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Our Economy: East Texas and Beyond

Director's Welcome

The research staff at CBER is pleased to bring you our third issue of East Texas and Beyond, *our newsletter. In this one, we discuss what is going in China and how US-China relations have changed, particularly with respect to doing business there. We also provide some brief answers to commonly asked questions about our economy. Finally, we also take a look at the national, state, and local economic conditions and comment on where the economy appears to be headed. If you have a suggestion for a topic you would like to see covered, please get in touch with us.*

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News From and About China

by B. MENDOZA

Mounting tensions over trade and geopolitics cause western companies to slowly reconsider their investments and operations in China, as governments call for increased "de-risking." Popularized by the European Commission president in her speech in March 2023, de-risking is the current diplomatic buzzword signaling the west's attempt at a less antagonistic approach to its relations with China.

The term refers to a moderate and less confrontational divergence from China, replacing the radical notion of "decoupling." Among the contributing factors to this de-risking movement are the US-China trade war, the COVID-19 pandemic restrictions on business activity, and the recent escalation of geopolitical tensions. We discuss each of these below.

US-China Trade War

The US-China trade war started in 2017, when the Office of the United States Trade Representative (USTR) launched an investigation into China's discriminatory business practices against US firms. It found that China's policies targeted the technological and intellectual property of US companies. Examples included foreign ownership restrictions and joint venture requirements that require the transfer of technology from the US firms, and systematic investments and acquisitions by Chinese companies of firms specifically to obtain intellectual property.

As a result of the USTR investigation, the US sanctioned China to Section 301 tariffs worth nearly $80 billion of Chinese exports in 2018. Section 301 is part of the US Trade Act of 1974 that authorizes the US President to take appropriate action against a foreign government that violates international trade agreement or unreasonably discriminates against US companies.

China retaliated by imposing tariffs on American products, resulting in a trade war, with the retaliatory tariffs seemingly targeted at US counties with a largely Republican voter base.[1] In 2020, US and China reached an agreement – the Phase One trade deal – that required structural reforms to

China's economic and trade regime regarding intellectual property and technology transfer, among other things. Despite the Phase One agreement, the tariffs currently remain elevated relative to pre-trade-war levels, which has inflated costs of US firms doing business in China.

The Impact of COVID-19

The outbreak of the COVID-19 pandemic worsened Chinese trade relations. As the largest exporter, accounting for 13.6% of world's exports in 2019, China suffered from trade disruptions stemming from both supply and demand shocks caused by the pandemic. China's rigid policies and stringent lockdowns further contributed to the reduction of its exports.

China's Zero-COVID policy presented a major challenge to foreign investors, restricting their travel to visit their plants, meet with locals, and generally do business. The pandemic-related visa travel restrictions through 2022 significantly affected foreign business operations, increasing labor and input costs, and hampering companies' and investors' ability to conduct standard due diligence. Furthermore, the uncertainty surrounding the policy lowered investor confidence, as demonstrated by the decline in China's foreign direct investment (FDI) growth from 20.2 percent in 2021 to 8 percent in 2022.

In December 2022, China eased its Zero-COVID policy. The sudden and immediate reopening of the Chinese economy was initially met with positive investor sentiment; however, China's recovery has been weaker than expected with industrial output and consumer spending falling short of expectations, and investments in real estate and manufacturing growing slower than last year.

Rising Geopolitical Tensions

Tensions between the US and China have been at their highest in decades due to concerns ranging from national security to economic competition. China has been frustrated with the US over the continued American support for Taiwan, increased rhetoric against Beijing's support of Russia's invasion of Ukraine, and new US trade and technology restrictions, imposed by the Trump and Biden administrations, that seek to protect advanced US technologies and businesses.

China has recently passed a new foreign relations law, designed to strengthen the government's ability to enact "countermeasures" against western hegemony and immediately lashed out against a wide array of western targets.

In February 2023, China imposed sanctions against two American defense manufacturers -– Lockheed Martin and Raytheon — over arms sales to Taiwan, a day after Beijing pledged "countermeasures" in response to Washington's handling of a suspected Chinese surveillance balloon.

In March 2023, London-based Deloitte received a three-month suspension and record fine from the Chinese government, amounting close to $31 million, due to its failure to perform assessment regarding asset quality of China Huarong Asset Management Co Ltd.

In May 2023, China banned products from US chipmaker, Micron, accusing the US of economic coercion and further escalating the microchip clash with the US.

