THE ECONOMIC SITUATION

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- Did the Yellow Brick Road Disappear?
- Stocks in Decline, China's Slowdown, and Currency Devaluation
- Construction to the Rescue
- More on Regulation's Imprint
- Suggested Fall Reading

Did the Yellow Brick Road Disappear?

June's Economic Situation began with Dorothy, Tin Man, Scarecrow, and Lion searching for the Yellow Brick Road and wondering if it had disappeared. Since then, there's been a whole lot of shaking going on. In this report, I first take a look back to June and come forward. Then, in the section to follow, I will deal with China, devaluation, and financial market reactions. After that, I cover some specialized topics. Let's hit the road!

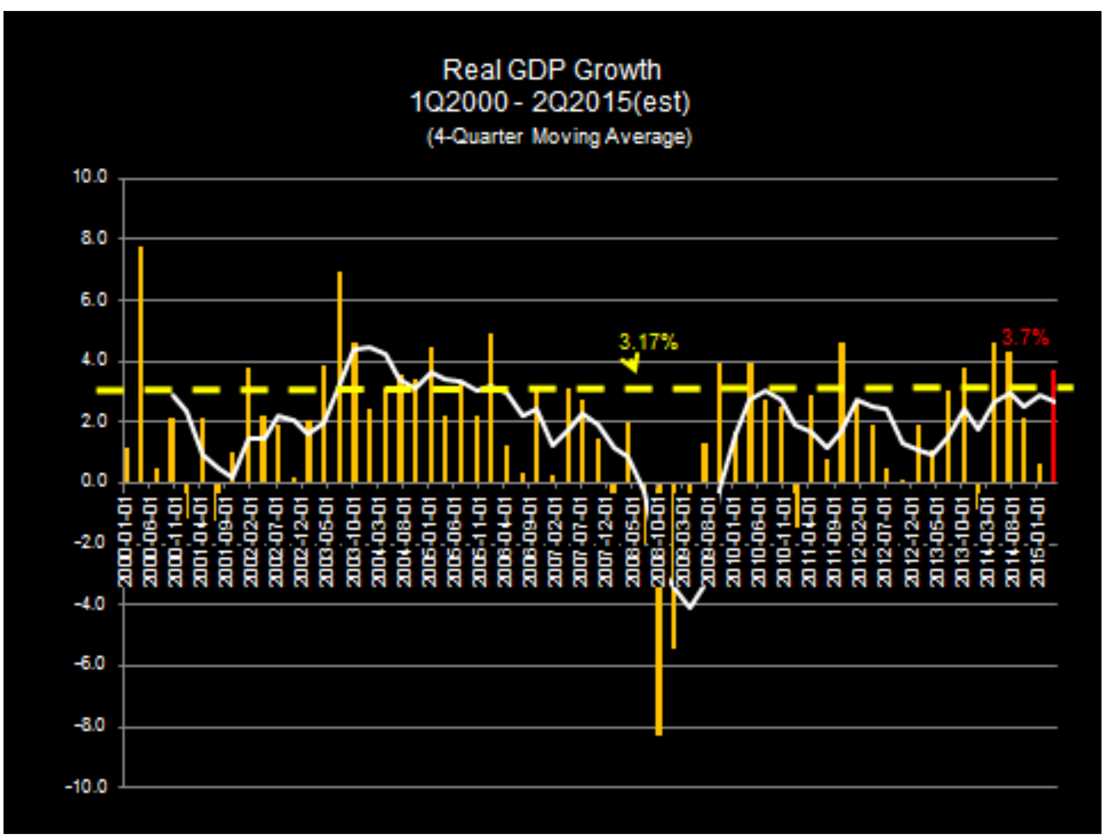
The Yellow Brick Road we hoped for in June, and now, generates at least 3.0 percent GDP growth—far more than the weak 0.6 percent growth recorded for the first quarter of 2015. When I stared at that first quarter number, optimism got the best of me. I realized that continued close-to-zero growth just wasn't in the cards. In spite of the unusually strong dollar taking the edge off export sales, the cold winter, and the Los Angeles longshoreman's strike, I was convinced the US economy was going to find its feet again and, yes, stumble toward that elusive yellow road that might take us to

Kansas, 3.0 percent GDP growth, or an even better place. (At the time I was staring at the data, the big August financial market decline had not occurred. More on those dark moments a bit later.)

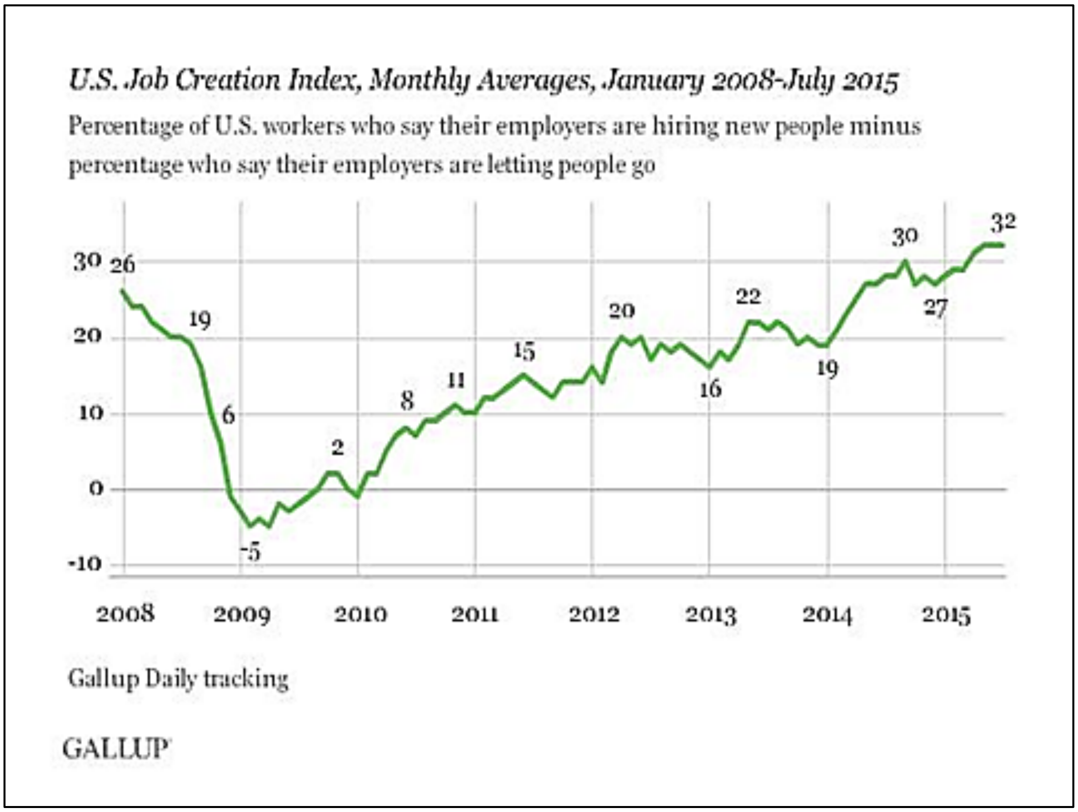
While optimism was reigning supreme, lo and behold, along came the Wicked Witch of the West. The Department of Commerce revised GDP growth in a negative direction for the most recent few years. Yes, things got worse; the path turned out to be weaker than I had thought.

