

The Outlook: Mississippi and the Nation

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I am pleased to be here today to discuss the economic outlook for Mississippi and the nation. Although the focus of this meeting is Mississippi, it is important to emphasize that all the states are bound together in the national economy. Thus, the national outlook is the place to start in discussing the Mississippi outlook.

After discussing the national economy, I'll turn to a few aspects of the Mississippi economy as it relates to the national economy. One issue concerns the business cycle in Mississippi and the extent to which the state's recent experience has been in sync with the national experience. A second issue concerns some of the differences between the Mississippi and national economies; this analysis serves to highlight the most pressing challenges facing the state. Finally, I'll offer some views on how public policy might improve the state's business climate in the interest of improving growth over the long run.

Before proceeding, I want to emphasize that the views I express here are mine and do not necessarily reflect official positions of the Federal Reserve System. I thank my colleagues at the Federal Reserve Bank of St. Louis for their comments, especially Kevin L. Kliesen, associate economist in the Research Division, who provided special assistance. However, I retain full responsibility for errors.

THE NATIONAL OUTLOOK

By all indications, 2004 turned out to be a pretty decent year for the U.S. economy. That's not to say there weren't the usual challenges that

perpetually confront those in the business of business or of making monetary policy. I'll talk about some of those challenges shortly.

A week from tomorrow, when the Bureau of Economic Analysis releases its advance estimate of real GDP for the fourth quarter of 2004, we'll find out with some precision just how good last year's economic growth was. The consensus estimate of the Blue Chip forecasters is that real GDP increased at about a 3.75 percent annual rate in the fourth quarter. If so, then real GDP will have increased by about 4 percent over the four quarters of 2004. We already know that the unemployment rate fell half a percentage point to 5.4 percent over the course of the year.

One of the biggest hurdles faced by policy-makers, consumers, and businesses in 2004 was the unexpected surge in the prices of crude oil and refined products. In fact, oil prices have been trending higher since December 2001, when the acquisition cost of crude oil paid by U.S. refiners from domestic and foreign sources averaged a shade over \$16.50 per barrel. By October 2004, prices had reached an all-time high in current-dollar terms, averaging a little more than \$46 per barrel. When adjusted for inflation, though, oil prices were still well below the record highs seen in 1980.

One of the unique features of the current episode of rising oil prices is that both supply and demand factors were working in tandem to push up prices. In contrast, during most previous oil shock episodes, prices surged because of unanticipated declines in supply—or the expectation thereof. Demand-side factors included unexpectedly strong worldwide growth, particularly among fast-growing economies like China

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and India. On the supply side, there were numerous global disruptions caused by wars, labor strife and hurricanes. Eventually, spare production capacity was whittled down significantly and marked declines in worldwide petroleum stocks occurred.

One of the treasures of a market-based economy like ours is that the pricing mechanism eventually allocates resources to their most productive uses. Hence, higher oil prices will stimulate both increased production and active energy conservation measures, both of which will tend to limit further price increases and perhaps drive down prices over time. However, the rise in longer-dated futures prices, such as the contract for delivery of West Texas Intermediate crude oil in December 2007, has persisted above \$30 per barrel for more than six months. This fact suggests the market expects that higher oil prices might be with us for some time.

Should we be concerned about longer-term economic effects of permanently higher energy prices? Certainly, but probably not to the degree we once were—say, in the 1970s, 1980s, or even in the early 1990s. Of course, higher oil prices do have adverse effects, but we should not underestimate the capacity of the U.S. economy to adjust to those higher prices. Technological improvements, which have made our economy much more energy efficient, and improvements in our regulatory structure, which have allowed the price mechanism to work more freely, mean that today's economy can endure periods of sharply higher energy prices that, in earlier periods, might have caused considerable economic disruption. Indeed, one of the remarkable aspects of last year's economic performance was just how well the economy performed in spite of a sharp run-up in energy prices. Unfortunately, many of those in the business of discussing the U.S. economy seem to underestimate our economy's resilience.

In thinking about the near-term economic outlook, one of the more useful exercises an analyst can undertake is to compare actual outcomes with forecasted outcomes. An analysis of forecast errors can sometimes provide clues as to why

the economy performed better or worse than expected.