De-risking China

The combination of the ongoing US-China trade war, the remnants of the pandemic-related restrictions, and the rising geopolitical tensions has prompted investors and companies to explore moving their operations out of China to nearby locations, such as India and Southeast Asia. US toymaker Hasbro is one such example.

Others, such as tech giants Apple and Intel are exploring different strategies: for example, allocating future investments to other countries while maintaining their existing plants in China, a strategy known as "China plus one."

Despite the high degree of uncertainty, immediate mass corporate exodus is very unlikely since China retains its advantages in the global supply chain as a top exporter in manufacturing. Business analysts express that most companies have no alternative to China, but should explore adapting to operating in a riskier business environment. Many firms contemplate a "China for China" approach in which operations are reorganized to produce in China goods only for domestic Chinese consumption.

Notes

[1] See Hanson, 2020; Fajgelbaum et al, 2020; Fetzer and Schwarz, 2021

FAQs

by M. Kouliavtsev

Here are a few frequently asked questions we have heard from our friends, coworkers, and audiences at the various talks and presentations.

Is the economy good or bad?

A common question we hear regularly – but even more frequently lately – is of the sort: “How are things in general? Are we doing well? Okay? Struggling?” At least some of the confusion is understandable.

The economy, for the record, is in excellent shape: unemployment is at a multi-decade low, job creation continues its fast pace, median family incomes have risen more sharply (even in inflation-adjusted terms) in recent years, consumer wealth has seen the largest growth on record between 2019 and 2022.

So why does it *feel* like things are not going that well? Well, for one, we saw headlines such as this one from a year ago (October 2022):

Bloomberg Subscribe

Politics | Economics

Forecast for US Recession Within Year Hits 100% in Blow to Biden

- Bloomberg Economics sees near certainty downturn will start
- Tightening conditions, inflation, hawkish Fed weigh on outlook

Also, to be completely fair, we have to acknowledge that at least some of the growth in consumer wealth is due to pandemic-era government stimulus spending, while another part is due to real estate values shooting through the roof. The latter is great if you own a home; not so great if you don’t but want to buy one.

We also lived through a brief period of much-higher-than-normal inflation, and the Federal Reserve had to force interest rates to over 5% (from near 0%). More on this below.

The inverted yield curve – that seems bad, right?

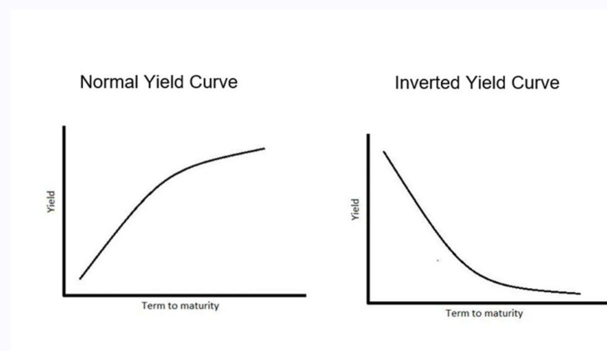
So, the economy is doing well, but are we headed for a recession? Isn’t the yield curve pointing to a looming economic downturn?

It’s true, the yield curve *is* inverted, and historically that has signaled that a recession is coming.

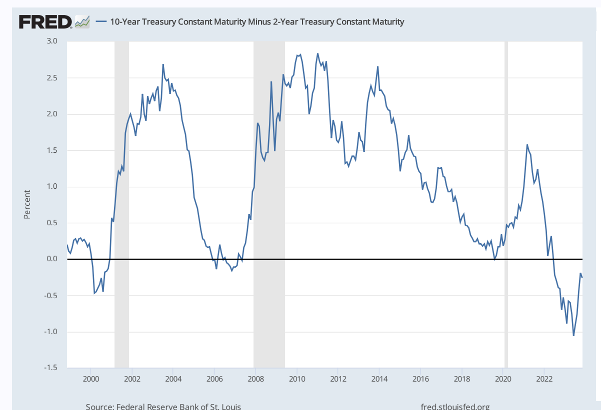
A *yield curve* is a graphic summary of the currently prevailing interest rates on bonds (or loans) of different terms (maturities). Typically, longer terms are associated with higher rates because longer-term investments carry more risk, and an investor needs to be compensated for assuming said risk.

For example, a 10-year bond will have a higher annual interest rate than a one-year bond; otherwise, investors would simply buy one-year bonds every year for ten years rather than commit to a 10-year investment. In other words, a typical yield curve is upward-sloping, reflecting that rates go up as time to maturity goes up.

