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The economic situation

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THE ECONOMIC SITUATION

A Strom Thurmond Institute and
College of Business & Public Affairs Report

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A quarterly report on economic trends.

SPRING 1998

- Spring has almost sprung, and the economy is rolling.
 - But are the Asian tremors behind us?
 - Interest rates look tame for as far as the eye can see.
 - The S.C. economy—looking good, but still a mixed bag.
 - Global warming: why it matters to the nation and South Carolina.
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Sizing Up the Spring Economy

The Prognosticators are Cautiously Optimistic

With all that has happened in the world economy, the good old American Bread Machine continues to chug. Third quarter 1997 GDP growth came in at an above-trend rate of 3.1%, and the number for 4Q1997 is predicted to be even higher. Since yearend, more than 300,000 have been added to the workforce each month. There's still a lot of zip in the market. The nation's overall unemployment rate remained at 4.7% percent as this letter was being written, with the rate standing at 3.8% for workers over 20 years old. The unemployment rate for married males was 2.6%; for married females, 3.1%. And the median time in unemployment was less than two months for workers seeking employment. Put another way, it's a good time to be looking for work.

While employment opportunities could not be much better, the tight labor markets nationwide are still not generating significant wage increases. One reason is global competition. The more fundamental reason is productivity. Wage increases depend ultimately on the average worker's ability to produce more goods and services in a given day. There is little evidence of unusual gains in productivity, this in spite of the much heralded information revolution.

Why might this be so? Some point to regulatory constraints that limit the flexibility of firms to shift technologies and reorganize production. Others point to ill-prepared workers who cannot perform adequately in the new high-tech work environment. Still others point mainly at global competition and constantly changing technologies that require continuous changes in production techniques. One last group sighs about the high growth services economy where productivity gains are hard to generate. One fundamental concern remains: We are not real good at measuring productivity. I tend to agree with all of these arguments, but assign the greatest importance to the last one.

Even with the bright shadow of the past, future prospects for economic growth don't look quite so exciting. Industrial production data, which give us the only monthly reading on the larger national economy, show systematic declines since October 1997. Indeed, the January number showed the economy dead in the water—no growth. And February came in with a negative reading. Remember, this is for the nation's factories, mines and generators of electricity. And remember, this has been a very warm winter!

The economy has slowed, but there is evidence that the economic engine is not choking down. The Philadelphia Federal Reserve's monthly *Business Outlook Survey* shows an increase in new orders, with the level of

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unfilled orders holding steady. Retail sales are still perking along, as are new home starts and sales. Meanwhile Consumer Price Index inflation hardly exists. Always sensitive to inflation, interest rates continue to be tamed.

GDP forecasters still see weakness ahead. The Blue Chip 1998 consensus forecast sees the following GDP growth rates: 1Q1998—2.7%, 2Q1998—2.2%, 3Q1998—2.1%, and 4Q1998—2.3%. Wake Forest University's Gary Shoesmith is a bit more optimistic, at least for this year. He expects 1998 GDP growth to show an average of 3.0%, followed by 2.3% in 1999. I am inclined to agree with Shoesmith for this year's prospects, but believe 1999 will be a bit stronger, barring unexpected shocks to the economy. (On this, see the section on global warming.)

Are the Asian Tremors Behind Us?

The softer economic outlook is clearly affected by the disruptions in Asia, which are yet to be fully felt in the world's economies. Changing export/import patterns are already showing up, and the purchase of Asian assets by western world firms at bargain basement prices is being registered. Related price and excess production capacity effects will be felt more fully in the remaining months of the year. Most of the Asian effect will obviously be seen in the goods market, not in the U.S. booming services sector. Evidence of this bifurcation of the economy is already seen in the growth in services sector wages compared to wage growth in manufacturing. Pressures from global competition are keeping the lid on manufacturing cost and price increases.

South Carolina's exposure to the Asian difficulties comes from direct global competition and indirectly from investment here by Asian firms. For example, the state's large electronics and apparel manufacturing sector are very sensitive to import competition and declining Asian demand for electronics-based products. Direct investment by Asian firms in the state presents a more graphic picture of risk. Japanese investors lead the Asian world with 75 firms in the state with almost 15,000 workers. Korean and Taiwan investors operate four S.C. firms each. China, Singapore, and Hong Kong are also repre-

sented in the state. In total, there are some 16,000 S.C. workers employed by Asian business firms. Of course, these facilities are located here primarily to serve the North American market. But disruptions at home can affect the availability of capital for expanding and maintaining operations elsewhere. (It might be noted that international firms now provide employment for more than 73,000 S.C. factory employees, about 20% of the total manufacturing workforce.)

Lower Inflation, Lower Interest Rates

Price inflation is being tamed by more intense global competition, tighter monetary controls in a slower U.S. economy, and a growing supply of petroleum and other commodities. Lower expectations of inflation produce lower interest rates. My most recent analysis of the relationship between the yield on the 10-year government bond and the Producer Price Index predicts lower interest rates in the weeks ahead. The PPI has been falling recently, but the yield on the 10-year bond has not fallen enough. Asian-induced caution by the Fed coupled with deflationary forces yields a flat-earth forecast for interest rates. Simply put, they should not change very much. Indeed, the Blue Chip forecasters see long-term interest rates, like those for 30-year bonds and mortgages, remaining basically unchanged through 1999. Of course, only the most fearless will forecast interest rates that far ahead, but it is still helpful to see what the fearless are thinking.

