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Economic Outlook

Mike Miller

South Dakota State University

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ECONOMICS COMMENTATOR

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ECONOMIC OUTLOOK

by

Dr. Mike Miller*
Assistant Professor

The U.S. economic recession appears to be ending, but recovery is likely to be slow, especially in the jobs market. Total employment continues to decline and the unemployment rate has reached a level not seen in over 25 years. However, growth in industrial production and the housing sector nationally have both turned positive. While the South Dakota economy has weathered this economic storm better than many other states and conditions are expected to improve in the future, the state has not been unscathed. Since December of 2007 (the beginning of the recession) South Dakota has experienced an increase in unemployment, falling tax revenue, and a state budget crisis.

Employment

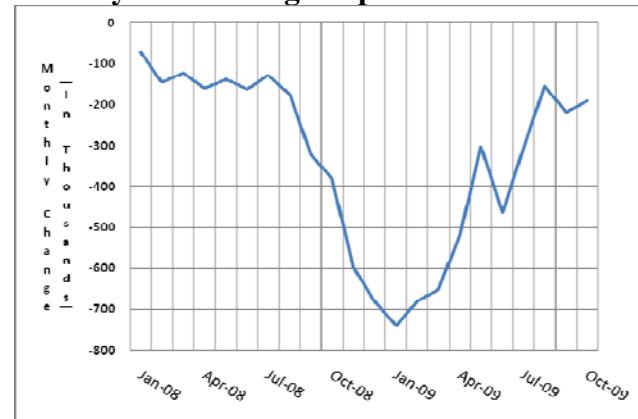
The U.S. Bureau of Labor Statistics (BLS) produces two different reports on employment - the Current Employment Survey (CES) and the Current Population Survey (CPS). Results from both of these surveys are presented in a monthly news release.

The CES is an "establishment" survey and provides employment data collected from the payroll records of 160,000 businesses and government agencies. Because the CES is based on payroll changes it is possible for duplication to occur. As an example, an employee that loses three part-time jobs disappears from three payrolls and is counted three times.

Therefore, the CES provides employment data, but not unemployment data. The CPS is a "household" survey, with information drawn from monthly BLS interviews with members of 60,000 households. Because the survey is based on data gathered from individual household members people are counted only once, even if they hold more than one job. Therefore, the CPS is used to calculate the official U.S. unemployment rate.

The November CES estimated a loss of 190,000 non-farm payroll jobs in October. This is a greater number than anticipated, but represents fewer losses than in September, when 219,000 jobs were eliminated. Overall, since the recession began, it is estimated that 7.2 million jobs have been lost, with almost 5.8 million eliminated in the last year – the largest 12 month loss since employment record keeping began in 1939. Total employment losses averaged approximately 272,000 per month between May and October and while this shows that negative job growth continues, it is less than half the per month average that occurred between November 2008 and April 2009 (645,000 per month).

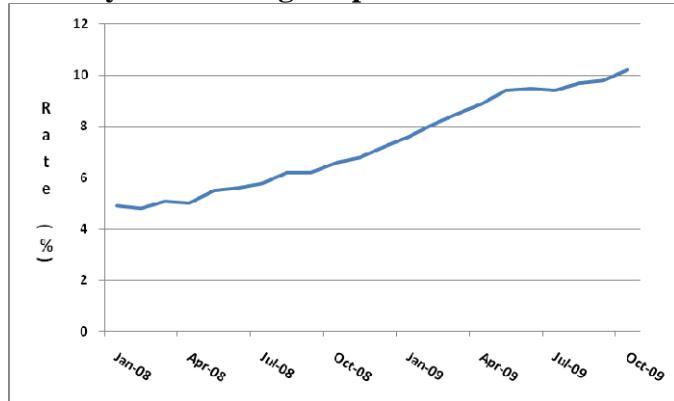
Figure 1. Monthly change in U.S. employment, January 2008 through September 2009.



*Contact the author at michael.miller@sdstate.edu or 605-688-4141.

Estimates from the CPS showed the number of unemployed individuals increased by 558,000 to 15.7 million during October, with the national unemployment rate rising from 9.8% in September to 10.2% in October. Overall, the number of unemployed has increased by 8.2 million people and the unemployment rate has increased by 5.3 percentage points since the recession began.

