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Economics Group

Special Commentary

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North Carolina is Still Well Off Its Glory Days[1]

The Outlook For 2011 Has Brightened, but Challenges Still Remain

The New Year starts amid a great deal of optimism. While the recession technically ended 18 months ago, it has only been in the past few weeks that people have finally begun to shed some of their fears about the coming year. Remember it was this past summer when the headlines were full of talk of a double dip, which was a prospect we consistently downplayed. Today, the pendulum appears to have swung the opposite direction, with optimism being fueled initially by the surprise tax compromise between President Obama and the Republicans and then later by reports of strong spending this past holiday season. When you add in a drop in weekly unemployment claims, an increase in exports and a slew of strong reports from the factory sector, the near term prospects suddenly appear much brighter. Real GDP likely increased at a 3.5 to 4 percent pace during the fourth quarter of 2010 and many forecasts for 2011, including our own, have been ratcheted up significantly.

Robust holiday retail sales combined with a string of better economic news has lifted optimism about the 2011 economic outlook.

Figure 1

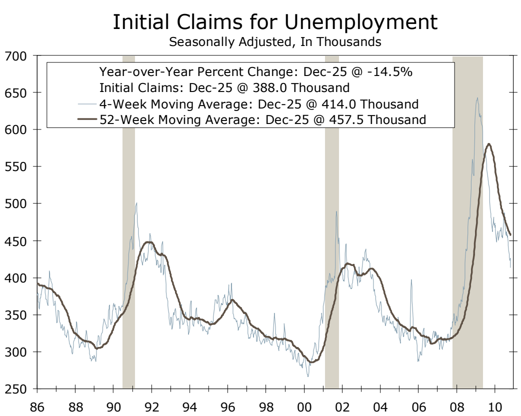
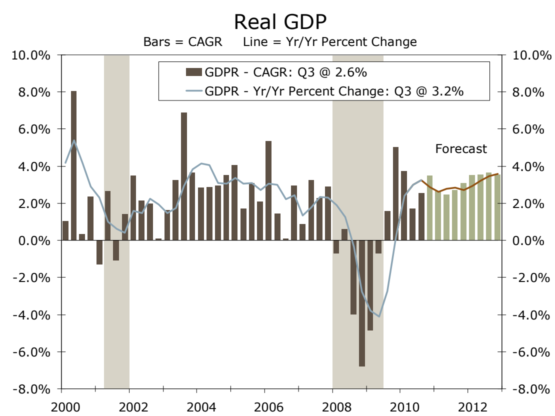


Figure 2



Source: U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities, LLC

While the outlook has improved, the vast majority of consumers, as well as quite a few small- and medium sized businesses, remain extremely skeptical. The Consumer Confidence Index fell in December and consumers feel only slightly better about economic conditions today than they did at the depths of the recession. Most believe jobs are still extremely hard to get and relatively few expect their income to rise over the next six months. The National Federation of Independent Business Survey of Business Optimism also remains far closer to levels seen at past recession lows than where it was 18 months into other post World War II recoveries. While comparable surveys

Consumers and many small and medium-sized businesses remain skeptical.

[1] **This report follows a presentation given at the *2011 Economic Forecast Forum* in Durham, NC, co-sponsored by the North Carolina Chamber and the North Carolina Bankers Association (NCBA) on January 3, 2011.**

are not available for North Carolina, the state's residents are likely equally torn, as the improved economic news has yet to translate into stronger job and income growth.

There is a good reason for this disconnect. The economy fell harder and longer than it did in any other downturn since World War II and the recovery, so far, has been ever so slight. Moreover, the recession followed an exceptionally modest economic expansion that produced relatively few new jobs, so folks that have been out of work for a long period of time are having difficult seeing where the improvement is. We also seem to face a long list of seemingly insurmountable problems including our ever mounting national debt, the precarious finances of many state and local governments, the housing mess, soaring commodity prices and an unemployment rate that appears to be stuck at around 10 percent.

North Carolina has underperformed the nation for much of the past decade.

North Carolina, which had become accustomed to outperforming the national economy, has underperformed the nation for much of the past decade. The unemployment rate, which had remained comfortably below the national unemployment rate from 1975 to 2000, has been at or above the national rate for the past decade. Moreover, job growth has been seriously lacking and nonfarm employment is actually lower today than it was at the tail end of the long 1990s business expansion.

