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Economic Outlook

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ECONOMICS COMMENTATOR

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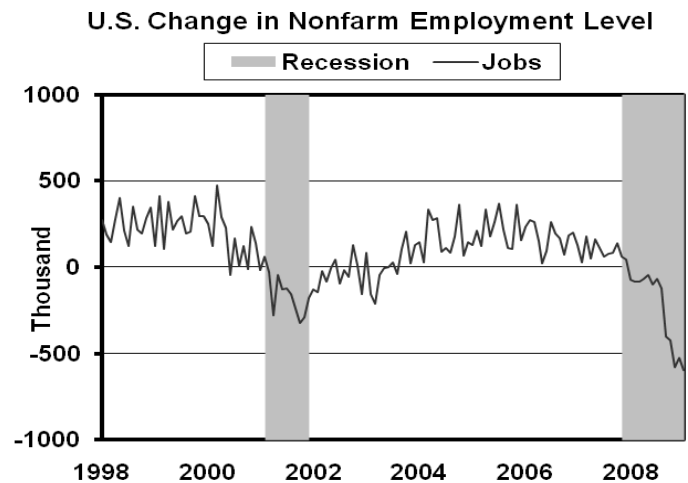
ECONOMIC OUTLOOK

by
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and
Bill Adamson, Professor

The current economic crisis has had negative economic consequences across the globe and has trickled down to main street South Dakota. Given these difficult times and as a service to the citizens of South Dakota, the Department of Economics at South Dakota State University has compiled factual and unbiased information on current economic conditions at the local, national, and global level. We intend to provide quarterly economic updates throughout the economic crisis.

Employment

The US Bureau of Labor Statistics¹ reported that the U.S. economy lost 598,000 jobs in January and 524,000 jobs in December; nonfarm payroll employment fell by 533,000 in November, following a decrease of 320,000 in October (see figure at top right). Nearly 2.6 million jobs were lost in 2008, with 2.2 million lost in just the past four months, according to a survey of workplaces. It is the biggest job loss in any calendar year since 1945, when 2.75 million jobs were lost as the wartime economy was demobilized. Job loss is directly related to declining production and is indicative of a recession. The current recessionary cycle will trough when job loss subsides. The current rate of job loss suggests that the recession is deepening.



Source: Bureau of Labor Statistics

Unemployment

The Bureau of Labor Statistics also reported that the January unemployment rate rose to 7.6%, up from 7.2% in December (see figure on next page, top left). The unemployment rate was 6.8% in November and 6.5% in October. The unemployment rate averaged 4.6% in 2007. The unemployment rate is the highest since the recession in 1981 and potentially could reach the double digit unemployment last attained in 1981. The official unemployment rate includes only job seekers that are actively looking for work. Underemployed workers (those who indicate that they would like full-employment) and discouraged workers (individuals who would like to work but are not actively engaged in a job search) are not included in the official unemployment statistics. The unemployment rate with underemployed and discouraged workers was 8.4% in December.

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U.S. Unemployment Rate



Source: Bureau of Labor Statistics

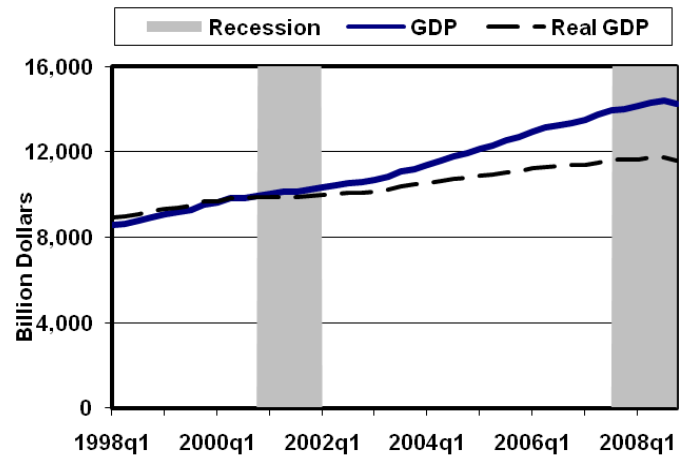
Industrial Production

Industrial production (comprised of manufacturing, mining, and electric and gas utilities) declined 2% in December; manufacturing declined 2.3%.² From December 2007 to December 2008 U.S. industrial production declined 7.8% and manufacturing output declined 16%. Industrial Capacity Utilization refers to the level of current industrial output relative to the level that could be achieved if the economy was at full employment with stable inflation. The Industrial Capacity Utilization rate declined 7.4% from December 2007 to December 2008, falling from 81%, to 73.6%. The last time this rate was estimated at 73.6% was during the bottom of the last recession.