But things changed again. (If this data isn't cyclical—or should I say cynical?—I don't know the meaning of the word.) Suddenly, a silver lining showed up in the clouds. The GDP gods provided a stronger estimate for the second quarter of 2015. Right on the heels of that 0.6 percent first quarter growth, the first second-quarter estimate to arrive showed 2.3 percent growth. This was revised up on August 27 to a wonderfully strong positive 3.7 percent.

The results of all this are seen in the accompanying GDP growth chart. The chart shows the most recent 2Q 2015 estimate of 3.7 percent, the 3.14 percent long-term average growth rate, representing the much-longed-for yellow brick road, and a white four-quarter running average. The backward looking four-quarter average is now registering 2.7 percent. However, the Atlanta Federal Reserve Bank's August 24 estimate for 3Q 2015 GDP is hitting a lowly 1.4 percent. Yes, it's a bumpy road. We will be lucky to see 2.3 percent GDP growth when 2015 is tallied.



For a small happiness break, let's look on the brighter side for a moment. Housing markets are strong, as are new orders for capital goods. We can see some yellow brick road evidence in Gallup's July job creation index. As shown here, the index is happily pointing north. We will also see some strong positive evidence when we take a look at construction later in the report.



Stocks in Decline, China's Slowdown, and Currency Devaluation

As I was completing this newsletter, equity markets worldwide were still trembling. Broad New York Stock Exchanges indexes had earlier fallen 10 percent in just one week. Some stability was beginning to show itself, but global investors had gotten a severe haircut. Some commentators argued the sharp decline should have been expected. (I would love to see how their portfolios fared.) After all, with practically no return from CDs and bonds, investors had moved cash into stocks, mutual funds, and emerging economy bonds in the hope of improving yields. Equity values had been bid up well above "fair value," so the argument goes. What's more, research on the effects of the Federal Reserve's easy money, zero interest rate policy indicates that the only detectable effect was found in equity markets. In a few words, the Dow-Jones Average (DJA) went up, and the wealth effects had positive effects on consumer spending.

The tremors we are experiencing may be rooted in Federal Reserve monetary policy, but the immediate source of the shaking is seen in action taken by Chinese political leaders. For more than a year, China's economy has been slowing. Of course, every economy has its ups and downs, but when the world's number two—and close to being number one—economy shifts out of overdrive, the effects are large. The Chinese economy, which had been expanding at 10 percent annually, dropped to 7 percent. And they call that slow! There are also serious questions regarding the accuracy of the estimates.

But the amount of Chinese GDP generated by the 3 percentage point difference between those two growth rates is equal to the size of Switzerland's annual output, or Bulgaria's, or closer to home, the annual output of Pennsylvania or New Jersey.

When we add to this Europe's lagging growth and Russia in recession, the combination yields one big economic dude on a diet, one that no longer needs as much beef, coal, copper, cotton, iron ore, zinc, silver or petroleum products. With the exception of petroleum products, China is the world's largest consumer of commodities. Now, with world demand falling, growth in world commodity prices is going negative.

Meanwhile, China, Europe and Japan continue to print money or reduce interest rates in an effort to spur economic growth. When other countries print money faster than America does, our money becomes more valuable. And when investors predict US interest rates may be nudged higher, that makes the dollar even stronger. By the way, I hope the Fed will make its 25 basis point move to higher rates soon by cutting the payment made on excess reserves held by US banks, which will stimulate consumer and business lending.

Strong Dollar and Yuan Devaluation

Currency and global financial markets began to quiver on August 10 when China suddenly devalued the yuan by 2 percent. The yuan's value continued to weaken after that. Before the devaluation, China's currency was pegged to the soaring dollar, which meant China's export economy was suffering along with ours. Chinese leaders appeared desperate to recharge their economy—particularly their previously soaring stock market. The Chinese market had fallen more than 30 percent from this year's high, carrying with it the political fortunes of political leaders whose reputations are paired to financial market indexes.

In efforts to reverse the falling markets, government funds were used to buy targeted equities, trading was curtailed, controls were imposed on selling shares, interest rates cut, and bank reserve requirements relaxed—all with little immediate effect, but with some market hints that stability was on the way.

Along with devaluation, the Chinese government indicated that it would no longer peg the yuan solidly to the dollar. Instead, something like a floating peg would recognize market forces on a daily basis. But the story is still not over. Once a major economy devalues, other global players respond with their own currency adjustments. Like a game of musical chairs when one chair is removed, all the players hustle to get comfortable before the music stops.

