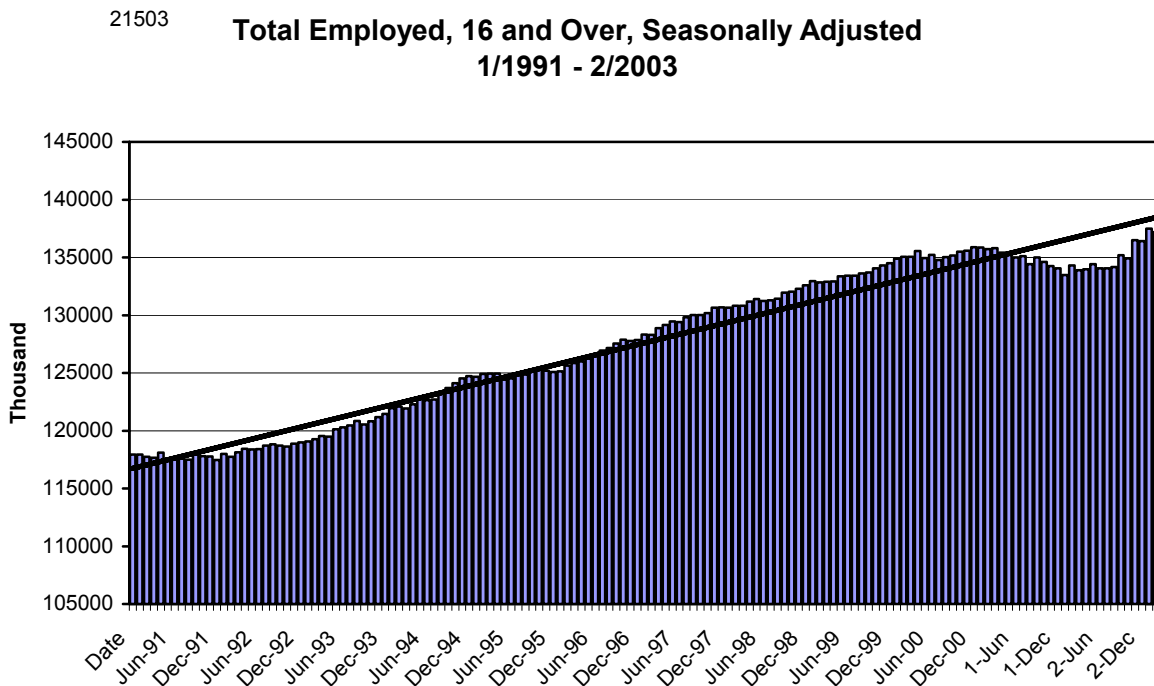
Oil prices one more time

Discussion of oil prices always ushers in one of my favorite charts. Readers will recall that this one is based on the historic relationship: 20 ounces of gold buys a barrel of crude oil. Historically, the price of oil, relative to gold, has oscillated around the 20-ounce rule. The next chart shows just how far off we are now. The March 12, 2003, observation has the relative prices at a 29-year high. The forecast of falling prices is now all the more compelling.



Jobs and the economy

The prospects for a 2003 recession mentioned earlier were reinforced by the February employment report that showed a loss of more than 300,000 jobs for the month. This time, losses extended to include retailing and wholesaling, one of the rare times when the trade sector has suffered. Until now, manufacturing has taken it on the chin. Construction has seen growing employment in conjunction with low interest rates, and services has carried the economy forward. While the February data were weak, there is still something to cheer about. As seen in the accompanying chart, with a trend line fitted to the data, a very nice positive total employment trend has been forming. Yes, one negative observation does not make a recession..., yet.



The Federal Reserve Board: A friend in time of trouble

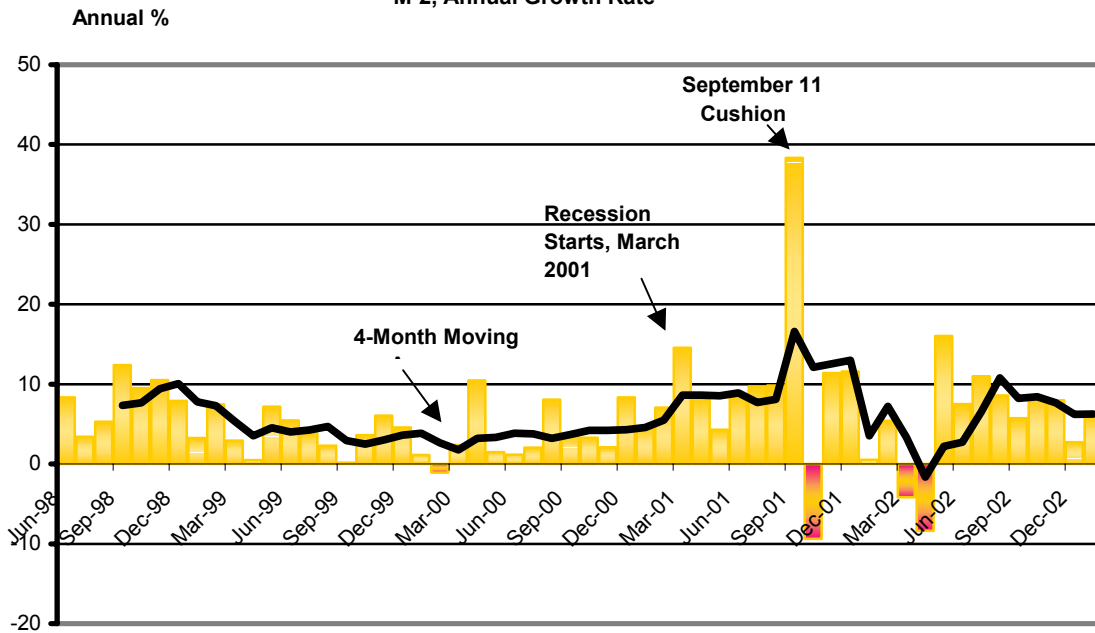
With war and economic uncertainty interacting, Mr. Greenspan and his friends have their hands full. Even with short-term interest rates barely to the left of the decimal point, Mr. Greenspan vows that monetary policy is not out of the picture, yet. Indeed, depending on the Iraq shake-out, the Fed is prepared to cut rates further and after that to purchase government securities in the open market, thereby pumping money into the economy.