An *inverted yield curve*, by contrast is exactly that: a situation where the curve slopes down because longer-term rates are below short-term ones. Here is an illustration:



So, why does this signal bad times ahead? It suggests that forward-looking investors are choosing short-term assets over long-term ones because their confidence in the long-run economic performance is low. Past recessions have, in fact, been preceded by periods of inverted yield curves. The graph below tracks the difference between a 10-year and a two-year US treasury bond; whenever this difference turns negative, we have an inverted yield curve.



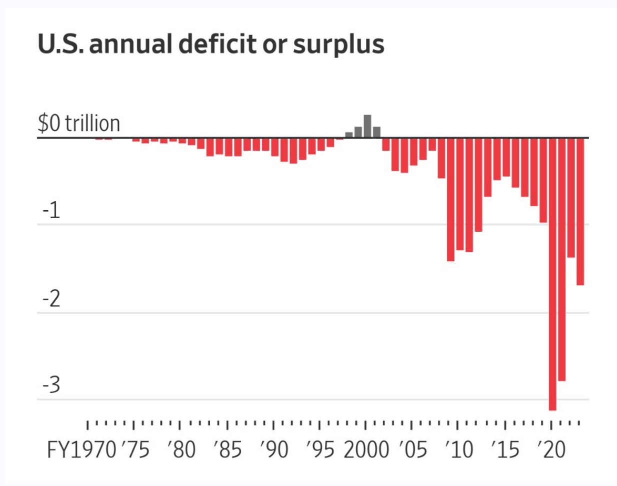
Vertical grey bars in the graph above indicate recessions.

In spite of all of this historic evidence, we have now observed an inverted yield curve for close to a whole year, and the economy is very clearly not in a recession currently.

How about the budget deficit (and debt)? Are we in trouble?

The budget deficit – amount by which tax revenue the government collects in a given year falls short of its spend-

ing that year – has been the story each year since the late 1990s. Furthermore, the size of the deficit has grown, particularly in recent years, which of course adds to the outstanding public debt – i.e., the accumulation of all past deficits.



While interest rates were at historic lows, the common theme among both economic commentators and those connected to fiscal policy was that borrowing was nearly costless, and if there are good reasons to do it – stimulate the economy, build infrastructure, invest in healthcare, education and other worthwhile initiatives – why wouldn't we do it?

The rates are no longer low, and the existing debt has become "expensive" in the sense that a larger portion of our economy's GDP needs to be devoted to paying interest on that debt.

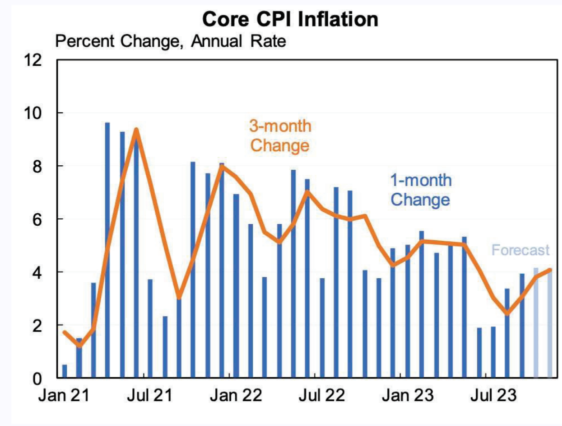
That is doubly troublesome (though far from catastrophic). First, more resources are being diverted from productive uses toward this debt service, thereby reducing our ability to grow, invest, and prosper. Second, the ability to borrow even more is compromised due to the size of the outstanding debt.

At one point, in August of 2023, Fitch actually lowered their assessment of US sovereign debt from AAA to AA+, although this move was universally regarded by economists as being somewhere between bizarre and absurd.

In any event, given the current interest rate environment, the federal budget is sure to receive more attention and scrutiny than it has in the recent past.

What is so particular about 2% inflation that the Fed wants? Can we live with higher inflation?

Here is where we currently are:



Inflation has been coming down steadily, but both one- and three-month rates of change in the CPI point to a slight uptick. Whether that is a reversal of trend, and inflation rate is picking back up or just a short-term blip, one thing is clear – we are not quite at 2 percent, which is the self-imposed goal of the Fed.

Other measures – such as core inflation, core minus housing, core minus housing and used cars, etc. – paint a similar picture, which is that inflation is much lower than a year ago but not as low as in 2020 or earlier.