With China's devaluation, dollars will look a bit larger to us when we go shopping at Walmart, Target, or Lowe's. In fact, as indicated in the next chart, which comes from the Federal Reserve Bank of St. Louis, the dollar was the strongest in more than a decade even before China's devaluation.

Value of US Trade–Weighted Dollar
January 2004 to June 2015

Exports Suffer

But while that may feel good when we go shopping, it doesn't feel quite so hot when exporters offer their goods and services on world markets. US exporters prefer to be paid in dollars, and dollars are dear. Earnings in Chinese yuan also look paler now when converted to dollars, and this hits American-owned businesses located in China.

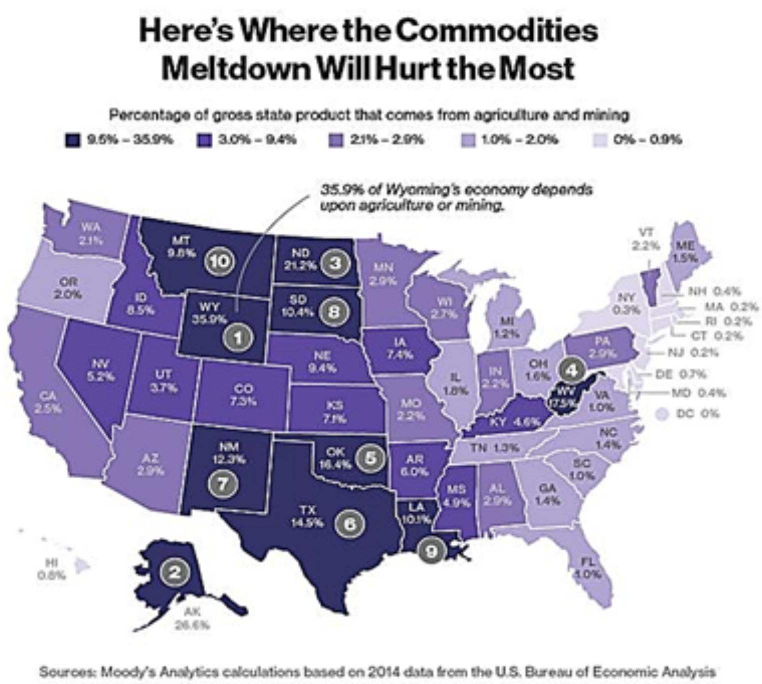
Because of the stronger dollar and slowing global demand for US goods and services, the real value of our exports peaked out in the fourth quarter of 2014, dropped again in the first quarter of 2015, and in the second quarter of 2015 stand lower than the fourth quarter of 2014 level. In a few words, exports hit a bump and have not fully recovered. Of course, this is part of the slower GDP growth we have seen since mid-2014. But remember, exports account for about 13 percent of US GDP, and that limits our exposure to variations in world economic activity. We are still largely a domestic economy and the major oil producer at that.

Ah, but then there is the import side of the strong dollar story. Remember how good it felt to go shopping at Walmart, Target, or Lowe's? Just about the time the real value of exports was falling, the real value of imports began to accelerate. In the third quarter of 2014 the real value of imported goods and services hit $2.53 trillion. When the second quarter of 2015 rolled around the value stood at an all-time high of $2.65 trillion. The stronger dollar did the job: higher imports, lower exports.

The effects of rising and falling export vary significantly across the states. Some states, like South Carolina, are major exporters of electrical machinery, tires, and automobiles. In fact, South Carolina is America's leading auto exporter and the leading tire producer. Others, such as Texas, West Virginia, and Wyoming, are heavy petroleum, coal, and mineral exporters.

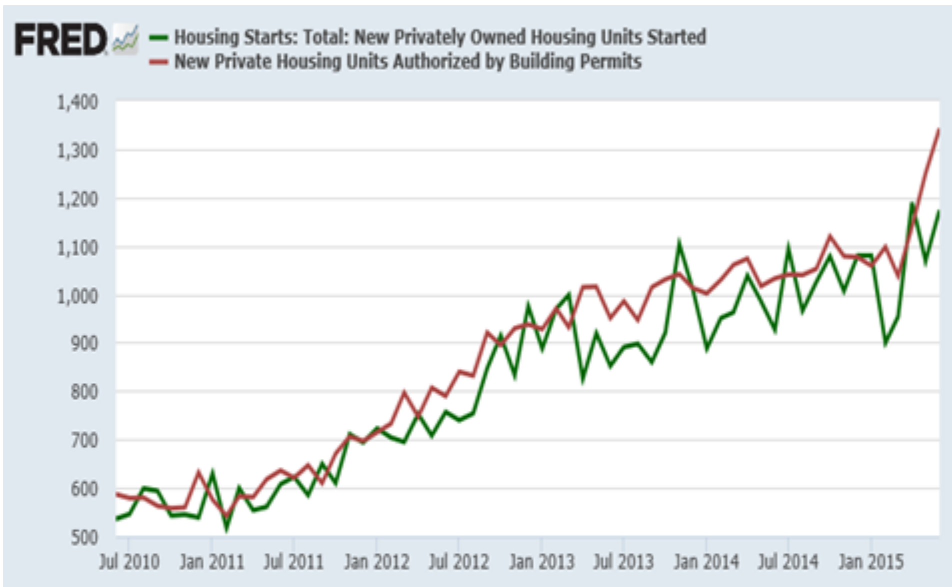
Regional Effects of the Commodity Glut

Growing world inventories of petroleum, copper, cotton, ethanol, and iron generate differential effects across the states. The accompanying chart reports the share of each state's GDP that comes from agriculture and mining; it tells us where weak commodity prices will hit hardest. Notice that Wyoming is hardest hit, followed by Alaska, North Dakota, and West Virginia. The darker the color, the harder the hit.

