

# KENAN INSTITUTE BUSINESS FORECAST

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## THE U.S. ECONOMY IS STRONG AND GETTING STRONGER

Here is some advice for you: pay little attention to any economic analysis produced by people running for president or their minions in the third quarter of every year divisible by four—such as now.

The incumbent and his supporters always want to play up the current situation (whatever it may be) as the best of all possible worlds (or at least the best that could be expected given all manner of ameliorating circumstances), while the challenger and his supporters want you to believe the current environment is absolutely terrible. They want you to buy the proposition that the only possible cure for the awful economic situation is to elect their candidate so that they can fix it. Naturally, both camps want you to believe that the office of the president has vast powers of mastery over the economy.

First, let's just say that the economy is somewhere between simply marvelous and absolutely terrible. Second, we can dispel the presidential power myth. The

president's best economic weapon is the bully pulpit. Considering there's a two-house Congress between any president and the ability to affect the economy, there is not much direct power in the hands of the president. As a matter of fact, the only two presidents who have had vast effects on the U.S. economy in the past 100 years managed their dark magic due to their being clueless. It may or may not be coincidental that those are our only two presidents who were engineers, which I consider good bipartisan evidence that it is unlikely to ever again see another member of that profession be nominated, much less elected.

The Republican example is Herbert Hoover, who allowed three dreadful economic mistakes:

- The Federal Reserve System let the money supply shrink by nearly 50 percent, which caused deflation. (While the Federal Reserve System is independent today, it was not when Hoover was president. He should have stopped this.)
- He signed the extremely bad Smoot-Hawley Tariff Act into law, thus setting off global trade wars and reducing world trade by over 75 percent from 1929-1933.
- He signed into law huge tax increases in 1930 and 1932 in a vain attempt to balance the budget.

All these actions turned what should have been the recession of 1929-1930 into the Great Depression of 1929-1933.

The Democrat example is Jimmy Carter. He did not understand that inflation is caused by excessive growth in the money supply, just as deflation is caused by a decline in the money supply. Consequently, when the Consumer Price Index hit a year-over-year peak increase of 14.7 percent in March 1980, some of you may recall that on March 14, 1980,

*continued on next page*

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*The U.S. Economy is Strong (continued)*

Carter scared us all with his Friday evening “chat” from the White House in which he told us inflation was all our fault because we were using too much credit to buy too many goods and services. Then, he announced that he had issued an executive order to implement the provisions of the Credit Control Act of 1969. This law gave the Federal Reserve System the authority to regulate the terms and conditions (which would determine the monthly payment) of every extension of credit in the United States. Four things resulted from Carter’s ill-fated decision.

- The Index of Consumer Sentiment (compiled by the University of Michigan since 1946), plunged to its nadir of 50 (March 1966 = 100), and the economy (as measured by real gross domestic product<sup>1</sup>) fell further, faster in one quarter (at a seasonally adjusted annual rate of 7.8 percent in the second quarter) than any since 1946.

- Ronald Reagan defeated Carter in the election on Nov. 4. Carter lost so badly that Republicans gained majority control of the Senate for the first time since the 1954 election.
- Every state except Arkansas repealed its usury laws. Legislators and voters could see that a prime rate of 21 percent suggested that rate limits on consumer credit of 12-18 percent made no sense.
- Congress saw the error of its ways and repealed the law. No future president can surprise us with credit controls because of this 1980 debacle. Of course, this is exactly what a previous Congress did to get rid of presidential authority to create wage and price controls after Richard Nixon imposed them on us in August 1971. Thus, no future president can surprise us by freezing prices and wages or by cutting off our access to credit.

Hoover went on to become one of America’s most admired ex-presidents, performing many important acts of public service. In 1919, he founded what is known today as the Hoover Institution on War, Revolution and Peace at Stanford University, where he was a member of the first graduating class in 1895. Eminent scholars such as 1976 Nobel laureate Milten Friedman work there today. Most people would agree that Hoover lived an exemplary life before dying at 90 on Oct. 20, 1964. He lived longer than any other President after leaving the White House.

Carter has also become a much-admired elder statesman since he left office. He is involved with many causes such as monitoring elections around the world and Habitat for Humanity.

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<sup>1</sup> GDP, the total value of all goods and services produced for final demand within the borders of the United States after adjusting for price changes.