Figure 2. Changes in U.S. unemployment rate (%), January 2008 through September 2009.



The CPS also reports on two other categories of individuals that, while not part of the official unemployment calculations, give important insight into the current economic situation. Part-time workers for economic reasons are those who have involuntarily had their work hours cut or have taken part-time jobs because they are unable to find full-time employment. These individuals are considered underemployed. There were significant increases in this number last fall and winter, but there has been little change since March. In September, this number stood at 9.2 million people. A second category not included in the official unemployment calculations is discouraged workers. These are individuals who are no longer looking for work because they believe there are no jobs available. There were an estimated 706,000 discouraged workers in September, up by 239,000 individuals from twelve months ago. When all categories were combined, in September 15.8% of the civilian labor force was unemployed, underemployed, or discouraged.

Job creation is often the last element of the economy to rebound from a recession and that appears to be the case in the current downturn. While other components of the economy are picking up, payroll losses and the number of unemployed persons continues to grow.

These trends are expected to continue for the remainder of the year, before reversing in 2010.

Industrial Production, Inflation, and Trade

Industrial production (comprised of manufacturing, mining, and electric and gas utilities) was positive in July, increasing 1.0% from June's production levels. This was the first positive change since October 2008 and only the third increase in the past 13 months. The Federal Reserve estimated that production also increased in August, moving up by an additional 0.8%. Industrial production in the largest sector, manufacturing, increased by 1.4% from June to July and was projected to increase an added 0.6% in August. This is contrary to the August 2008 through August 2009 trend when total industrial production fell by 10.7%, with manufacturing production down 12.2%.

Led by increases in the manufacturing and mining sectors, the August capacity utilization rate for all industries showed a one month increase of 0.5% to 66.6%. This is on top of the July increase of 1.0% over the June figure. However, capacity utilization remains at its lowest level since the 1981-1982 recession and currently is 11.3 percentage points below the 1972-2008 average. This means that the actual industrial output is below the potential output, creating slack in the economy and indicating that demand in the economy is weak. A lower capacity utilization rate further indicates lower inflation rates in the future.

A small bright spot in the economy for consumers is the continued low inflation rate. 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 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). Due to the current and expected weakness of the economy, inflation is expected to remain low for the foreseeable future.

September U.S. exports totaled \$132.0 billion while imports totaled \$168.4 billion, resulting in a goods-and-services deficit of \$36.4 billion, up from \$30.8

billion in August, revised. September exports were \$3.7 billion less than August exports of \$128.3 billion, while imports were \$9.3 billion more than August imports of \$159.1 billion. While the larger trade deficit may appear to be negative for the U.S. economy the increases in total imports and total exports indicates that global economic activity is increasing. However, activity is still considerably below the September 2008 levels, when total exports were \$152.0 billion and total imports were \$212.1 billion.

Economic Growth and Policy Responses

Driven by the federal government supported programs for home buying and automobile purchases (e.g. *Cash for Clunkers*) Real Gross Domestic Product (GDP) surged upward at an annual rate of 3.5% in the third quarter of 2009 (July-September). This is a significant improvement over the first quarter decline of 6.4% and second quarter decline of 0.7%. Before the third quarter growth the economy had contracted the 4 previous quarters and 5 out of the last 6 quarters. As a result of the small decline in the second quarter and this third quarter increase, as well as other macroeconomic trends, it is anticipated that the economy will show positive economic growth in the fourth quarter of 2009.

The *Financial Stability Plan (FSP)* was established to help provide support and confidence in U.S. financial markets, to facilitate commercial and personal lending and to create an atmosphere in which consumer confidence in the financial institutions is strengthened. An important aspect of the *FSP* is the development of the *Financial Stability Trust*. The Trust is intended to provide capital investments to financial institutions, with those investments held in a separate entity. The investment funds are provided through the development of the *Capital Assistance Program*, a program that makes Treasury funds available to qualifying institutions. These funds are used until private capital is found and are made available to institutions that are able to pass a government instituted stress test. The stress test is intended to ensure that financial institutions have the capital to meet future lending and operational obligations in the event of another severe economic slowdown.