The Federal Reserve has regularly made it clear that the current goal of its monetary policy efforts is to bring the rate of inflation down to its desired level of 2 percent. But why 2 percent? And can it be some other number, say, 3 percent?

To understand the position that the Fed finds itself in, we need to consider the broad role of the central bank in the US. While this has varied somewhat over the 100+ years of the Fed's existence, often depending on the economic conditions at the time as well as who was in the position of Chair of the Board of Governors, broadly speaking, the Fed wants to maintain economic stability. This is often described as a *dual mandate*: the task of keeping price levels stable (i.e., inflation low and predictable) while also encouraging stability in labor markets and supporting steady economic growth.

This is in contrast, by the way, to many other countries' central banks, which are primarily concerned with price stability only. In other words, whereas these other banks may have a set target for the inflation that they want to "hit" and maintain, the Fed *could*, in principle, change the desired rate of inflation if it meant its other goals are better met by doing so.

The difficulty arises from the fact that the Fed has to rely on and manage *inflationary expectations*. Much of the movement in the overall level of prices of goods and services is affected by businesses' and business owners' expectations of future prices.

For example, when a home builder determines what price per square foot to set for her clients who are looking at building a house, she must consider what she expects to

pay for drywall, plywood, brick, cement, and appliances in the next several months. If the Fed comes out with strong statements about its intentions to get inflation down to 2 percent, there is little reason to doubt that it plans to do that – it always has in the past. Accordingly, the builder anticipates that while short-term inflation may be a little higher, over the medium term (say, six months), it will be brought down; that means the cost of building should be about 2 percent higher next year, and she can set her prices accordingly.

If instead, the Fed were to announce that it will abandon its goal of 2 percent inflation and aim for 3 or 3.5 percent, then the expectations of *future* inflation immediately change.

First, clearly we should expect prices to be higher for raw materials, and therefore should set higher prices for final products. That itself raises prices, of course.

Second, what will stop the Fed from changing its course again in the future? If it reneged on its plan of 2 percent, why wouldn't it ditch the 3 percent plan in favor of an even higher goal? Clearly, this would lead a major loss of confidence, and ultimately rob the Fed of an important tool it has – ability to affect behavior by shaping inflationary expectations.

All this is to say that while the Fed *may* in the future reconsider its goals for inflation, for the time being, it has committed itself to the 2 percent target.

Economic Snapshot: National and Local Conditions

As we already discussed above, the economy seems to be doing quite well, both nationally and in our area. Every available metric and every piece of data we have for 2022 and first half of 2023 confirms strong economic growth, continued job creation, and inflation that has been brought under control (even if not all the way down to 2 percent).

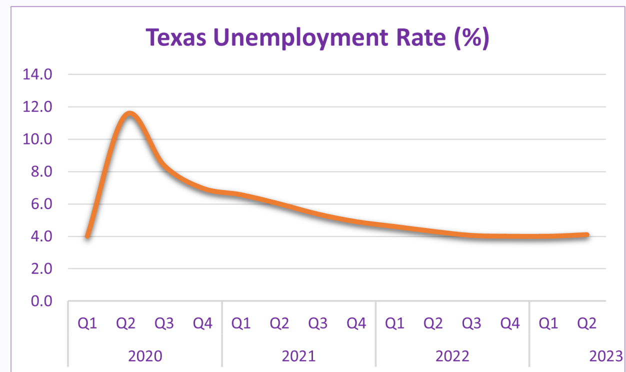
If there is some concern about whether this kind of economic performance is sustainable going forward, it is that what we saw in 2022 was the turbocharged recovery from the 2020-21 slowdown. A crimped garden hose can be a useful analogy here: a kink prevents the flow of water, and pressure builds up behind the crimped spot. Once the hose is straightened out, water shoots out of it with additional force, and the flow is restored.

The kink in this case is the supply chain disruptions, the pandemic lockdowns, and the build-up of savings in consumers' wallets. Now that those restrictions have been removed, economic activity exploded, but by itself this rate of growth is not sustainable. In a way, the economy has grabbed all of the low-hanging fruit available to keep expanding.