Economic Growth

Real Gross Domestic Production (GDP) is a broad measure of total output in the United States. Real GDP edged down 0.5% at an annual rate in the third quarter (Q3)³ as consumer spending fell, business investment declined, and the housing sector continued to weaken. Inventory investment and government spending provided some support to the economy, while net exports (exports minus imports) remained a source of strength, contributing 1.1 percentage points to real growth. Advanced estimates for fourth quarter (Q4) real GDP show a much steeper decline of 3.8%. The decrease in Q4 real GDP was broad based with a sharp decline in exports, personal consumption expenditures, business equipment and software, and residential housing. The only positive contributions to real GDP were government expenditures, increases in inventories, and a decline in imports. The decline

U.S. Gross Domestic Product



Source: Bureau of Economic Analysis

in exports suggests that the recession is spreading globally.

Credit Crisis

The Emergency Economic Stabilization Act of 2008⁴ was enacted to provide stability and confidence in U.S. financial markets and to free-up commercial lending. The Administration and the Congress together have taken strong action to support the economy through the emergency funding of approximately \$700 billion to stabilize the banking sector. The Treasury had intended to use the emergency funding to purchase risky home-mortgage securities; however, it has to this point used it to provide additional capital to distressed banks. Treasury is working to allocate the remainder of the funding (roughly \$350 billion) to stabilize markets, promote increased lending, and foster improved growth and job creation.

Stabilization Policy

Pro-growth policies used to recover from the current recession and enhance long-term U.S. economic growth.

Fiscal Policy: The Federal budget deficit widened by \$292 billion to \$455 billion (3.2% of GDP) in FY2008, following three years of improvement that trimmed the deficit to \$162 billion (1.2% of GDP) in FY2007. The increase was due in part to the slowing economy and the economic stimulus package enacted early in 2008. The rising FY2008 budget deficit was intended to address short-term recessionary

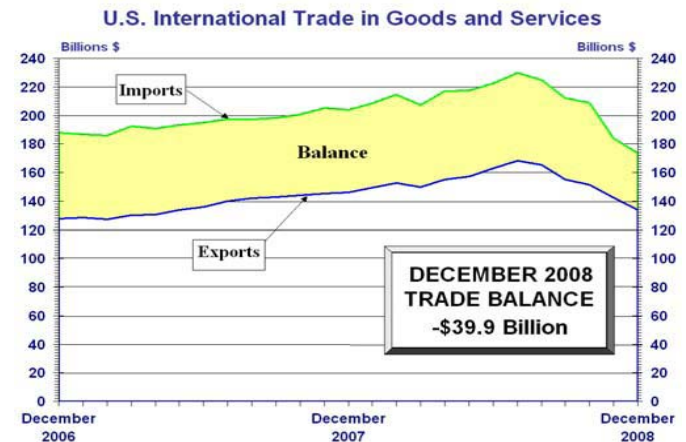
challenges. The projected FY2009 budget deficit is \$1.2 trillion. The rising FY2009 budget deficit reflects the continuing deterioration in the US economy and the \$700 billion in credit market stabilization funds. Because of continued weakening of the US economy, the current Administration and Congress have agreed on a \$789 billion package. The economic stimulus package has a combination of government spending initiatives and tax cuts. The stimulus package is weighted more heavily to spending (65%) since it has a direct impact on real GDP whereas tax cuts affect GDP indirectly. The package will have a larger impact on real GDP than the initial amount of the stimulus via the fiscal multiplier effect.

