CHAPTER 1

THE ECONOMY

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U.S. ECONOMIC GROWTH

American economic performance has been quite impressive in recent years. What makes this newsworthy are the recent "shocks" to the economy including a mild recession in 2000 and 2001, the events of September 11, 2001, an extended period of interest rate hikes by the Federal Reserve, a near quadrupling of oil prices during the past few years, and the fits and starts of the nation's housing market.

U.S. economic growth over the past 25 years has occurred with only a modest period of economic decline. The two mildest recessions during the post–World War II period were of short duration in 1990 to 1991 and in 2000 to 2001. Aside from these modest economic contractions, the American economy grew at a pace ranging from subdued to robust for the majority of the 1981 to 2007 period.

Such an extended period of U.S. economic growth is a major departure from the more severe economic gyrations that characterized much of the nineteenth and twentieth centuries. Economic downturns in prior periods were typically more severe, with extended periods of economic decline "highlighted" by the Great Depression of 1929 to 1933. In fact, similar sharp declines of the American economy were almost commonplace in near 20-year cycles during the nineteenth century.

What accounts for this moderation in economic volatility? The most likely answers include more timely and accurate economic data as well as the enhanced ability of this nation's central bank, the Federal Reserve, to use monetary policy to smooth out economic volatility during the past 25 years.

The Past Dozen Years

Democrats are fond of boasting about the powerful U.S. economic growth that occurred during President Bill Clinton's second term

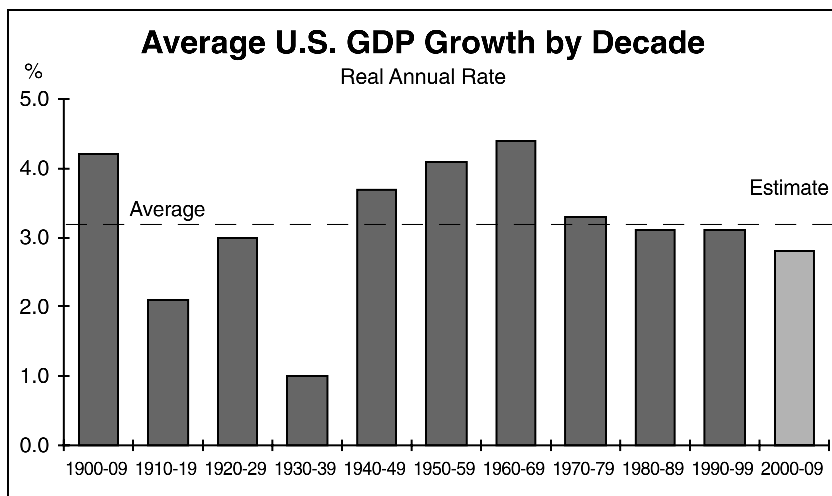

FIGURE 1.1 Average U.S. GDP

Source: Based on data from the U.S. Bureau of Economic Analysis.

from 1997 through 2000. Republicans are equally willing to boast of the solid economic performance of the 2003 to 2006 period, even as the national media tells a different story.

In fact, U.S. economic growth in both decades was merely in line with the average growth rate during the twentieth century, although performance of the global economy during these periods was very different. U.S. economic growth during the late 1990s was impressive given the fact that roughly half of the global economy had fallen into recession during 1998 and 1999. In contrast, U.S. economic growth of recent years was in tandem with solid economic performance around the world. (See Figure 1.1.)

Growth by Decade

Recent U.S. Economic Performance

The American economy has grown at a solid pace during the past four years. Many economists have referred to "the best of all worlds"

mix of solid and extended U.S. economic growth, near-full employment, minimal inflation, and relatively low short- and long-term interest rates.

This growth has occurred even as the U.S. economy has faced two powerful headwinds that would have brought the economy to its knees during prior expansions. The first of these was extensive monetary tightening by the Federal Reserve. The Federal Reserve raised its key short-term interest rate 17 times between June 2004 and June 2006. In contrast, various prior periods of extensive monetary tightening to ward off inflation pressures soon found the U.S. economy flat on its back.

The second headwind was a painful spike in energy costs. Oil prices ranged from the mid-$20s to the mid-$70s during the past four years. Even so, U.S. economic growth continued at a solid pace. Such performance was a strong testament to the underlying strength and diversity of the American economy.

Solid global economic performance has also occurred, with the 2003 to 2006 period being the strongest four-year period since the early 1970s. Tens of millions of people around the world have seen their standards of living improve, even as the global community has experienced as much change as at any time in history.

The Late 1990s

Solid U.S. economic growth during much of the current decade compares to strong U.S. economic performance during the second half of the 1990s. Economic growth then was, in part, tied to the enormous expansion of the Internet and the surge in technology and other stocks. Unfortunately, the excesses of stock price appreciation resulted in a serious stock market meltdown in following years, contributing to the economic weakness that soon followed.