Figure 3

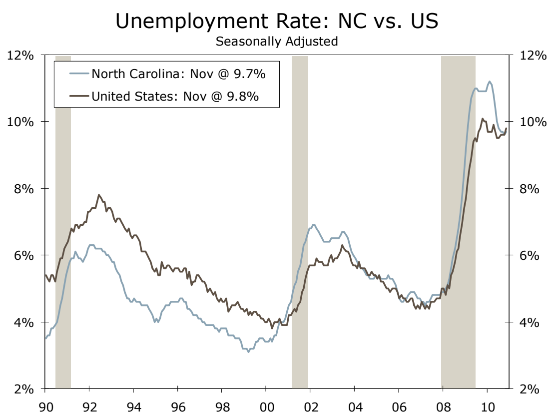
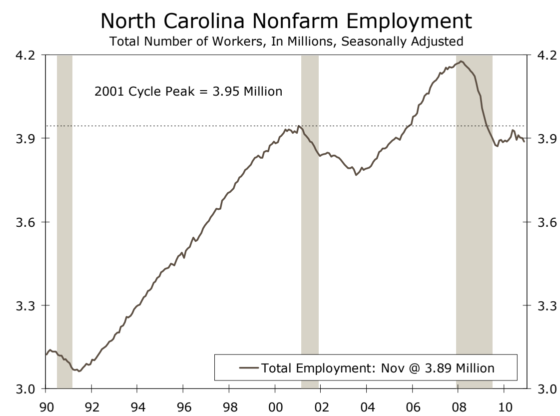


Figure 4

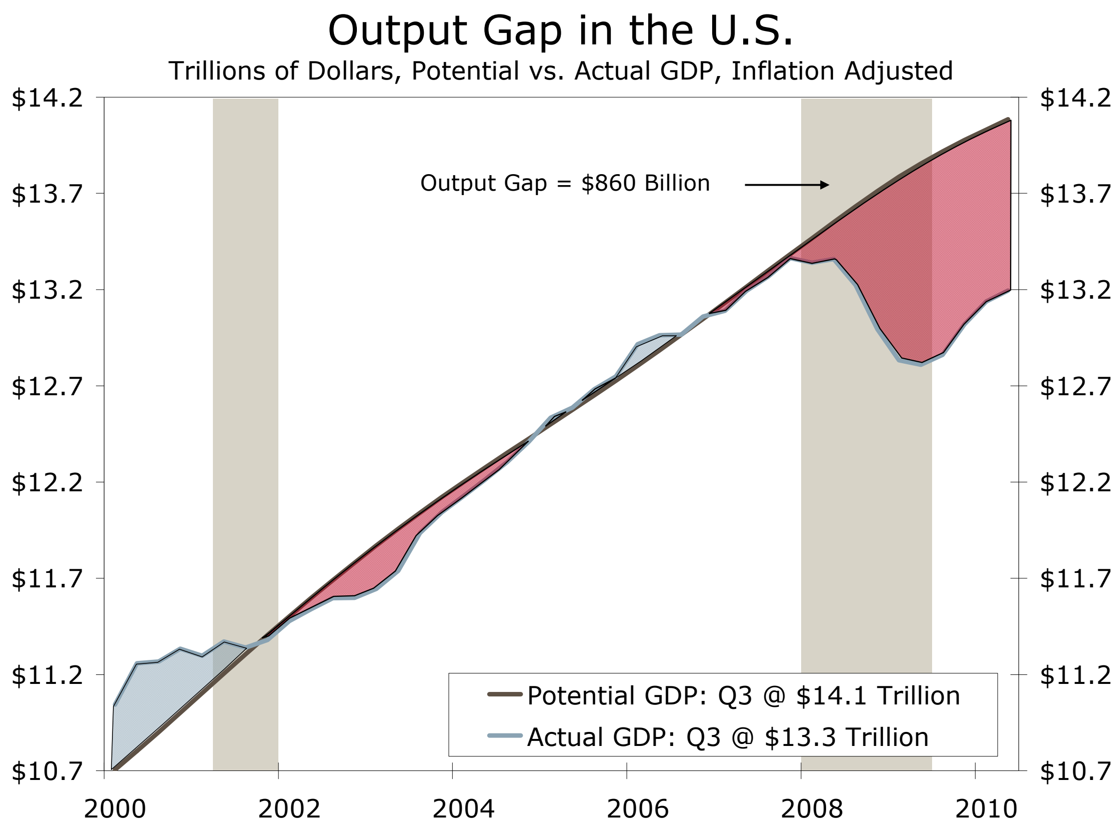


Source: U.S. Department of Labor and Wells Fargo Securities, LLC

Many of the nation's and state's problems are rooted in the enormous output gap which first began to widen in 2007 and then ballooned in 2008 to nearly $1 trillion. The output gap is the difference between the amount of goods and services produced in the economy versus how much could be produced if the economy were operating at full employment, which would be an unemployment rate of around 5 ¼ percent. The Congressional Budget Office currently estimates that the output gap is running at about $860 billion, which is an improvement from the worst of the recession, but still much larger than what we dealt during the aftermath of prior recessions.