Using data through the third quarter, it appears that the Blue Chip Consensus forecast for 2004 published in December 2003 was pretty close to the mark—largely because forecasters nearly nailed their estimate of the growth of real consumer spending, which is about 70 percent of total spending. In December 2003, the Blue Chip Consensus predicted that real GDP would increase by 3.9 percent in 2004, which is its actual growth over the first three quarters of the year.

Digging a little deeper indicates that the economy in 2004 surprised forecasters in a few important respects. First, capital spending by businesses was a little stronger than expected. Second, residential construction continued to power ahead, to the surprise of most forecasters. In fact, new single family home sales in 2004 will probably set an all-time record high for the fourth consecutive year. Mortgage rates essentially ended the year where they started—roughly 100 basis points below their five-year average of approximately 6⁵/₇ percent.

Third, the growth of U.S. exports of goods and services was modestly weaker than expected, while the pace of domestic purchases of foreign-produced goods and services was a little stronger than expected.

Finally, the growth of consumer after-tax income adjusted for inflation was appreciably weaker than expected. This outcome was a reflection of decline in purchasing power stemming from higher energy prices. I might add, however, that because consumer spending largely tracked the way forecasters had expected, the personal saving rate over the second half of 2004 will come in below forecast. The saving rate probably averaged around 0.5 percent—clearly too low to be consistent with the saving necessary to support a sustainable pace of capital formation over time.

The labor market continued to surprise many analysts over the past year. In 2004, nonfarm payrolls increased 2.2 million, or an average of nearly 186,000 a month. This increase was a little better than the expected average gain of 166,000

per month in 2004.¹ I should also note that, for the first time in five years, employment gains in the establishment survey surpassed those measured by the household survey. The establishment, or payroll, series is the one that is widely reported in the press and which most analysts believe is the more accurate of the two measures.

Peering into 2005, it seems likely that labor market conditions will continue to improve and that monthly employment gains will probably exceed by a comfortable margin the roughly 125,000 per month necessary to keep the unemployment rate constant. It's an open question, though, whether we will return to the days when monthly employment gains of 200,000 per month or more were the norm, as they were during the last two business cycle expansions. Today's era of higher labor productivity growth and increased globalization may tend to limit employment growth.

However, more rapid employment gains might well occur if a significant percentage of those workers who exited the labor force after 2000 return as the economy continues to strengthen. A reasonable expectation, based on past behavior, is that the participation rate will begin to increase as the growth of GDP begins to outpace that of labor productivity. Trend productivity growth seems likely to settle down to something around 2½ percent—a respectable estimate of its sustainable rate. In that scenario, real GDP growth of 4 to 4½ percent for 2005 seems pretty reasonable.

But—and this is an important point—we should not forget the usual forecast errors. Given all the unpredictable things that can happen, a point forecast of 4 percent growth over the four quarters of 2005 should really be expressed as a growth rate of 4 plus or minus 1¼ percent.

Overall, I expect that this year's economic growth will be boosted to an important extent by continued strong business fixed investment. In addition, augmented by continued strong labor productivity growth, improvements in the labor market, and a recovery in household purchasing

power reflecting lower energy prices, growth of consumer spending should also remain healthy.

The outlook for inflation is not a topic that should be forgotten. The Federal Reserve's strategy for encouraging maximum sustainable economic growth has depended on maintaining price stability. Forecasters were surprised by the pickup in inflation last year: The consumer price index (CPI), the best known measure of consumer prices, rose by 3½ percent over the twelve months of 2004, which was about 1½ percentage points higher than forecasters had expected. Much of this forecast error was due to unexpectedly higher energy prices. Still, when we strip food and energy prices out of the CPI, we find that "core inflation" was about 2¼ percent, substantially higher than 2003's unusually low increase of 1.1 percent.

The Fed's preferred measure of prices, though, is the price index used to deflate personal consumption expenditures (PCE) in the national income and product accounts, less food and energy prices. In the July 2004 *Monetary Policy Report to the Congress*, the Federal Reserve presidents and governors projected that the core PCE inflation rate would finish 2004 between 1.75 and 2 percent. Through November, core PCE prices have risen at a 1.5 percent annual rate. From this perspective, then, inflation is coming in slightly below the FOMC's midyear projection. Recent data, then, suggest that inflation is well controlled. The FOMC has emphasized that it is prepared, if necessary, to move more aggressively to protect the relatively low rates of core inflation that now exist.