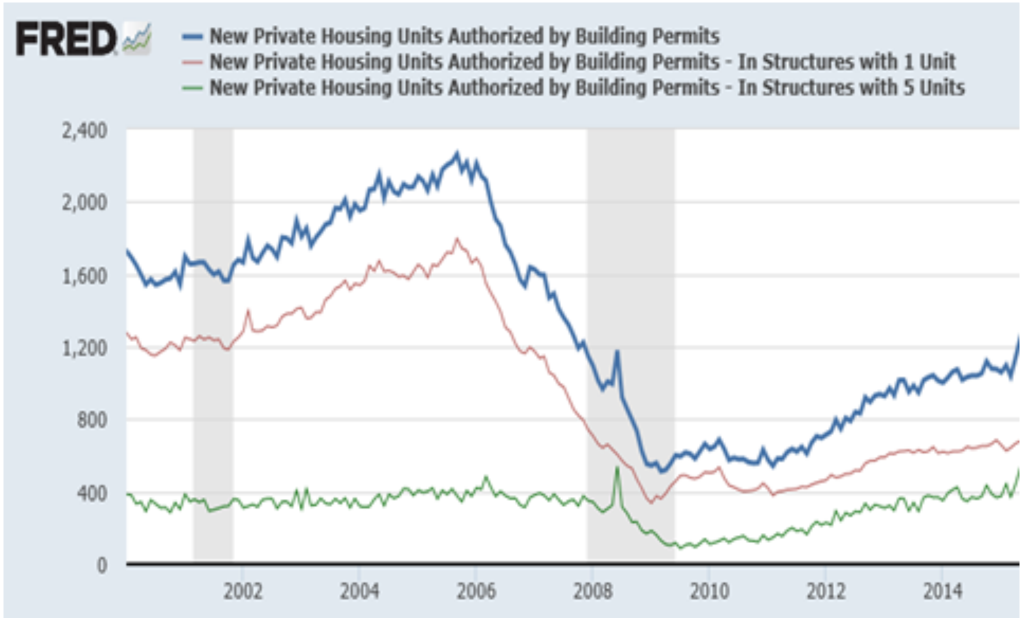


Construction to the Rescue

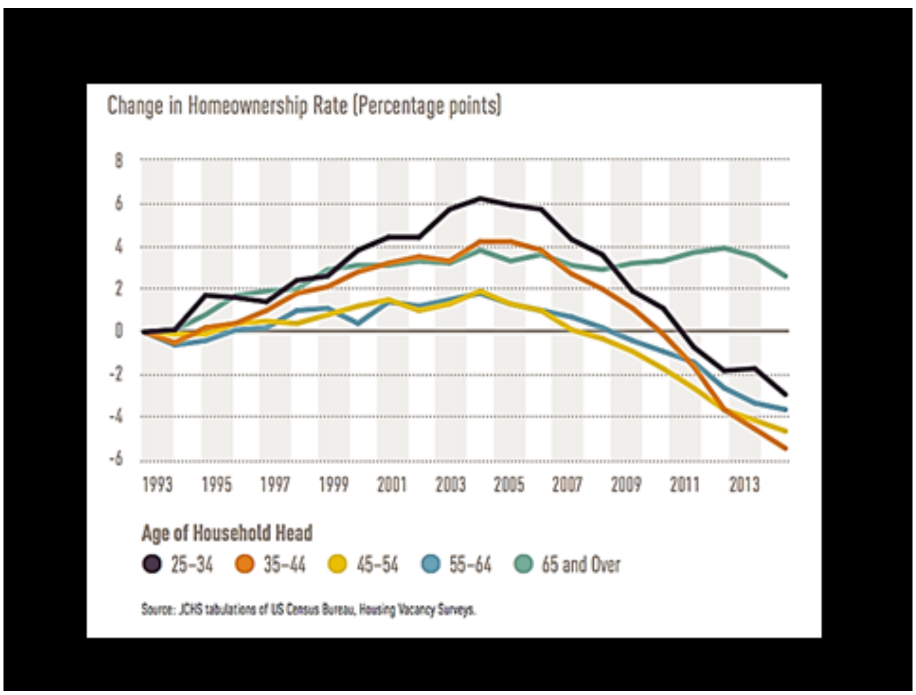
Ah, but there is still more to the story. Fortunately, America's economy is well diversified. When one sector begins to lag, another starts to rise. Exports and commodity production are down, while housing starts and other construction are heading north but still on a bumpy road. The next Federal Reserve Economic Data (FRED) chart, which maps housing permits and housing start data, tells the tale.



Note first that permit data, shown by the red line, tend to lead starts, the green line, by just a brief amount, roughly 30 days. Then, consider the most recent mid-2015 observations. Housing starts have been moving upward on a bumpy path, but housing permits are heading to the sky. The next FRED chart tells us about the kind of housing construction that is leading the pack. Multi-family apartments and condos are becoming the toast of the day! But why? What is happening with age group demand for home ownership?