The federal budget deficit widened by \$950 billion to an estimated \$1.4 trillion (9.9% of GDP) in FY 2009. The deficit now represents the highest percentage of the GDP since the end of WWII and it follows the FY 2008 deficit of \$459 billion (3.2% of GDP). The 2009 deficit increase is due mainly to decreased revenues and increased governmental spending that was intended to address recessionary challenges. Interest paid on the debt fell by approximately \$60 billion as a result of lower interest rates. The large deficits are expected to continue in FY 2010 and reflect the continuing problems in the U.S. economy and the government stabilization funds.

The Federal Reserve target for the Federal Funds Market (interest rate on overnight bank-to-bank loans of reserves) continues to be at a record low level of between 0% and .25% (rate may vary on a daily basis). 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. This record low Federal Funds rate, along with fiscal policy initiatives, has begun to show some progress with an increase in commercial lending resulting. However, as shown by the recent CIT bankruptcy, there is some indication that commercial lending entities may experience additional problems in the near future.

South Dakota Economy

The South Dakota economy appears to be emerging from the recession as total nonfarm employment increased to 425,860 and the unemployment rate dropped to 4.4% in September. The number of unemployed fell to 21,400 workers in September – a decline of 500 unemployed individuals from the August figure. However, since September of 2008, the unemployment rate in South Dakota rose by 1.2%. While there has been a decrease of 1,146 unemployed persons since March of this year, the South Dakota economy has lost 9,466 jobs since the nationwide recession began in 2007 (a loss of 2.3% of nonfarm employment).

The South Dakota Business Conditions Index (a leading economic indicator based on a survey of supply managers conducted by Creighton University) showed South Dakota's leading

economic indicator at above growth neutral for the third time in the last four months. However, there was a decline from 58.1 in September to 55.5 in October. The overall index is divided into several components. In the most recent report new orders were at 77.0, production at 73.9, delivery lead time at 45.8, inventories at 32.2, and employment at 48.5.

The Rapid City Metropolitan Statistical Area (MSA) unemployment rate increased from 2.8% to 4.4%, with a corresponding loss of 1,115 jobs during the recession. Despite improvements in the rate between March and July of this year (the rate fell from 5.3% in March to 4.1% in July), the unemployment rate climbed by 0.1% in August and by 0.2% in September. Following employment increases between January and August, there was a decrease of 2,710 jobs in September.

Overall, the Sioux Falls MSA has lost 460 jobs during the recession. However, in 2009, there has been a net increase of 1,435 jobs, with particular gains seen between March and July. The September unemployment rate, at 4.6%, is the same as in January of 2009, but has dropped by 0.5% since hitting the peak of 5.1% in March and is down 0.1% in the last month. While the rate declined recently, it is almost twice the level seen when the recession began. Good future employment news may be in store for the Sioux Falls area as the Manpower Employment Outlook Survey forecasts that the area will experience an 8% increase in job creation during the 4th quarter of 2009. This represents the 5th highest percentage growth of any community in the United States.

Outlook for 2010 and Beyond

The outlook for the U.S. economy in 2010 is cautiously optimistic. While the economic output is expected to increase, the unemployment rate is also expected to grow during the first part of 2010, peaking at around 10.5% before beginning to decline in the second half of the year. The Congressional Budget Office (CBO) projects economic growth of 2.8% from the fourth quarter of 2009 through the fourth quarter of 2010, with growth continuing at a 3.8% pace in 2011 and at 4.5% in 2012. Since 1937 recessions in the United States have averaged 13 months in duration. Given the December 2007 recession beginning, the current downturn is almost twice the average length and is the longest since the Great Depression.

At the federal level, aggressive monetary and fiscal policy initiatives have stimulated economic activity this year and have mitigated some of the economic hardship that Americans would otherwise have endured during this recession, but at the cost of increased deficits. According to the CBO, the deficit for FY 2010 can be expected to reach \$1.6 trillion (11.2% of the GDP). Annual budget deficits are expected to decline, but remain over \$500 billion through 2019. The percentage of total debt held in public hands is projected to reach 61% by the end of 2010 - the highest level since 1951.

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Department of Economics
South Dakota State University
Box 504 Scobey Hall
Brookings, SD 57007-0895
Phone: 605-688-4141
Fax: 605-688-6386
E-Mail:Penny_Stover@sdstate.edu
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