Much of the debate among policymakers in Washington deals with how to close this output gap. On one side are folks that advocate increased government spending to make up for the shortfall in aggregate demand. Others prefer to cut taxes and reduce government spending to promote more growth in the private sector. We have tried lots of things, including tax rebates, cash for clunkers, increased government spending, cash for caulkers, aid for first-time home buyers, energy-efficient appliance rebates, a second round of aid for first-time homebuyers and trade-up buyers, increased infrastructure spending and now we are set to cut the employee portion of the FICA "tax" 2 percentage points for a year as well as extend the preferential tax rates on dividends and capital gains for two years. In addition, the Federal Reserve is continuing its purchases of Treasury securities announced in November.

Figure 5



Source: Congressional Budget Office, U.S. Department of Commerce and Wells Fargo Securities, LLC

Unfortunately we do not expect the most recently enacted tax compromise or the Fed's second wave of quantitative easing to produce lasting and meaningful benefits. Too much of the stimulus is aimed at correcting cyclical imbalances, but most of the problems plaguing the U.S. and North Carolina economies today are structural and not likely to go away soon.

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The problems in the housing sector provide a good case in point. Sales of new and existing homes have plummeted in recent years and home building is running at its weakest sustained pace since World War II. Given the weakness in demand, some sort of government assistance for home owners would seem in order. But housing did not collapse because too few people could afford to buy homes. The problems we face in housing today are that too many people bought homes they could not afford, and took on too much debt, leading to a surge in delinquencies and foreclosures. Providing incentives to encourage first-time homebuyers and trade up purchasers only pulled demand forward, robbing the economy of the upward surge in demand that normally occurs with recovering labor markets. The same is true of motor vehicle sales, where cash-for-clunkers boosted sales for a short time, but also set up a more protracted recovery in motor vehicle sales.

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Without a strong recovery in housing and motor vehicle sales, it is hard for us to see how the economy will grow much faster than 3 percent over the next couple of years. Unfortunately, without stronger growth than that, the unemployment rate will likely remain stubbornly high, as even 3 percent growth will not make a meaningful dent in the output gap. Moreover, much of the growth we are seeing in the economy is coming from capital-intensive parts of the economy such as mining and energy extraction, agriculture, information technology, and high-value industrial products. The net result is stronger GDP growth but only modest employment gains. This makes it especially hard to put the 15.1 million unemployed nationwide, and particularly the 6.3 million people that have been unemployed for six months or more, back to work.

Figure 6

Source: U.S. Department of Labor and Wells Fargo Securities, LLC

Policymakers must now find a way to motivate and incentivize the mountain of capital that is sitting on the sidelines on corporate balance sheets.

Rather than fighting the last war, policymakers must now find a way to motivate and incentivize the mountain of capital that is sitting on the sidelines on corporate balance sheets. Cutting rates and dividends and capital gains helps but reducing corporate tax rates, providing more certainty about health care and benefit costs and taming the regulatory beast would undoubtedly do much more. Risk taking does seem to be making a bit of comeback on its on. This past year saw a noticeable increase in industrial development announcements and lending has picked up at large banks. Much of this new investment, however, is tied to some sort of cost-cutting initiative, either through merging and consolidating competing operations or constructing much more efficient manufacturing facilities in the U.S. and abroad.

North Carolina's economy also appears to be on the mend, although a surprisingly weak employment number for the month of November has raised some questions as to how much conditions have actually improved. Private sector payrolls had increased in 8 of the first 10 months of 2010, before plunging by a nation's worst 11,500 jobs in November. On a year-to-date basis, private sector jobs are now roughly even with where they were one year ago, which is well off the 35,000 jobs we expected to be added this year.