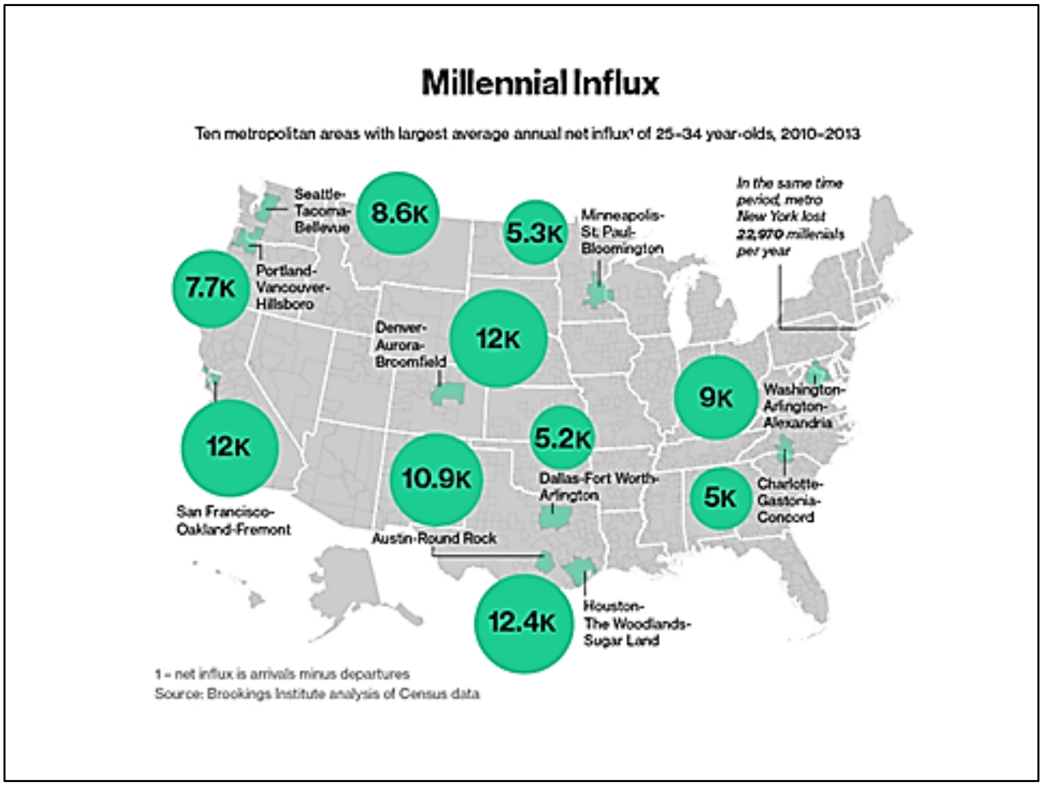


We get a glimmer of an answer to that question in the next chart. Notice that only the graying population shows a growing preference for keeping the home fires burning.



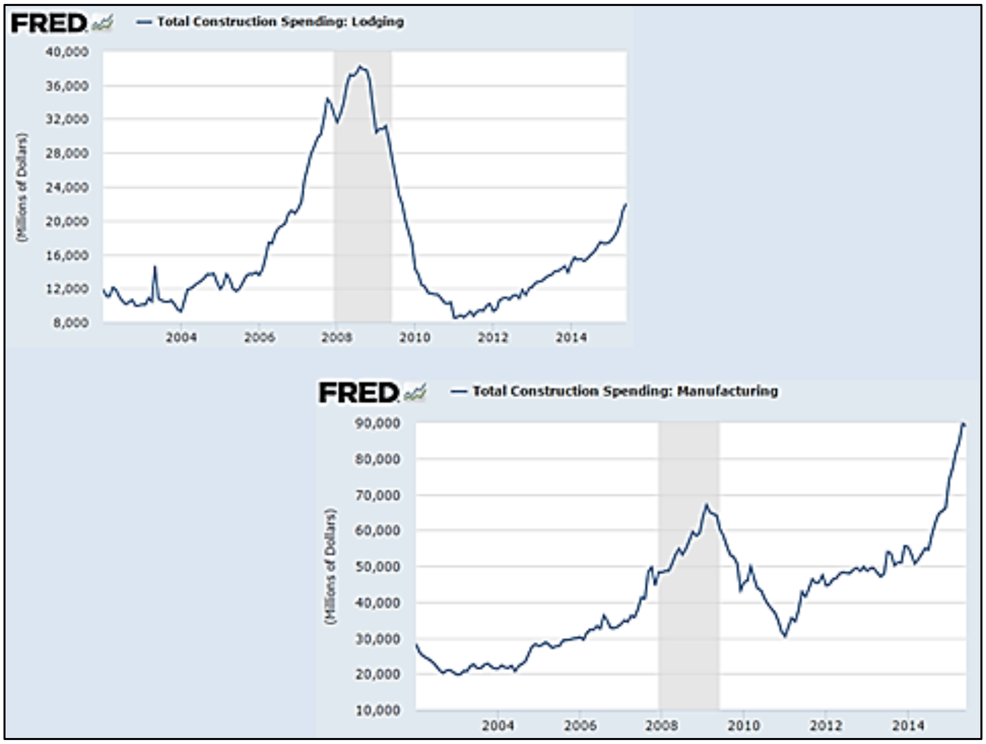
The Millennial Effect

Part of the increase in rented versus owned housing is associated with the large millennial generation, which prefers urban living and carries a significant education debt load that cuts against adding debt for housing. There is also a growing migrant population that has lower incomes and a fall in household formation overall, which is linked to millennials. As always, of course, there is wide variation across regions, states and metro areas. Because of the importance of the size of the age group, things tend to accelerate most in those locations desired by millennials. The next map shows the hot spots.