HOW MISSISSIPPI GROWTH CORRELATES WITH U.S. GROWTH

Economic models of the national economy often use aggregate indicators of economic activity, such as the gross domestic product (GDP), which is available on a quarterly frequency. The

¹ Blue Chip forecasters were asked to predict the average monthly increase in nonfarm payrolls in the February 10, 2004, issue. This was their first job forecast made in 2004.

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corresponding measure of economic activity at the state level is the gross state product (GSP), which is available only on an annual basis and is released with a lag of two years. Between 1990 and 2002, the latest available date, Mississippi's real GSP grew at an average annual rate of 3.3 percent; this rate is somewhat higher than the rate of growth of the national real GDP during the same period of 2.9 percent.

Employment

Another useful indicator of economic activity at the state level is the payroll employment measure from the establishment survey produced by the Bureau of Labor Statistics, which is released on a monthly basis. From the beginning of the recession in March 2001 until its end in November of the same year, total non-farm payroll employment fell just slightly more in the country as a whole than in Mississippi—1.2 and 1.1 percentage points, respectively. As you are no doubt already aware, the recovery from the recession has been slow in producing jobs. This circumstance has been even more evident in Mississippi than in the country as a whole. Between the end of the recession and November 2004, the most recent month for state-level data, the United States replaced about three-quarters of the jobs lost, while Mississippi replaced just less than half of the jobs lost.

Unfortunately, the picture for Mississippi has been even bleaker than these numbers suggest because payroll employment in Mississippi peaked more than a year earlier than national employment did and started to decline while national employment was still rising: Mississippi lost about 2 percent of its non-farm employment between September 1999 and March 2001. If you include these losses, only about one-sixth of the jobs lost had been recovered by November 2004. The reason for Mississippi's more unfortunate employment performance is that it is more concentrated in manufacturing than the country as a whole. It was employment in the manufacturing

sector that was hit hardest by the recession and has dragged down employment growth during the recovery.

State Business Cycle Phases

In an attempt to understand the differences in recession and expansion experiences across the states, and how they relate to the national business cycle, colleagues of mine at the Federal Reserve Bank of St. Louis have analyzed state business cycles using coincident indexes as measures of economic activity.² In their analysis they uncover the dates of individual state recessions since 1979, and find that, like much of the south, Mississippi's periods of recession and expansion have been in sync with the national experience about 80 percent of the time. They also find that the differences across states in the timing of recessions and expansions can probably be explained by a combination of factors including differences in the states' industrial composition as well as in demographic characteristics.

Differences in states' growth rates during recessions tend to be associated more with differences in their industry shares rather than with demographic factors. During expansions, however, differences in growth rates are explained by differences in demographic factors—such as educational attainment levels—but not by differences in industry shares. The implications of this research for Mississippi are that the severity of recessions can be lessened by having a more diverse economy and long-term growth can be enhanced by improving educational attainment, which includes attracting talented people from elsewhere and retaining talented Mississippians.

CHALLENGES FOR MISSISSIPPI RELATIVE TO THE NATION

A convenient way to describe local conditions is to focus on some key spreads or differences between economic and demographic indicators in

² Owyang, Michael T.; Piger, Jeremy and Wall, Howard J. "Business Cycle Phases in U.S. States," Federal Reserve Bank of St. Louis Working Paper 2003-011E.

Mississippi and the United States. This approach permits us to specify some problem areas and challenges facing Mississippi.

Employment Composition

Over the past several decades, employment in manufacturing as a share of total employment has declined dramatically in the United States, to about 11 percent today. Manufacturing, however, remains an important sector of the national economy, and one that is particularly sensitive to business cycle fluctuations. In a state such as Mississippi, where manufacturing employment still represents about 16 percent of total non-farm employment, business fluctuations in manufacturing can have significant consequences for the economy of the state.

While manufacturing employment has declined, the proportion of service-sector jobs has increased in the Mississippi and national economies. Service-sector employment represents about 79 percent of total non-farm jobs in Mississippi, a proportion that is only a tad lower than the 83 percent of the United States as a whole. In contrast to manufacturing and overall employment, employment in the service sector has increased in both Mississippi and the United States since March of 2001. Services payrolls grew by about 28 thousand jobs, or about 3.2 percent, in Mississippi from March 2001 to November 2004. During the same period, services payrolls increased by almost 2 million jobs, or about 1.8 percent, in the United States as a whole.