We are still holding out hope that the 2010 numbers will be revised higher. November's drop looks awfully suspicious and the state employment figures are often revised up substantially once more accurate employee counts are made available. This may once again happen this year. The unemployment rate has shown much more improvement, falling from a peak of 11.2 percent back in February to 9.7 percent in November. In the past, consistent meaningful improvements in the unemployment rate have been a sure sign that hiring was picking up more rapidly than the initially reported data suggested. While there are good reasons to believe this is once again happening today, there are also good reasons to remain skeptical. Almost all of the improvement in North Carolina unemployment rate this year has been the result of a drop in the civilian labor force and the number of discouraged workers in the state hit an all-time high in November.

Figure 7

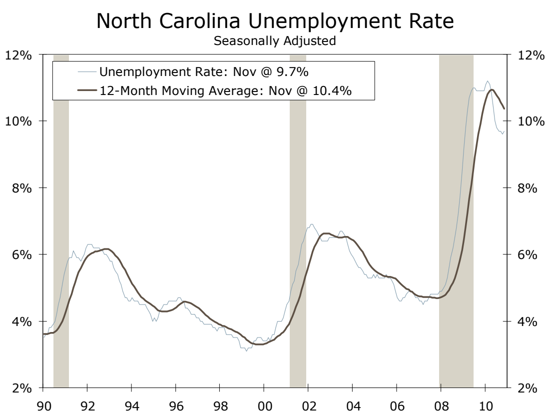
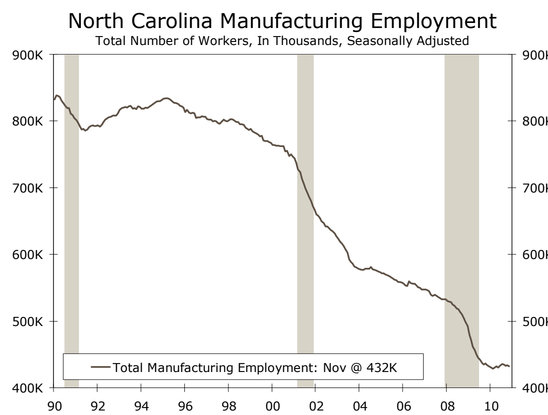


Figure 8



Source: U.S. Department of Labor and Wells Fargo Securities, LLC

Manufacturers have eliminated 318,000 jobs across North Carolina over the past decade.

North Carolina is also facing more structural issues than the nation is. Not only is the state still reeling from the aftermath of the housing boom, which has weighed on employment in construction and financial services, but it is also dealing with the ongoing restructuring of its industrial base. Manufacturers have eliminated 318,000 jobs across North Carolina over the past decade, with many of the losses occurring in the state's smaller metropolitan and rural areas. When financial services, technology, tourism and construction were booming, many of these displaced workers could be absorbed in other jobs in the Triangle or Charlotte. Today, however, these industries are growing more slowly and displaced workers are remaining unemployed for longer periods of time.

North Carolina remains a great place to manufacture products and is a favorite for site selection professionals.

Conditions should improve in 2011. Businesses appear to be more inclined to hire today then they were a year ago. North Carolina remains a great place to manufacture products and consistently ranks high among surveys of site selection professionals. The state's tech sector is also growing solidly again. Several Triangle area businesses announced plans to expand their local operations and hire more workers, including SAS, Red Hat and Novartis. Other areas of the state have shared in this success, with notable new arrivals such as Caterpillar in Winston-Salem, Google and Apple in Catawba County and Facebook in Rutherford County, all providing much needed shots in the arm to hard hit areas. Other significant newcomers that enhance the state's near-term prospects include Siemens, which is building a $170 million gas-turbine plant in Charlotte and Spirit AeroSystems, which is assembling fuselage components at the North Carolina Global TransPark outside Kinston.

The influx of new industry and expansions at existing firms helps broaden North Carolina's industrial base but also creates some challenges, as many of the jobs being created require specific skill sets that may not provide many opportunities for the 441,000 North Carolinians currently out of work. Relatively few laid-off furniture and textile workers are likely to find work at the data centers opening up in Catawba and Rutherford counties. The facilities are highly automated and employ only a handful of workers. Even the large industrial announcements by Caterpillar and Siemens, which will each create hundreds of high paying jobs, will only offset a tiny fraction of the 318,000 manufacturing jobs lost across the state during the past decade. The net result will likely be another year of sluggish job growth, albeit better than 2010. Our own forecast calls for the creation of 48,000 net new jobs in 2011 and we expect the unemployment rate to fall 0.5 percentage points to 9.2 percent by the end of next year.

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