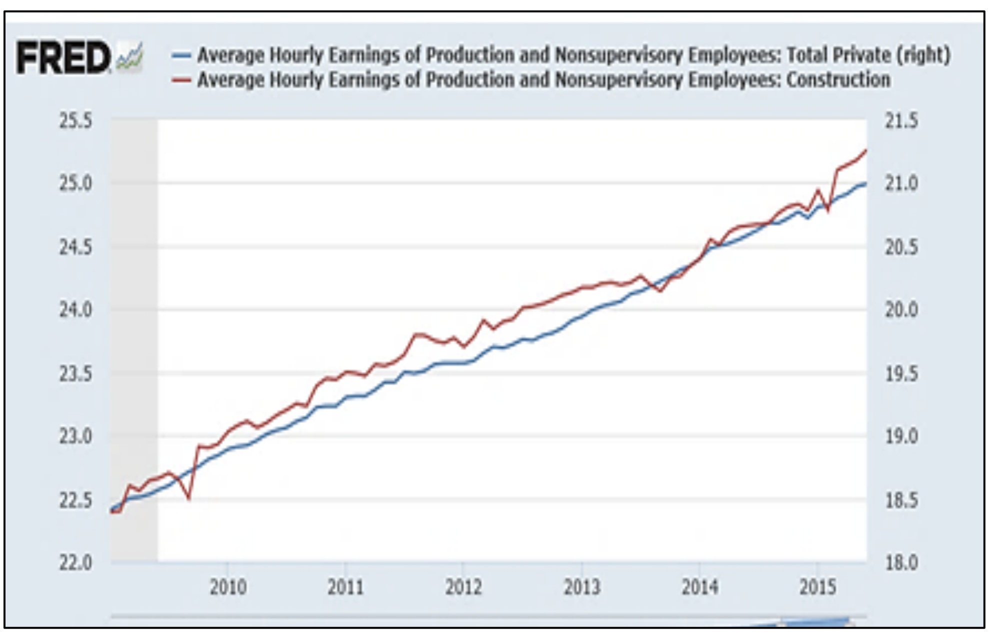


Construction in Other Sectors and Labor Market Effects

Another booming part of the construction recovery is seen in manufacturing and lodging. The data emerging from these two sectors augur well for continuation of reasonably good GDP growth.



Low interest rates, plentiful building materials, and available labor are helping. But of these three input factors, it is labor that may become the limiting factor. Evidence seen in the next FRED chart shows what is happening to construction and all other wages in the economy.



The construction recovery brings good news for that toughest part of the labor challenge: workers over 25 years old who have less than a high school education. This group often includes highly skilled construction workers. The next chart on participation and unemployment rates for workers based on educational attainment offers some clues about what is happening. Of the four achievement categories, the less-than-high-school group shows the largest increase in participation and reduction in unemployment rate. By the way, the data for this group translate into a gain of 200,000 employed over the past 12 months. It has been a long time coming.

Labor Participation & Unemployment Rates
By Academic Achievement
July 2014 – July 2015

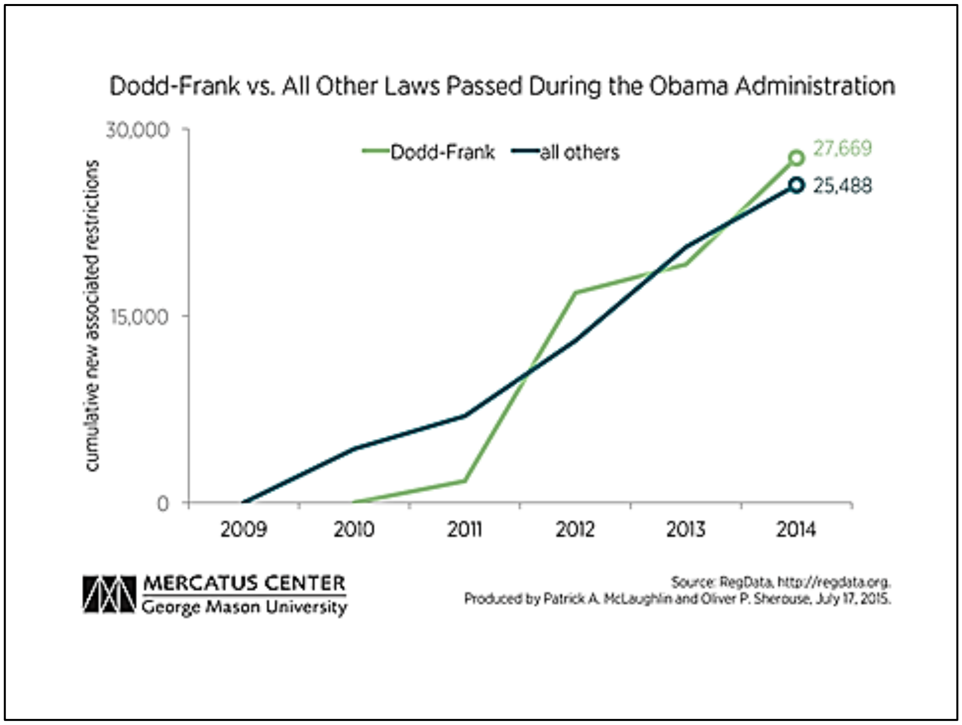
	July 2014		July 2015	
Achieve	Participate	Unemploy	Participate	Unemploy
<H.S.	44.7%	8.2%	46.2%	8.3%
H.S.	57.0%	5.5%	57.1%	5.5%
<B.S.	66.0%	4.5%	65.9%	4.4%
B.S.	74.7%	2.8%	74.5%	2.6%

Before leaving this chart, take a hard look at the part of the labor force with a bachelor's degree or more. The 2.6 percent unemployment rate is about as close to zero as we get. Our economy is constrained by the limited number of experienced workers holding college degrees. Does that mean goodbye to the yellow brick road? Not quite. But it does mean that future growth acceleration will depend on employment growth for workers with lower educational attainment.

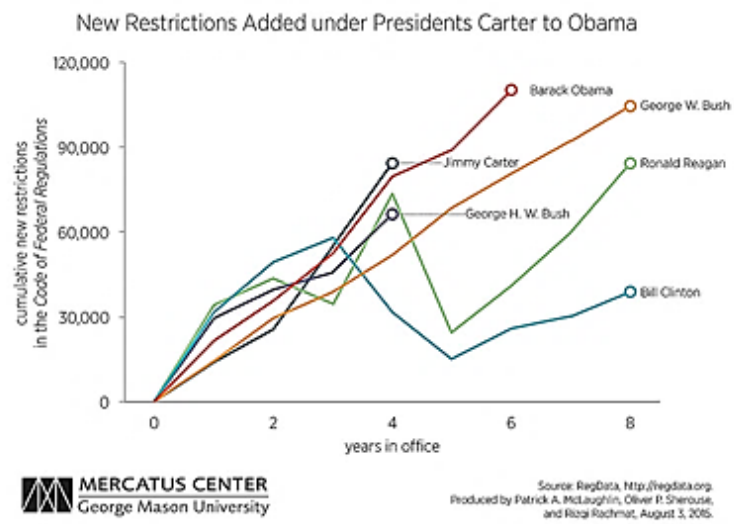
More on Regulation's Imprint

In the June 2014 Economic Situation, I discussed an index developed at the Mercatus Center at George Mason University that measures the degree of regulation imposed by federal regulators on the US economy and economic sectors within the economy. The index can be found at Regdata.org. It is based on the frequency of command-and-control words found in the *Code of Federal Regulation*. The words counted are "shall," "must," "may not," "prohibited," and "required." These words form constraints that alter production and consumption and also reduce competition and the ability of firms and industry to respond to changing economic circumstances.