Another factor, in my opinion, that contributed to solid U.S. economic growth during the 1990s was split government. Democrats lost control of both the U.S. Senate and the U.S. House of Representatives in November 1994. The resulting Republican control of the Congress, combined with Democratic control of the White House, created an impasse regarding new policy. With only limited government interference, the American economy was allowed to work its own magic.

Split government, in my view, is at times the best government of all. This political reality of "don't do something, just stand there" was just what financial markets desired in the mid- to late 1990s. The result? Financial markets responded favorably, with powerful gains in stock prices in the years that followed.

Leadership

The U.S. role of dominance in the global economy during the past decade has been as clear-cut as at any time since the 1950s. As economists, we try to identify the critical industries of the future. I would currently identify seven:

- Technology
- Telecommunications
- Transportation
- Financial Services
- Energy
- Entertainment
- Bio-medicine

All seven of these industries currently find the United States as the principal player.

The Next Recession?

A question I am frequently asked when I give presentations to clients around the world is, "What could trigger the next U.S. recession?" Terrorism on American soil, avian flu, a major stock market plunge, and a general loss of confidence in the effectiveness of government typically come to mind.

In addition, the "headwinds" of sharply higher short-term interest rates and much higher energy prices could derail the expansion. More recently, economic pain associated with declining real estate values in various coastal markets and in the nation's Southwest could also contribute to renewed economic weakness.

GOODS AND SERVICES

The national media has consistently told a story of demise in recent years regarding America's ability "to make things." The common wisdom clearly states that this country has seen our manufacturing base move to Mexico and China.

As the story continues, millions of formerly high-paying goods production jobs have been replaced with jobs at fast-food restaurants. The common wisdom? We don't build or manufacture much anymore, we simply serve each other hamburgers and trade information with each other.

The common wisdom is largely misguided. American GDP (gross domestic product) is the total value of all goods produced and services provided in the economy. This total now exceeds $13.5 trillion annually.

We have not lost our ability to make things. We produce, manufacture, mine, and build more than ever before. We simply do it more efficiently than ever before.

Productivity Gains

According to the U.S. Bureau of Labor Statistics, we have lost a significant share of former manufacturing jobs. One of every six manufacturing jobs that existed in the United States seven years ago is gone. Thousands of jobs have been lost to lower-cost production facilities in Mexico, China, and other countries.

However, most of the decline in American manufacturing jobs has resulted directly from powerful gains in worker productivity. Manufacturing sector productivity gains have outpaced such gains in all other employment sectors in recent years.

We simply build products more efficiently than ever before. Given powerful technology and the use of more effective tools, it takes fewer people to produce a tire, fewer people to build a house, fewer people to strip-mine coal, and fewer people to operate most factories.

A good analogy notes that a hundred years ago roughly 50 percent of the American workforce was involved in agricultural production. Less than 3 percent of the workforce is involved in agricultural production today, with that share of workers producing a great deal more than ever before.

Higher Living Standards

Rising worker productivity is a key contributor to higher standards of living for American workers. From 1973 to 1995, U.S. productivity recorded lackluster average gains of just over 1 percent annually. Since then, productivity gains have grown at a much faster rate.

Average worker productivity rose at an average annual rate of 3.0 percent between 2002 and 2006, the strongest five-year period of gains in more than 40 years. It is likely, however, that productivity gains will slow somewhat as the current U.S. economic expansion becomes more mature. Is the economy long in the beard? In March 2007, the current U.S. economic expansion was 65 months in duration.

THE MISERY INDEX

One of the major political issues that greatly impacted results of U.S. presidential elections during 1976 and 1980 was frequent reference to "the misery index." This so-called "index" was simply the sum of the nation's most recent unemployment rate and the nation's consumer price index for the most recent 12-month period. This combination was a simple way to measure the level of "pain" or "misery" of the American people when it came to the overall level of joblessness and the loss of purchasing power due to rising inflation.

The misery index was first made politically newsworthy by Democratic presidential candidate Jimmy Carter in 1976. During the presidential election of that year, Mr. Carter constantly attacked President Gerald Ford for his mishandling of the American economy.

Candidate Carter frequently noted during the campaign that the misery index was in the mid-teens, as compared to much lower levels during the 1950s, 1960s, and early 1970s. Mr. Carter's criticism of President Ford's economic mismanagement was effective, helping him defeat the incumbent Republican president during the November 1976 election.

"What Goes Around..."

...comes around" as the saying goes. During the 1980 presidential campaign four years later, Republican candidate Ronald Reagan constantly made reference to President Carter's economic failings—as measured by Carter's misery index.

By November 1980, the misery index had moved even higher, with several monthly measurements above 20. Candidate Reagan's constant battering of President Carter with his own index turned out to be effective as Reagan handily defeated the incumbent Democratic president.