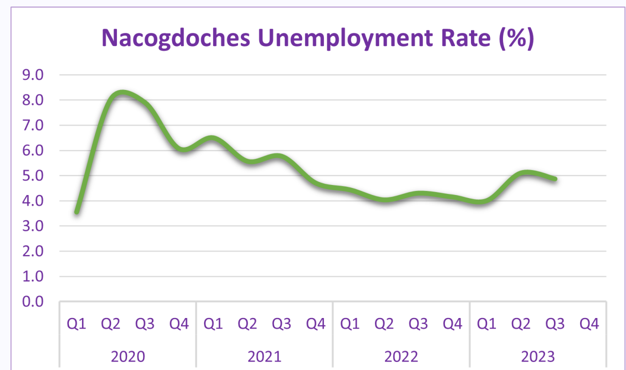
On the other hand – and what kind of an economic commentary would this be if there wasn't an "on the other hand" – there are some positive economy-boosting aspects on the horizon. For example, several of the federal laws – the Inflation Reduction Act and the Bipartisan Infrastructure Law – are yet to kick in, in terms of actual funding for programs. Also, as inflation keeps coming down, and the Fed may begin to see an opportunity to begin cutting interest rates in the near future, some of the business investment and major projects that are currently on hold (due to high borrowing costs) may start to come online.

Labor Markets

Unemployment rates, both nationally and in Texas, have continued to decline. Overall, the US unemployment sits at 3.7 percent at the end of Q3, while in Texas it is at 4.1 percent, – consistent with the recent trend of our state having unemployment a tick higher than the US.

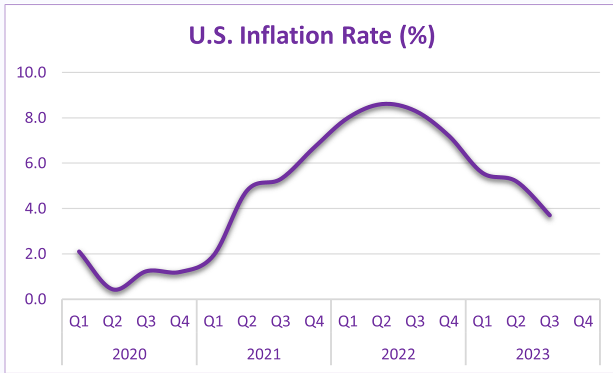


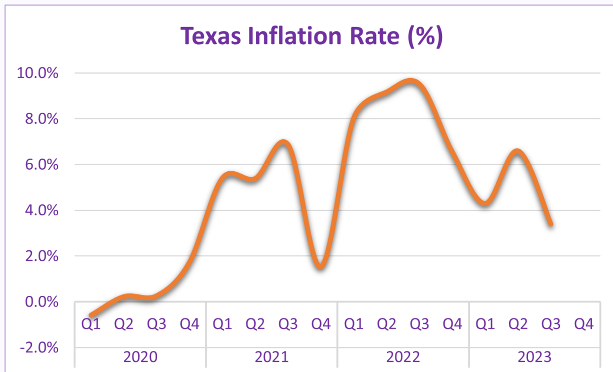
Locally in Nacogdoches, we have seen unemployment increase to about 5 percent from a low of 4 percent at the start of 2023. Given how noisy this data series appears to be, this should not be a major source of concern.



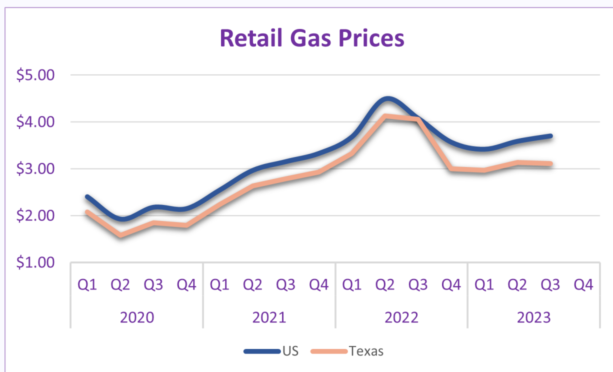
Price Levels and Cost of Living

We commented on inflation rates coming down above, and we are seeing this continuing trend both in the US series and in Texas shown below.