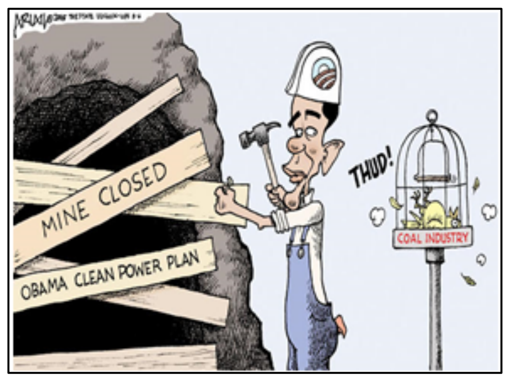
Just recently, RegData's keepers produced two charts that caught my eye. The first one gives a reading on the count of regulatory constraints affecting US banks and financial institutions found in the rules spawned by Dodd-Frank. The count of Dodd-Frank rules is compared to the count of constraints generated by all other federal regulations that have emerged during the Obama administration. Dodd-Frank alone exceeds all other regulation combined.



The second RegData chart that I found interesting compares the extent of command-and-control regulation—using the RegData measuring stick—produced annually by successive presidents. Before looking at the chart, one might ask which president, Carter, Reagan, Bush I, Clinton, Bush II, or Obama is the heaviest regulator? As the next chart tells you, it is not Bill Clinton.



Looking Closer at EPA's Clean Power Plan



EPA's recently announced Clean Power Plan is the latest bundle of command-and-control regulation to hit the US economy like a freight train. Targeting the burning of coal for generating electricity, the new rules require a 32 percent cut in power plant carbon emissions by 2030 based on 2005 levels. The regulations will bring dramatic increases in power costs to US regions like the Ohio River Basin and the Southeast that have abundant coal and lots of coal-fired electricity generators.

A recent study by the Institute for Energy Research (IER) explains why costs will rise significantly. IER estimates that electricity from existing coal-fired plants costs $38 per megawatt-hour, and electricity from existing natural gas plants costs $48.90. But for new natural gas plants, which are expected to replace the shuttered coal-fired plants, the cost rises to $73.40, partly because of more onerous emission standards they must satisfy. And from wind, the cost is $106.80. The wind energy cost estimate includes the cost of improving the grid for handling energy produced in more remote areas.

Writing in *Forbes* recently about the Clean Power Plan, James Delong touched on EPA data that indicate the billions, or perhaps trillions, in cost associated with the new rules will avert global warming increases by 0.18 degrees Celsius by the year 2100. That's not a lot of heat avoided.

Of course, most of us are rationally ignorant about such details and tend to trigger a left-brain analysis of proposals that have lofty titles and a happy media spin accompanying them. Who could be opposed to clean power? Our response is then almost religious in nature. The lofty title—Clean Power Plan—and promises of environmental salvation lead us to speak positively and expressively in support of the proposals. “After all, we are a rich people,” we demur. “We can easily afford to avoid the horrors that might come with global climate change.”

Bootleggers and Baptists Understand

And then there are the Bootleggers and Baptists (B&B) who, rationally informed, are struggling mightily to get the regulations in place. Delong puts it this way:

> Climate change has produced a B&B juggernaut. On the Bootlegger side, it has an industry now billing out at $1.5 trillion per year, ‘includ[ing] everything from carbon markets to carbon consulting, carbon sequestration, renewables, biofuels, green buildings and insipid cars.’ On the ideological side, it has dozens of environmental groups with revolving door relationships with EPA, supported by millions/billions of dollars in government and foundation grants. (Actually, being an ideologue is so profitable that a third category should be added: ‘Bootlegging Baptists’.)

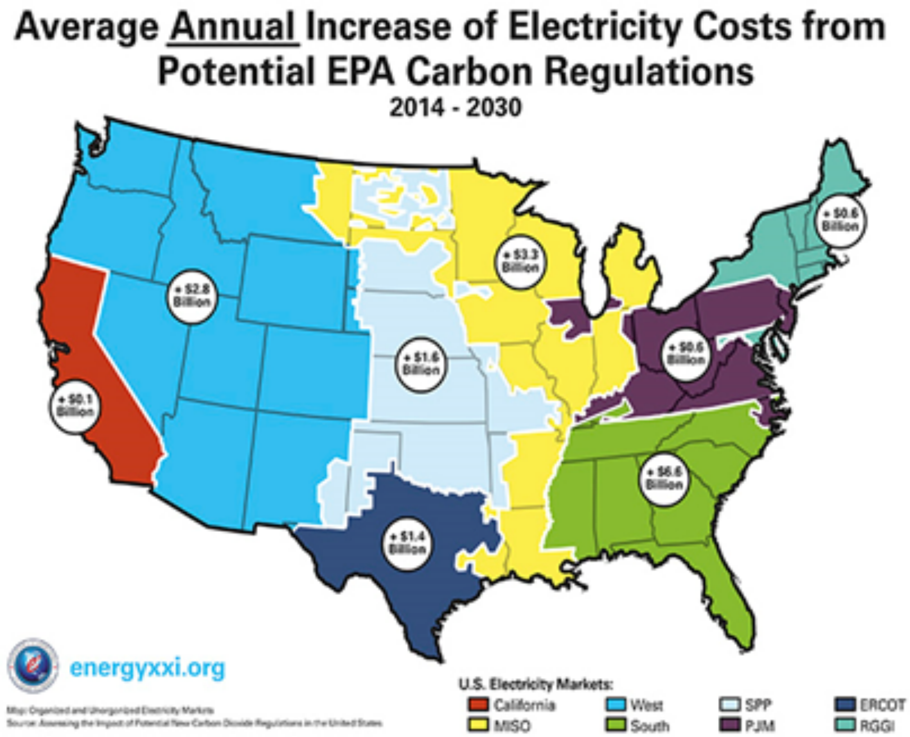
And I would add “Baptizing Bootleggers.”