## THE CURRENT ECONOMIC ENVIRONMENT IS MUCH BETTER THAN AVERAGE BUT NOT FABULOUS

Over the past 25 years (100 quarters), the U.S. economy has grown in 91 quarters and declined in only nine. That is the best growth pattern yet recorded for the U.S. economy. Thus, there’s a lot of truth in California Gov. Arnold Schwarzenegger’s Aug. 31 speech to the Republican Convention in which he said, “There is another way you can tell you’re a Republican; you have faith in free enterprise, faith in the resourcefulness of the American people and faith in the U.S. economy. To those critics pessimistic about our economy, I say, ‘Don’t be economic girlie-men!’”

It probably would have been easy to predict that one of the most

consistently bearish economists in the United States, Stephen Roach, the chief economist of Morgan Stanley, would respond. In the Sept. 6 “Weekly International Briefing,” Roach’s column, titled “Global: Confessions of an Economic Girlie-Man,” cites several measures of this expansion compared to the average of the six previous ones (1961-1991) to suggest we’re not doing well and hones in on excessive government spending.

The single statistic that pessimists like to cite the most is the very sluggish growth in nonfarm payroll employment. This important but not all-important economic indicator hit its peak in March

2001 at 132,507,000 jobs. From there, nonfarm payroll employment fell to a trough of 129,789,000 in August 2003. This was the lowest since September 1999, a loss of 2,718,000 jobs.

On Sept. 3, the Bureau of Labor Statistics of the U.S. Department of Labor reported that there were 131,475,000 total nonfarm payroll jobs in August. President Bush and his spokespeople will concentrate on the increase of 1,686,000 jobs, or 1.3 percent, since August 2003.

Sen. Kerry and his advisers will talk about the fact that we are still 1,032,000 jobs below the peak. Neither side will talk about the total number of payroll jobs nor about the statistical questions that make such precise accounting of job gains or losses suspect.

An extremely interesting and useful analysis of the employment situation in

1999-2000 is contained in a recent paper by professor William C. Dunkelberg of Temple University in Philadelphia.<sup>2</sup> He is also the chief economist for the National Federation of Independent Business (NFIB). Dunkelberg argues that the level of the employment-to-population ratio in 2000, around 64.6 percent, is higher than can be sustained. The August '04 level of 62.4 percent may be much closer to the norm.

He uses data from NFIB monthly surveys to show that firms were in a hiring frenzy in 1999 and early 2000. This led to record differences between output and incomes that he feels help to demonstrate excessive employment during that period.<sup>3</sup> Certainly, the short existence of many firms that raised billions of dollars from venture capitalists and initial public offerings in 1999 while failing in 2000 and 2001 suggests at least some people were employed who probably should not have been. A greater understanding of this "excess employment" phenomenon in 1999-2000 would contribute a lot to a more informed debate on whether the current state of payroll employment is about what we should expect or not.

Total employment has been growing quite strongly throughout the expansion. It reached 139,681,000 people in August, up 1,986,000 people or 1.4 percent from a year earlier on a seasonally adjusted basis.

There were 8,022,000 unemployed people in August. As always, they were disproportionately teenagers and people over age 25 with no college attendance at all.

While the national unemployment rate was 5.4 percent in August, a very low rate historically, it was only 4 percent for high school graduates with some college or an associate's degree. For college graduates above 24, the rate was 2.7 percent in June, July and August.

On Aug. 30, the Bureau of Economic Analysis (BEA) of the U.S. Department of Commerce reported that personal income in July was a record \$9.6 trillion at a seasonally adjusted annual rate. Disposable personal income was also a record \$8.6 trillion.

In current dollars, disposable personal income per capita was a record \$29,222 in July, up 3.3 percent from the \$28,296 of July 2003. In real terms, it was \$27,066 in July, up a paltry 0.9 percent from a year earlier. This is the famous "pocketbook indicator," and it strongly suggests President Bush is in deep trouble in his re-election bid. It would take a very strong pickup in August and September to get the big increase in disposable personal income he needs.

To refresh your memory, if real disposable personal income in the third quarter of an election year is 3.2 percent or more above the level one year earlier, the incumbent or his party wins. If it's 2.8 percent or less, the challenger wins.