References to the misery index have clearly waned in recent years, although it remains a reasonable—if simplistic—measure of the

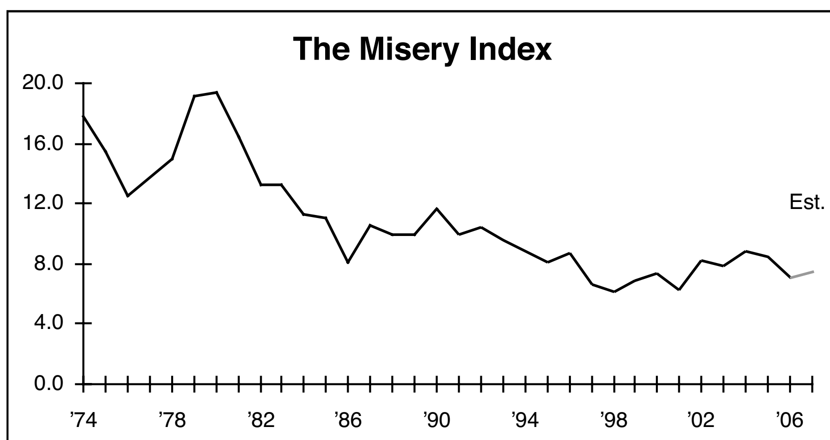

FIGURE 1.2 Misery Index

Source: Based on data from the U.S. Bureau of Labor Statistics.

American consumer's economic well-being. As Figure 1.2 shows, the United States made enormous progress in reducing this particular measure of consumer pain, especially during the decade of the 1990s.

The Numbers

On the employment side of the equation, impressive U.S. economic growth and resultant strong job creation during much of the past 10 years led the nation's unemployment rate to average 4.1 percent during calendar years 1999 and 2000, its lowest annual average in 30 years. The nation's unemployment rate actually fell slightly below 4.0 percent during various months in 2000, the lowest monthly rate since January 1970. While true, one actually has to go back to the mid-1950s to find a *peacetime* unemployment rate as low as 3.9 percent.

More recently, the nation's unemployment rate again declined from the near 6.0 percent average following the mild 2000 to 2001 recession. The 4.6 percent average in 2006 was its lowest average level in five years.

On the inflation side, pressures remained modest in the first years of the 21st century due to (1) fierce domestic and global competition in nearly every major industry; (2) more aggressive actions by consumers to resist price increases; (3) more effective corporate utilization of technology, and (4) the inflation-fighting nature of the Internet.

The escalation of numerous commodity prices during the 2004 to mid-2006 period led inflation pressures higher. Global prices for oil, steel, copper, lead, aluminum, and the like, tied in part to sharply rising demand from China and India, led overall inflation pressures higher before easing in late 2006. Such upward pressure on commodity prices was a key ingredient in the Federal Reserve's elongated monetary tightening program of June 2004 through June 2006.

Bottomed Out?

Has the misery index bottomed? Very likely. The nation's unemployment rate dipped to extremely low levels in 1998 to 2000. This decline was particularly impressive in light of frequent cost reduction and layoff programs regularly announced by prominent U.S. companies during the late 1990s. Inflation pressures were also largely muted during 1997 to 2003. The misery index will enter the history books as an interesting political footnote.

STATE OF THE STATES

The current U.S. economic expansion, now into its sixth year, has contributed to varying levels of performance among the 50 states. The simplistic comparison suggests that states in the West and the South have enjoyed stronger performance, while those in the Northeast and the Midwest have seen less robust economic growth.

Many states with significant natural resources including oil, natural gas, and coal are doing well. Many states more dependent on manufacturing are struggling.

The Rocky Mountain region leads the way in employment growth. By comparison, much of the region was hit very hard by the recession of 2000 to 2001; the events of September 11, 2001; and the initially weak U.S. economic recovery.

Conversely, the nation's industrial heartland of Indiana, Michigan, Ohio, and parts of the Northeast finds itself in the bottom 10 states as measured by employment gains, accompanied by Louisiana and Mississippi (hurricane impact). The primary culprit in the industrial Midwest has been ongoing job cuts in the auto sector and various auto suppliers.

Buddy, Can You Spare a Worker?

Extremely tight labor markets will contribute to some slowing in the high-growth states over the next 24 months. It is extremely difficult to fill open positions in numerous markets around the nation, including the Rocky Mountain states, the Upper Midwest, and Florida.

Various employers, including many in the construction, education, health care, natural resources, and transportation sectors, have publicized thousands of open positions with little, if any, response. Employers in various industries are paying signing bonuses for new hires or providing bonuses to current workers who bring in another potential employee.

More Revenue, Less Borrowing

Solid U.S. economic performance has led to a majority of the states (more than 40 at last count) now running budget surpluses. Many states are dealing with the greatest surge in tax revenue ever recorded.

Many states that suffered from serious budget challenges two to four years ago are now flush with new money.

A number of states are primarily spending excess revenues. Other states are returning a significant share of the revenue surpluses to taxpayers. State and local economic growth is clearly subject to fits and starts. Those state legislators who choose to primarily spend excess revenues, and largely commit taxpayers to higher spending in the future, may rue the day. States that cut income tax rates in times of excess revenue typically have greater levels of job and income creation versus those that ramp up current and future spending.

It's not rocket science.