The Fed's somewhat relaxed stance is shown in the next chart that shows the growth of one important measure of the money supply. A quick glance at the chart reveals the huge increase in money that came with 9/11. A slower glance reveals that the large increase was mopped up later when money supply growth plummeted.

In more recent months, we see an increase in growth. Note the 4-month moving average. The prediction: Barring a difficult war and adjustment to it, we should see accelerating economic activity in this year's last quarter. However, that acceleration will not occur unless major uncertainty—the happy war forecast—is removed.

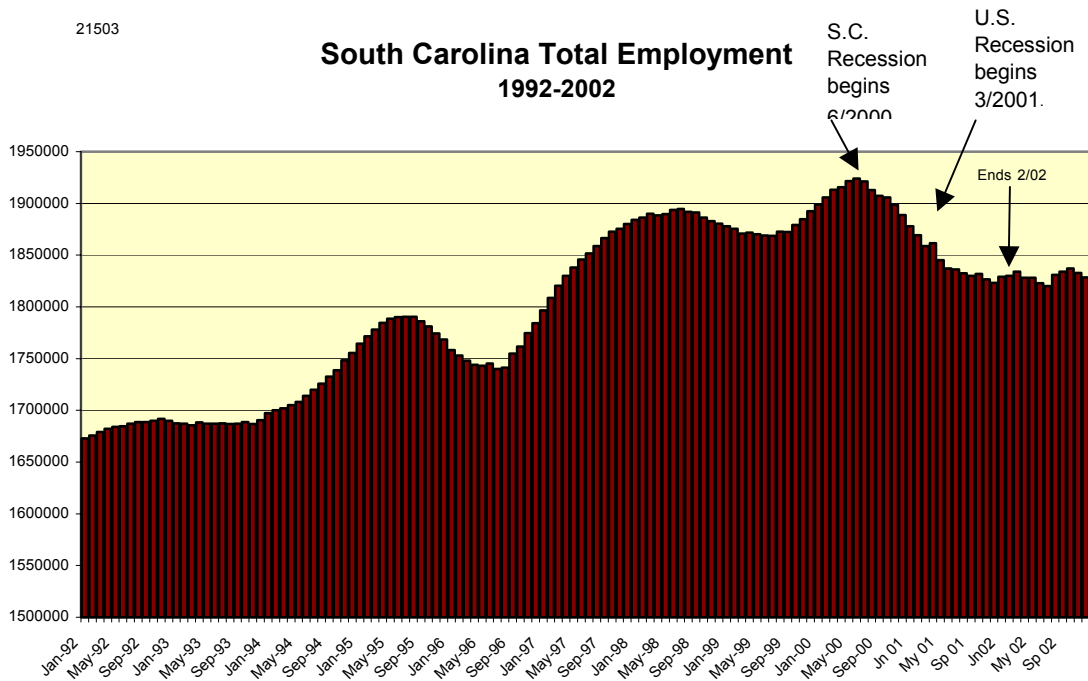
MONEY SUPPLY GROWTH M-2, Annual Growth Rate

2/24/03



The South Carolina economy

Talk of employment growth and the prospects for the national economy leads to questions about South Carolina's prospects. Unfortunately, the manufacturing recession has not loosened its grip on the state's economy, at least yet. This is seen in the most recent employment data for the state shown in the next chart. There is a stark difference between the picture here and the national picture shown earlier. Employment for the nation is growing, but not for South Carolina. Indeed, the most recent forecast for the state suggests we will not see meaningful economic growth until 2005, and this assumes no national recession.



Wild plum at night

With plum trees flowering around us, it is easy to relate to the wonderful words Orrick Johns penned when he wrote Wild Plum at Night. We find his main point, perhaps, in a couple of beautiful lines.

They are unholy who are born to love wild plum at night,

Who once have passed them on the road glimmering and white.

At times when we as a nation are challenged and stressed, we sometimes fail to celebrate the beauty of the life we know and the liberty that allows freedom to prosper.

But focusing on the fruits of prosperity can cause us to neglect celebration of the patrimony of freedom, markets, and rule of law that we share as Americans.

Whether properly guided or misguided in our Middle East ventures, we must not stop celebrating America. It is better than wild plum at night. Far better.