The revised number for the third quarter of 2003 was released by BEA on Aug. 3. It was \$26,842. Thus, a number of \$27,701 or higher is great news for Bush. A number of \$27,594 or less would signal victory for John Kerry.

The preliminary number will be announced by BEA at 8:30 a.m. EST on Nov. 1, just one day before the election. Then we'll be able to tell if this indicator lives up to its reputation for accuracy.

Other economic indicators are overwhelmingly positive. Retail sales continue to set new records, and industrial production in August finally eclipsed its old peak set in June 2000. That's another indication of how far out of whack the economy got in the 1998-2000 bubble.

Construction expenditures continue to set new records. On Sept. 1, the Census Bureau reported that construction spending in July hit a new peak of \$997.2 billion at a seasonally adjusted annual

rate. This was an increase of 9.7 percent from July 2003. For the first seven months of 2004, construction spending was a new high of \$550.2 billion, up 9 percent from the same period in 2003.

Total private construction was up 11.3 percent in July from a year earlier, totalling \$758.3 billion at a seasonally adjusted annual rate. The biggest year-over-year increases in private construction were 22.7 percent in "lodging", 16.9 percent for health care facilities, 15.5 percent for "amusement and recreation," 13.8 percent for the residential sector (\$537.5 billion at a seasonally adjusted annual rate or 70.9 percent of private construction) and 10.7 percent for power.

Total public construction was \$238.9 billion at a seasonally adjusted annual rate in July. This was an increase of 4.6 percent from the year before.

Inflation remains under control. The Consumer Price Index (CPI) total was up 3 percent from a year earlier in July. However, the CPI less food and energy was up only 1.8 percent.

There is nothing here or on the horizon to scare the Federal Open Market Committee, the part of the Federal Reserve System that sets monetary policy. It should stay at its planned "measured pace" to move the target for the Federal Funds rate in 25-basis-point (one quarter of one percent) increments toward a "neutral" rate of 3-4 percent over two years.<sup>4</sup>

<sup>2</sup> William C. Dunkelberg, "The Output Gap and Excess Labor Employment: An Empirical Look at the Evidence from a Small Firm Perspective," forthcoming in *Business Economics*, available at [www.nabe.com](http://www.nabe.com).

<sup>3</sup> The National Income and Product Accounts derive GDP from both sides - one adds up incomes and one adds up outputs. If the income side is significantly larger than the output side, (the "statistical discrepancy"), it suggests that people are being paid to produce nothing in the way of goods or services.

<sup>4</sup> The interest rate that banks charge each other for overnight loans to meet reserve requirements.

## OIL PRICES AREN'T WORTH WORRYING ABOUT - REALLY

Many people have begun to worry loudly about the impact of high oil prices. In *The Wall Street Journal* survey of forecasters released Aug. 13 ([www.wsj.com](http://www.wsj.com)), the consensus for growth in the third quarter dropped to 3.8 percent from 4.4 percent in the July survey and to 4.1 percent from 4.2 percent in the fourth quarter, all at seasonally adjusted annual rates.

A special question in the same survey asked what level of sustained oil prices “would tip the U.S. back into recession.” Only 15.4 percent of us were in the \$80 or more camp. No one was below \$50, but 32.7 percent of the survey participants picked the \$50-59 range, and a further 28.8 percent selected the \$60-69 range.

Research from the OECD, Organization for Economic Cooperation and Development, shows that a \$20-a-barrel increase in oil prices reduces U.S. real GDP growth by 1 percent. Thus, it would take a sustained price of over \$100 to push the United States into a recession. No one has a forecast that ridiculous. Even prices above \$30 a barrel are enough to cause increased supply and decreased demand responses. They have worked that way for the past 30 years. That is why the OPEC target is \$22-28 a barrel—when the price goes up past \$30, we figure out ways to conserve, or we find more from non-OPEC countries. A good example of this phenomenon is the emergence of Kazakhstan as a major oil producer.

A recent analysis by Global Insight, the world's leading economic forecasting organization, compared the global impact of three oil price scenarios labeled “Crisis, Crumble and Crunch.”

In the “Crisis” scenario, oil prices climbed to \$65 a barrel for two quarters before falling to the mid-\$20 range. That awful scenario would reduce U.S. real GDP growth by 1 percentage point, to 3 percent in 2005, pushing Germany and Italy back into recession.