As the share of manufacturing employment continues to decline in the United States and in Mississippi, driven by productivity gains and the movement of lower-skilled jobs overseas, the new face of manufacturing is one of high efficiency and use of advanced technology. The prospects for Mississippi and the nation to generate high-paying jobs in this sector hinge on attracting high-skilled workers. And this leads us to what is perhaps the most important challenge facing Mississippi: education.

Education

The difference of educational attainment in Mississippi relative to the rest of the country is a historically notorious problem. Nevertheless, during the last decade Mississippi has seen significant improvements. Educational attainment in Mississippi measured by the proportion of all persons aged 25 years or older who have completed high school increased dramatically during the 1990s: from 68.9 percent in 1990 to 80.3 percent in 2000, an increase of 11.4 percentage points. This increase was almost double the increase in the rest of nation, helping to narrow the educational attainment gap between Mississippi and the United States. During the 1990s, this gap fell from 8.7 percentage points to only 3.8 percentage points.

Mississippi has also made progress in the attainment of college degrees, although not as impressive as the increase in high school completion. During the 1990s, the percentage of people in Mississippi aged 25 or older with a college degree increased by more than 4 percentage points to 18.7 percent. This increase was slightly smaller than the national increase of about 4.3 percentage points. As a consequence, the gap in the percentage of college graduates between Mississippi and the United States remains stubbornly large at about 7 percentage points. To a large extent, this gap can be attributed to the difficulty Mississippi has had in attracting people with college degrees and in retaining its own college graduates.

Measures of Economic Development

Over the past 75 years, the United States has seen a dramatic increase in the standards of living of its citizens brought about by economic growth. Research at the Cleveland Fed indicates that during this period, the disparities in per capita income growth across states have declined and continue to do so.³ The study finds, however, that a wide gap between the richest and poorest

³ Gomme, Paul and Rupert, Peter. "Per Capita Income Growth and Disparity in the United States, 1929-2003." Federal Reserve Bank of Cleveland *Economic Commentary*, 2004.

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states still remains. The observed convergence across states is thus associated with the fact that poorer states are improving at a faster pace than richer states. Mississippi is no exception, and particularly in recent years it has seen a significant improvement not only in per capita income but also in a wide array of economic development and quality of life indicators.

Mississippi's real median household income was \$32,728 in 2003, which represents only about 75 percent of the national level of \$43,318. From 1990 to 2003, however, real median household income in Mississippi grew at an annual rate of about 1.3 percent, whereas the nation's annual growth rate was only about 0.4 percent. By this measure, then, Mississippi has been catching up with the rest of the country, but there is still a long way to go.

Another indicator of the convergence of Mississippi and the rest of the country is the faster decline in the poverty rate that Mississippi underwent in the 1990s, relative to the decline observed for the United States as a whole. Census estimates indicate that, for the period 2000 to 2002, the proportion of all persons in poverty averaged about 18.5 percent in Mississippi and 11.7 percent in the United States. Compared with the poverty rates of 1989, the decline experienced in Mississippi was 6.1 percentage points—more than 5 times the nation's decline of only 1.1 percentage points.

The most important demographic challenge facing the nation today is the rising proportion of older people in the population rather than population growth itself. The median age in the United States has increased from 30.0 years in 1980 to 35.3 years in 2000. The median age in Mississippi during the same period has risen from 27.6 years in 1980 to 33.8 years by 2000. Although the median age spread between Mississippi and the nation has narrowed in recent years, the median age in Mississippi is still about 1.5 years lower than in the United States as a whole. Total population in Mississippi grew at an average annual rate of 0.9 percent from 1990 to 2003; this growth rate was somewhat

slower than the national average annual rate of 1.2 percent during the same period. Much of the difference between the United States and Mississippi is due to continuing out migration from Mississippi, particularly of prime-aged workers.

FUTURE GROWTH OPPORTUNITIES

In the final part of my remarks I will offer my personal views on how public policies might improve economic activity and will describe my views on how to create a more favorable business climate.

What can Mississippi do to improve its economic situation relative to the nation? A major concern of policymakers in any state is the ability of the state to generate high-skilled and high-paying jobs. In Mississippi, the state government over the years has made great efforts to improve the state's business climate by providing incentives to attract investment and foster the creation of better jobs. These incentives have included direct incentives, such as tax breaks, subsidies and financial programs for training workers, as well as institutional incentives, such as maintaining limited labor market regulations and a relatively simple and favorable tax code.