It might be remembered that Chesapeake Energy and the American Gas Association provided $26 million in gifts to the Sierra Club that assisted in an EPA struggle to eliminate coal-fired utilities. As reported by the *New York Times*: “The Sierra Club used the Chesapeake Energy money, donated mainly by the company’s chief executive from 2007 to 2010, for its Beyond Coal campaign to block new coal-fired power plants and shutter old ones. Carl Pope, then the club’s executive director, promoted natural gas as a cleaner ‘bridge fuel’ to a low-carbon future.”

This is called using regulation to raise rivals’ costs.

The next chart shows the US Chamber of Commerce estimate of the annual cost of the Clean Power Plan regulations by US electricity markets. I call attention to the differential effects. The estimate of annual cost is by far the highest for the South at $6.0 billion and lowest in California at $0.1 billion. It doesn’t take a long look to realize that there may be another B&B story here. Regions of the US, let us say, California versus the Southeast, can use regulation to raise rivals costs just as industries may. Clean Power rules, just like a higher federal minimum wage, can partially remove a lower cost-of-living advantage found in some states. I point out that the proposed regulations recognize the differential effects generated in the cost of electricity across regions and income groups. The new rules provide subsidies, training programs for the unemployed, and state actions that will be taken to assist lower income people in dealing with the higher costs.

The proposed rules go far beyond regulations affecting power production. They include a host of required transfer payments.



While digesting all this, there is one last point to consider. According to IER: "China consumes more than 4 billion tons of coal each year, compared to less than 1 billion tons in the United States and 600 million tons in the European Union. China surpassed the United States to become the largest global carbon dioxide emitter in 2007, and it is on track to double annual US carbon dioxide emissions by 2017. By 2040, China's coal power fleet is expected to be 50 percent larger than it is today and these power plants typically operate for 40 years or more."

The old song by Benny Goodman, made famous by Peggy Lee and recalled by all the over-70 population, put it this way: "Somebody else is taking my place." We are reducing carbon emissions, making room for China and others to increase their emissions. Or so it seems.

Suggested Fall Reading

No doubt about it, there are lots of good books out there**.** I start with a really enjoyable read: John Kounios and Mark Beeman**,** *The Eureka Factor* (New York: Random House, 2015). Where do "a-ha" moments originate? Why are some people super creative and others not so? These two neuroscientists explore the working of the brain in an attempt to explain insight, where it comes from, and how we might enhance the prospects of having more of those “Eureka! I have found it!” moments. Drawing on their personal research as well as that of leading psychologists and other neuroscientists, this highly readable book is downright enjoyable. It is strongly recommended for those who wish to know about insight, creative thought, and the incredible power of the subconscious mind. I offer a few tips for those who may not read the book. Most are just common sense. Moments of insight may be triggered by breaking your work routine—for example, strolling around the office or heading to the garden for quite time. Some suggest taking showers! The noise shuts out the world, and the warm water is soothing. When attempting to “converse” with the unconscious mind, it often helps to close your eyes and relax. Another eureka moment researcher has suggested to get REST: random episodic silent thought. By the way, Quakers may have an advantage here, but the rest must be random.

For those who may share my concern about the longer-run prospects of the Great American Bread Machine’s ability to produce wealth, I have two books to suggest. Philip K. Howard, author of *Death of Common Sense* (New York: Random House, 2011) has a follow-up to consider. *The Rule of Nobody: Saving America from Broken Laws and Dead Government* (New York: W. W. Norton, 2014) is a critical assessment of the rise of the US as a code law country, one with endless regulations that are too numerous and too complicated for anyone to comprehend, a situation that denies common sense and human interpretation of right and wrong. Howard, a practicing attorney, gives us a well-written criticism of our political economy that includes some proposals for bringing improvement. If you are into politics and regulation, you will like it. After considering this report’s RegData presentation, we might wish to make the book required reading for our flock of aspiring presidents.

Now consider Charles Murray’s *By the People: Rebuilding Liberty Without Permission* (New York: Crown Forum, 2015). Murray, a prolific sociologist housed at the American Enterprise Institute, writes a companion to Howard’s book just discussed. Murray also recounts the rise of the regulatory state but then suggests a radical remedy—civil disobedience. As Murray sees the situation, there just can’t be enough regulation policemen to enforce all the minute rules. He calls for a return to common sense inspired by a quiet regulation rebellion. Some good treatment of constitutional law is found along the way.

Decades of expanding welfare programs, experiments in education, and slow economic growth interacting with a host of other complex social forces have generated an America where many families are producing and enjoying wealth while many other families—or, better said, households—live in broken homes and communities with little prospect for enjoying the American dream. Robert Putnam, one of America’s leading social scientists, has written a compelling and disturbing story of what is happening to the nation’s children. *Our Kids: The American Dream in Crisis* (New York: Simon and Schuster, 2015) is a moving, carefully documented book. At times based on Putnam’s personal life experience, the book seeks to show how America is coming apart, and how the economic separation of families has led to two distinct cultures, lifestyles, and future expectations for the next generation.

Putnam argues that American life has become more stratified; there is less mingling and interacting as between the rich and poor, which will limit future economic mobility. While he paints a convincing picture, Putnam comes up short with novel solutions, which I think we should expect, given the deep complexity of the problem. He could have well explored an expansion of the negative income tax as a partial replacement for welfare programs and the decriminalization of crimes without victims as a way to reduce the prison population and get more parents back home with their children. But, of course, the challenge is far greater than implied by these ideas. For the sake of understanding America today, I think this is a must-read.