In the “Crumble” scenario, oil prices fall quickly to \$22 a barrel and stay there until 2006. The United States grows at 4 percent in 2005 and the world at 4.2 percent in this scenario.

The “Crunch” scenario has oil prices remaining in the \$35-40 a barrel range for two years. That scenario would only reduce U.S. and world real GDP growth by 0.3 percent in 2005.

Oil simply doesn't impact on the U.S. economy like it did in 1973, when the first oil shock helped create a long and deep global recession. The United States has fallen from oil demand of around 3 percent of GDP in 1970-1973 to only 1.9 percent in 2003. This is still a world-leading 23.4 barrels a year per person. China is at 4 percent or 1.5 barrels a person. Since the U.S. produces far more goods and services than any other country, it should not be a surprise that our oil consumption is high. Therefore, worrying about oil prices is a bit ludicrous.

## WHAT HAPPENS WITH THE CHINESE ECONOMY IS IMPORTANT TO THE WHOLE WORLD

For the past 25 years, the growth rate of the Chinese economy has been one of the wonders of the world. Over that period, China has gone from a small, extremely underdeveloped economy to a large, rapidly developing one.

This has been accompanied by such commitments to education and infrastructure improvements that China has become the manufacturing platform of choice for major companies around the world. Along with China's globalization, spurred mightily by its accession to the World Trade Organization (WTO) on Dec. 11, 2001, has come a huge increase in the country's share of world trade. In fact, China is now the largest trading nation in Asia, surpassing Japan, whose economy is four to five times larger than China's.

On Aug. 25-26, it was my privilege to be one of five participants from the United States in the first investment banking conference ever held in China. It was sponsored by Changsha City Commercial Bank and held in Changsha, the capital of Hunan Province. My wife and I then toured China, visiting Beijing, Xi'an and Shanghai.

Beijing and Shanghai are two of the world's largest metropolitan areas. Both have populations about the same size (15 million or more) as the New York City primary metropolitan statistical area. While traffic in Beijing is chaotic and

far more sclerotic than that in New York, Shanghai's roads seem less congested.

Most people in China are gearing up for two huge global events. The first is the 2008 Olympics in Beijing. For that, the Chinese government wants to have all construction projects, whether Olympic-related or not, completed by the end of 2007. The point is to give them time to ensure one of the smoothest Olympics in modern times.

The second event is the global Expo in Shanghai in 2010. Getting ready for that will be a huge effort.

The Chinese growth rate of industrial production and investment will probably drop to year-over-year increases of 10 percent or a little less over the next 12 months. While growth rates like that would be a boom in most countries, they will represent a slowdown from the 15-25 percent pace these areas seen over the past 18 months.

This result, if achieved, would qualify as a soft landing. Everything we saw and heard during our two weeks in China suggested that the country is well on track to achieving these goals.

The only other country in the world to grow so rapidly as China has since 1979 is Japan, from 1955 to 1980. The rest of the 1980s saw the development of Japan's "bubble economy," which featured the most dramatic explosion of real estate values in history. For example, the value of all real estate in Japan, a country of 140 million people that is about the same geographic size as California, exceeded that of the entire United States at the end of 1989. Tokyo's Emperor's Palace valued greater than that of all the real estate, both residential and nonresidential, in Florida.

The bursting of this bubble on Dec. 31, 1989, has left the Japanese economy in tatters. There has been essentially no growth in Japan since then, and the banks are still encumbered with so many bad

loans that they have not been able to increase lending for years.

China's leaders so far seem to be aware of these pitfalls and determined to avoid the fate of Japan. They have many programs in place to increase home ownership. Japan failed to increase its housing stock in line with demand, so prices soared to levels most consumers could not afford. Of course, the typical Chinese home in a major metropolitan area is a very small condominium in a high-rise building. For example, we met one young lady in Beijing who told us her neighborhood association had 7,000 families as members. When we inquired as to the size of the neighborhood, she told us it was two buildings!

Still, home ownership has all the same types of benefits to China that it does to the United States. Home owners are more responsible than renters and take

better care of their property. A higher proportion of home ownership is also highly correlated with lower crime rates.