My personal view favors the use of the second type of measures, which are general measures consisting of establishing institutions, laws, and regulations that reduce the transactions costs of running a business and facilitate entrepreneurship by private individuals. Mississippi's business climate is characterized by labor markets that are relatively free of excessive regulations and by personal and corporate income tax codes that feature relatively low top marginal rates. Low tax rates and the absence of excessive labor market regulation are only two aspects of a favorable business climate.

In contrast, the use of active measures, such as targeted incentives in the form of tax breaks and subsidies, often generate distortions in the behavior of firms and individuals and may pre-

vent resources from flowing to those areas where they are most valuable. Attracting businesses with favorable tax relief programs and government-provided financial assistance seems to be the unavoidable consequence of having to compete with other states. Although these efforts may be successful and lead to the creation of new jobs in the short run, policymakers should be cautious that financing these incentives does not prove onerous to the state's taxpayers and that attracting certain types of businesses does not divert resources from more socially beneficial activities. In sum, I would focus on the general business climate and place a relatively high bar to offering targeted incentives to attract particular firms.

As many observers emphasize, probably the most important challenge facing Mississippi is improving the level of education of its citizens. An educated workforce is a critical aspect of a state's business climate; businesses certainly value it highly, but having an educated workforce can also generate great social benefits through its spillover effects on other areas of society. Moreover, business leaders considering moving to a new location insist on good schools for their own children.

A recent study at the Federal Reserve Bank of St. Louis suggests that increases in the proportion of educated labor force in cities tend to be associated with future growth in the number of high-paying jobs.⁴ The same study finds that the creation of high-paying jobs tends to be followed by wage increases in lower-paying jobs as well. This wage spillover in which high-paying jobs tend to increase wages in low-paying jobs does not occur in the opposite direction when more low-paying jobs are created. To be sure, most of the results from this study can only be derived for jobs in metropolitan areas, as the data required for the analysis are not available for rural areas; however, the economic and social benefits from the creation of high-paying jobs should be obvious without any sophisticated calculations.

CONCLUDING COMMENTS

I will conclude my remarks with the discussion of two recent reforms enacted by the Mississippi government.

First, Mississippi seems to be making definite progress on the education front, particularly in very recent years, and the state appears to be committed to continuing these efforts. The brand new Education Reform Act proposed for 2005 highlights the benefits of focusing the state's efforts on improving performance of students by providing incentives to teachers and parents to achieve this goal. An improved incentive structure is precisely the feature that academic experts in the economics of education suggest should be part of an effective education reform. An emphasis on incentives contrasts with previous efforts targeted at merely increasing funding for education without regard for students' performance. The need for improving Mississippi's educational system still remains, however, and continuing efforts will be required in the future to narrow the gap with the rest of the nation.

Second, Mississippi has made national headlines in past years because of exorbitant awards granted in civil lawsuits. The large number of civil lawsuits and the magnitude of damage awards have made it expensive for individuals to engage in the medical and other business professions. High costs of medical malpractice insurance, for example, reduce returns in medicine and encourage physicians and hospitals to locate elsewhere.

Tort system reform has become a pressing issue in Mississippi and many other states. With the Tort Reform Act of 2004, Mississippi has joined the ranks of states that have enacted comprehensive reforms imposing limits on the amounts of punitive and non-economic damages in medical and other civil lawsuits. It is still too early to identify benefits in economic performance from this reform, but this legislation may be a first step in improving the fairness of the

⁴ Wheeler, Christopher H. "Employment Growth in America. What Determines Where Good Jobs Are Created?" Federal Reserve Bank of St. Louis *Bridges*, Winter 2004-2005.

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state's legal system, which should make it more attractive for business activity to continue to grow in the state.

A detailed knowledge of local conditions is required to make appropriate judgments as to how best to use scarce resources to improve the business climate. But citizens in every state and every community should be asking themselves continuously how the business climate can be improved. Some improvements can be had for free, by eliminating burdensome regulation that was enacted in an earlier age and no longer serves productive public purposes. Other improvements require a careful analysis of how best to spend scarce tax resources—tradeoffs are often necessary. Without question, though, the rewards of investment in an improved, and continuously improving, business climate are impressive.

No outsider can do the job for any given community—each community must look to its own leadership and not expect that someone else—from Washington, for example—will take the initiative to do what needs to be done. This is a message I am especially pleased to offer in Tupelo, for I know from my prior visits here that this community has been taking responsibility for improving education and its business climate for at least a half century.