How Is South Carolina Doing?

The state's economy continues to perform better than the nation's. The most recent data on growth in total personal income show powerful improvements in employment. On a year-over-year basis, total employment is growing in excess of 3.0%. Practically all of this is occurring outside of manufacturing, with the large changes showing in the services, trade, and construction sectors. Total employment in the state government, the sector with largest decline, is down by more than 4,000 workers. Those who favor a lean and mean government machine can pause and celebrate. For the year, Georgia

and Florida are expected to be the highest income growth states in the southeast, with South Carolina nudging out North Carolina to take third place.

General indicators of economic activity across S.C. regions show a changing picture for the Charleston area as compared with the Upstate and Central Midlands. Operating at about the same level as Columbia until 1996, Charleston has shaken the effects of the shipyard closing and is now pulling toward Greenville in retail sales and exceeding the other two major metro areas in housing activity. Indicators on housing activity show considerable weakness in the Upstate and in the Columbia area, but not in the Low Country.

Layoffs and closings in the apparel sector continue to displace a significant number of workers. Since August 1997, more than 3,000 workers have moved from apparel and textiles, with more than 800 losing jobs since the first of the year. Consider this: The textiles sector had 140,000 workers in December 1994. In December 1997, the number stood at 117,000. In December 1994, there were 377,000 workers in all of manufacturing. At the end of 1997, there were 358,000 workers. But get this: At the end of 1994, there were 44,000 workers producing durable goods in the state. At the end of 1997, there were 144,000 employed in that sector!

The numbers suggest a story. Productivity gains in manufacturing reduce the need for workers generally. Competition also takes its toll. Textiles and apparel have shed 23,000 workers. But the durable goods sector has added 100,000 workers. Generally speaking, wages are higher in durable goods production. These massive changes have not been without pain, but they have generated higher wages overall.

Global Warming: Should We Care?

Representatives of some 160 nations met in Kyoto, Japan, in December to discuss the prospects for doing something about global warming caused by large amounts of carbon emissions. Kyoto is a long way from South Carolina, and the upper atmosphere is even further away, but the problem discussed and remedies proposed will come close to home.

First off, the science on the topic, which is obviously not my area of expertise, is controversial. Some models of global warming predict gradual but meaningful temperature increases in the decades ahead. Other estimates show decreases. And those who forecast higher temperatures have recently revised their estimates downward. We must grant that any significant increases in earth temperatures can have dramatic effects. One model says low lying areas could be submerged by sea water. Large parts of Canada now uninhabited could become a vast breadbasket for the world. Regions that are now producing cold-climate crops would shift to something else. Other experts suggest evaporation increases induced by global warming will generate more beachfront property; that the south of Florida will not submerge, and that little change will occur across the earth's regions. In short, there is a debate about global warming. We should nonetheless take the topic seriously.

Out of all this came a Kyoto agreement for international carbon emission control that has nothing to do with the problem, if there is one. My conclusion is straight forward. Only the industrialized world is bound to reduce carbon emissions. The rest of world made no commitment, and the rest of the world produces about 40% of the emissions now and will produce the largest share in the decades ahead. In other words, part of the world is bailing out the boat while the rest is boring holes.

The agreement, which must be ratified by the U.S. Senate, could lead to a 50 cent increase in gasoline prices, more than a doubling of coal prices (and the eventual substitution of natural gas for coal in most production), and sharp associated declines in energy-based manufacturing. The bleaker estimates of the economic effects on the U.S. economy show losses of 1.6 million jobs over baseline by 2010, if the U.S. takes the action promised. GDP growth would fall by 2.2% to 3.6%, below baseline, by 2010. The cost of Kyoto exceeds that associated with the Arab oil embargoes of the 1970s.

What does this mean for South Carolina? Estimates by the Wharton Econometric Forecasting Associates indicate the following: South Carolina manufacturers would see natural gas prices nearly double. Electricity prices

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would rise by 67%. There would be 24,000 fewer jobs in the state by 2010; 10,000 fewer in manufacturing. The typical family would spend \$500 more per year on energy and \$300 more for operating vehicles. Wages and salaries would fall by 2.7%, relative to baseline. In summary, each state resident would pay a price for reducing carbon emissions, and the cost for each person would reach \$260 in lost annual income by 2010.

What are the benefits? There are none, if the nonindustrialized world goes on emitting carbon. And there are surely none if the global warming problem turns out not to be a problem after all.

Final Thoughts

Though there may not be global warming, we can surely look forward to the warming of spring. In spite of all the costly steps taken to improve or change economic policy, the old American Bread Machine keeps on chugging. Is it a miracle? Or is it just the market economy driven by creative human beings? The power of the market economy to improve human wellbeing seems miraculous indeed. Would that all people could enjoy the fruits of a free market society.

The Economic Situation is printed quarterly by the Strom Thurmond Institute of Government and Public Affairs at Clemson University and the College of Business and Public Affairs. For more information contact the Strom Thurmond Institute at:

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