Monetary Policy: Federal Reserve target for the Federal Funds Market (interest rate on overnight bank-to-bank loans of reserves) has declined to the record low level of 0% to .25%. The very expansionary monetary policy being pursued by the Federal Reserve is designed to lower short-term interest rates and increase incentives for banks to make new commercial loans. Despite the record low Federal Funds rate, commercial lending has seized-up due the credit crisis. In light of interest rates near zero, interest sensitive spending—primarily fixed investment and durable goods—declined by 12.3% and 22.4%, respectfully, in Q4. The equipment and software and residential housing components of fixed investment expenditures were down by 27.8% and 23.6%. It appears that the Fed is “pushing on a string.” Credit markets will probably have to stabilize before the interest sensitive spending component of real GDP increases. The emergency financial stabilization program administered by the Treasury is designed to reduce the risk of lending and free-up the credit markets.⁵

International Trade

U.S. Import and Export trade in goods and services peaked during mid-summer 2008. The decline in monthly import and export levels has accelerated in the 4th quarter. As a consequence the U.S. trade deficit has declined from \$51.6 billion in November to \$39.9 billion in December. This trend reversal for exports has facilitated the decline in the U.S. economic growth in the 4th quarter. The declining trade deficit implies that import levels are declining faster than export levels.⁶ If the U.S. recession

deepens, U.S. demand for foreign goods and services will continue to weaken. While a declining trade deficit is positive for the U.S. economy, this trend reversal will fuel global recessionary pressures in 2009.



Bright Spot

Core retail inflation, which excludes the changes in the prices of food and energy, remains contained, primarily due to falling consumer demand. Core annual retail inflation for the last three years has been 2.6% (2006), 2.4% (2007), and 1.7% (2008). The decline in retail inflation is more dramatic when food and energy are included: by this measure, inflation for the last three years has been 2.5% (2006), 4.1% (2007), and 0.1% (2008).⁷ Lower core inflation will help to improve consumer purchasing power once spending begins to improve.

South Dakota Economy

The South Dakota economy is beginning to experience the effects of the nation's economic downturn taking place nationwide.⁸ South Dakota total nonfarm employment peaked at 415,400 in August and has fallen to 411,800 in December (seasonally adjusted data). Between August and December, the South Dakota economy lost a total of 3,600 jobs, or a 0.87% decline in total nonfarm employment. Employment was unchanged over the same period in 2007. The Rapid City Metropolitan Statistical Area (MSA) experienced a loss of 5,200 jobs or a decline of 7.9% between August and December. Much of this job loss is seasonal (employment declined by 4600 in the leisure and hospitality industry), but the percentage job loss between August and December of 2008 is higher than the job loss in 2007. The Sioux Falls MSA lost 1,300

jobs since its peak of 137,500 in September (Sioux Falls gained 200 jobs over the same period last year). As a consequence of declining employment, the South Dakota December unemployment rate rose to 3.9% from 3.4% in November and 3.2% in October, and is up 1.1% from the January 2008 unemployment rate of 2.6%. The December unemployment rate is 3.7% in the Sioux Falls MSA and 4.0% in the Rapid City MSA.

The 2009 outlook for the South Dakota economy suggests that the regional recession will further deepen. The South Dakota Business Conditions Index (a leading economic indicator based on a survey of supply managers conducted by Ernie Goss of Creighton University) continues to decline.⁹ The index declined to 39.5 in January, a record low. The index was 42.5 in December, 47.9 in November, and 57.3 in October. The index had peaked at 65.8 in September. Goss predicts that the South Dakota unemployment rate will rise to 4.5% by mid-2009.

Outlook for 2009

The outlook for the U.S. economy for 2009 remains weak. Historically, global recessions inflict long-lasting recessions on the U.S. economy that last on average 18 months. Given that the National Bureau of Economic Research¹⁰ has estimated this current recession began in December 2007, the general consensus is that the current recessionary environment will persist through 2009. The economic indicators discussed above suggest that the decline in overall economic activity in the U.S. economy has not yet ended. However, aggressive monetary- and fiscal-policy initiatives at the Federal level should stimulate economic activity in 2009 and mitigate some of the economic hardship that Americans will otherwise endure during this recession.

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¹ <http://www.bls.gov/>

² <http://www.federalreserve.gov/releases/G17/Current/default.htm>

³ <http://www.bea.gov/national/index.htm>

⁴ <http://www.ustreas.gov/initiatives/eesa/>

⁵ <http://www.ustreas.gov/initiatives/eesa/>

⁶ http://www.census.gov/foreign-trade/Press-Release/current_press_release/ft900.pdf

⁷ <ftp://ftp.bls.gov/pub/special.requests/cpi/cpi.txt>

⁸ <http://www.bls.gov/eag/eag.sd.htm>

⁹ <http://www2.creighton.edu/business/economicoutlook/regional/mid-americanstates/index.php>

¹⁰ <http://www.nber.org/dec2008.html>