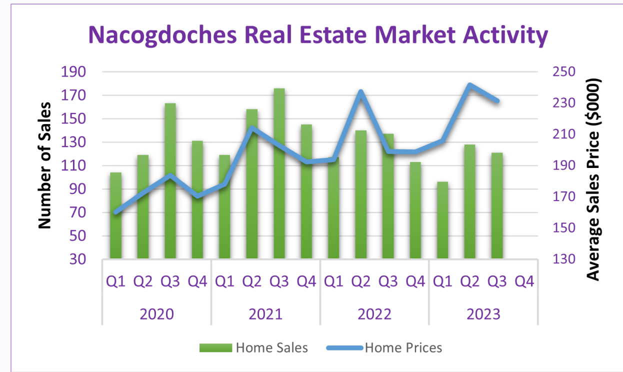


Retail gasoline prices are falling (even if not quite obvious from the graph below – the price declines are recent and may not be in the official data yet); Texas prices are lower than those in the U.S., and locally our gas is even cheaper than state average. The national average in Q3 of 2023 was $3.70 per gallon, and in Texas – $3.11.



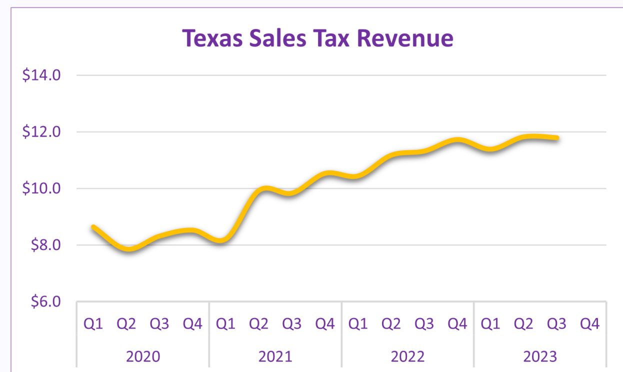
Housing Markets

High mortgage interest rates have certainly cooled off the real estate activity some. On the other hand, as the rates have continued to remain above 8 percent, many buyers who previously postponed buying homes if they could, may now be no longer able to delay buying. The longer rates remain high, the greater the perception among buyers that they will continue to be high.



Sales Tax Revenues

Statewide sales tax revenue continued to increase through the first three quarters of 2023, confirming that economic activity is expanding.



CBER: Who We Are

Meet the team of faculty members in Stephen F. Austin State University's Department of Economics and Finance who are affiliated with the center.

Dr. Rebecca Davis
Energy and Environmental Economics
PhD, University of Tennessee

David Kaiser
Banking and Financial Services
MBA, Western Washington University

Dr. Stephen Kosovich
Labor Economics
PhD, University of Oregon

Dr. Mikhail Kouliavtsev
Industrial Organization, Antitrust Policy
PhD, Temple University

Dr. Beverly Mendoza
International Economics and Trade
PhD, Indiana University

Dr. Mark Scanlan
Tax Policy
PhD, University of Florida

CBER Staff in the Media

- ☞ How to find the best car insurance company for your needs. (M. Kouliavtsev. *MoneyGeek*)
- ☞ Advice on high-yield savings accounts and mistakes to avoid. (M. Scanlan, *WalletHub*)
- ☞ Insight into whether drivers should keep a totaled car, how to get the most from your insurance company, the most important thing you should do after your car is totaled and if you should consider extra insurance. (B. Mendoza, *WalletHub*)
  - ✏ Also, commentary from our colleague, Ryan Phelps
- ☞ Advice for first-time or newer cash back cardholders and discusses mistakes people make with credit cards and specifically rewards programs. (B. Mendoza, *MoneyGeek*)
- ☞ Discussion of 0% APR credit cards. (M. Scanlan, *WalletHub*)
- ☞ Advice in the aftermath of the Silicon Valley Bank news. (D. Kaiser, *KETK*)

Other Research by Our Colleagues

- ✓ Davis, R. and Blount, J. (in press). Regulating CO2 Emissions Post-West Virginia v. Environmental Protection Agency. Williamsburg, VA: *William and Mary Environmental Law and Policy Review.*
- ✓ Davis, R., Holladay, J., and Sims, C. (2022). In M. J. Kotchen, T. Deryugina, and J. Stock (Ed.), *Coal-Fired Power Plant Retirements in the U.S.* (vol. 3). Environmental and Energy Policy and the Economy.
- ✓ McDermand, R. and Kosovich, S. (in press). A Quantitative Analysis of the Financial Impacts of COVID-19 on Division I Collegiate Athletics. *Journal of Higher Education Athletics & Innovation.*
- ✓ Mendoza, B., Lopatin, N. and Westenberg, J. (2023). Section 301 and Politics: Analysis of Tariff Exemptions. *Economics & Politics.*
- ✓ Davis, R. and Mendoza, B. (in press). The Impact of Using Real-World Data Analysis in Applied Business Statistics Courses. *Global Journal of Business Pedagogy.*