Consumer spending is rising rapidly in China. We visited what is probably the world's largest Wal-Mart in Changsha. It appeared to be at least 250,000 square feet with a lower store that was a supermarket, complete with one section that looked like a pet store as it was full of tanks of live turtles, frogs, crabs, and every type of fish and sea creature one could imagine (fresh seafood for dinner anyone?) and an upper floor that had all manner of apparel, appliances, office equipment and so on like a Wal-Mart in the United States.

Keeping an eye on China will be important for years to come. It is an important market of 1.3 billion people with rising incomes.

## THE NORTH CAROLINA ECONOMY IS COMING BACK STRONGLY

In the typical post-World War II recession, the N.C. economy fell much more steeply than the national average and then rebounded more quickly to new record heights.

That was primarily due to the fact that the share of jobs in manufacturing and the share of manufacturing in the gross state product were both much higher than the national average.

That pattern was shattered with the 2001 recession, which began in March and ended in November. For some parts of 2000 and 2001, North Carolina had the highest unemployment rate in the United States. That had never happened before.

Part of the problem, especially in the Triangle (the Raleigh-Durham-Chapel Hill metropolitan statistical area [MSA]) was an over-concentration in "bubble"

industries such as telecommunications. Another part was an over-concentration in textiles and furniture, especially in sectors of those industries that were no longer globally competitive.

North Carolina sank faster and took far longer to come back than in any other recession since World War II. This was despite the fact that on a national basis, the 2001 recession was the mildest one ever recorded, with a peak-to-trough decline in real GDP of only 0.05 percent.

Nevertheless, it now appears that the N.C. economy is back on track to outperform the national average as it

*continued on next page*

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*The North Carolina Economy (continued)*

usually has in the past 50 years. In July 2004, the unemployment rate in North Carolina was 5 percent, well below the national average of 5.5 percent on a seasonally adjusted basis.

This was a huge drop in the unemployment rate from 6.6 percent in July 2003. There were 4,189,200 people in the labor force in North Carolina in July, and 211,200 of them were unemployed. That was a decline of 71,200 in the ranks of the unemployed in one year.

The total number of nonfarm payroll jobs in July 2004 in North Carolina was 3,858,000. This was an increase of 40,200 jobs or 1.1 percent from July 2003.

Among MSAs in the state in July, the lowest unemployment rates were in Asheville (3.3 percent), Raleigh-Durham-Chapel Hill (3.6 percent), Wilmington (3.9 percent) and Jacksonville (4.4 percent). The biggest improvement over the 12 months ending in July 2004 was the Hickory-Morganton-Lenoir MSA, which saw its unemployment rate fall from 10.1 to 7.6 percent. The Rocky Mount MSA had a fall from 9.3 to 8 percent.

About one-third of the total statewide gain in nonfarm payroll jobs in the year to July 2004 occurred in the Raleigh-Durham-Chapel Hill MSA. Another 23.6 percent was in the Charlotte-Gastonia-Rock Hill (SC) MSA. These two MSAs accounted for over half the statewide gain.

On June 29, the BEA reported that personal income in North Carolina was \$247.5 billion at a seasonally adjusted annual rate in the first quarter of 2004. That was an increase of 5.8 percent from the first quarter of 2003. The national average increase was 5.2 percent. It's good to see North Carolina once again growing more rapidly than the national average.

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## THE OUTLOOK IS QUITE GOOD

The U.S. economy remains on track for 4.7 percent real GDP growth in 2004, which would be the fastest pace in 20 years. We should be able to achieve real GDP growth of 4.2 percent a year from 2005 to 2008. If we do that, the five years from 2004 to 2008 (inclusive) will be the best such growth period since 1962 to 1966.

The rest of the world would appreciate such strong growth in the United States. Our NAFTA partners, Canada and Mexico, would be lifted up by such a result. The weak economies of continental Europe – especially France, Germany and Italy – would derive some benefits from such strong U.S. growth. So would Japan, which has had essentially no growth for 15 years now.

We need to stay vigilant to avoid protectionist pressures. The United States, by far the world's largest economy, needs to take the lead in expanding trade negotiations under the Doha Round of the WTO. This will benefit all 147 WTO members.

The next Congress needs to work diligently to cut government spending, which has grown 29 percent in the past four years. This includes "fixing" Social Security, Medicaid and Medicare. This is the biggest challenge facing the U.S. economy.