Current Economic Conditions

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SOME DOUBTS ABOUT FASTER GROWTH

Doubts about the acceleration in U.S. economic growth I wrote about last month – and about the ability of President Trump to boost growth through his economic policies – have risen in recent weeks, sending both stock prices and bond yields down. The S&P500 stock price index has fallen 2.2% since March 1, with most of that decline coming since March 20. The yield on 10-year Treasury notes has fallen to 2.18% from 2.61% on March 13. Doubts about growth have been triggered by the failure of the Republican-led House of Representatives to pass a bill to repeal and replace the Affordable Care Act (ACA) and by weaker-than-expected reports on motor vehicle sales, payroll employment, and retail sales. Light vehicle sales fell in March to their lowest seasonally adjusted annual rate since February 2015. Payroll employment rose by just 98,000, the smallest increase since last May. Retail sales fell 0.2% in March, and February's 0.1% increase was revised into a 0.3% decline. Industrial production in U.S. manufacturing fell 0.4% in March, due largely to a big decline in motor vehicle production.

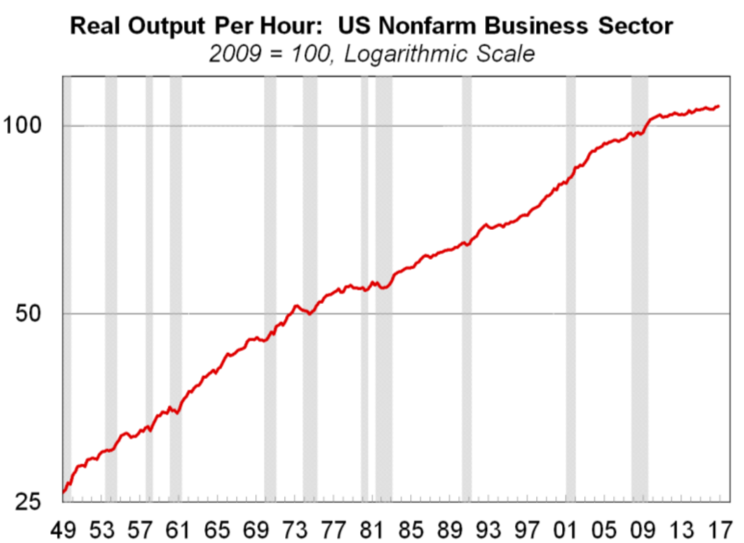
But other economic data, including the rest of the March employment report, suggest that we shouldn't be so quick to give up on an acceleration in economic growth. Even though payroll employment (from a survey of employers) rose just 98,000, civilian employment (from a survey of households) rose 472,000, and the headline unemployment rate (also from the household survey) fell to a cyclical low of 4.5%. The U-6 unemployment rate, which includes those who are working part-time but would prefer to work full-time and those who have not looked for a job within the last month because they are discouraged, fell from 9.2% to 8.9%, the lowest since December 2007, the peak of the last economic expansion. Even though the financial press focuses on payroll employment, economic analysis shows that movements in unemployment rates are the most reliable measures in the employment report since errors in estimates of employment and the labor force tend to have offsetting effects on unemployment. March's decline in retail sales was due entirely to the decline in vehicle sales and a decline in gasoline prices. Excluding motor vehicles and gasoline, retail sales were up 0.1% in a month when retail prices fell.

Data from business and consumer surveys remained strong in March. The Institute of Supply Management's Manufacturing PMI and its forward-looking New Orders component fell just fractionally from very high levels, suggesting that the March decline in industrial production was a one-off event. (ISM's Non-manufacturing index fell more significantly but remained well above the neutral level of 50.) The National Federation of Independent Business's Small Business Optimism Index also fell slightly but remained near January's 12-year high. Early reports for April also look good. The University of Michigan's Consumer Sentiment Index rose in early April. The 13-week moving average of new claims for unemployment insurance has fallen to a 43-year low. (As a share of population, it's at an all-time low.)

Mortgage applications for purchases have recently approached their highest levels since 2010, a normal response to a short-term decline in interest rates after the beginning of a cyclical upturn.

Pessimism in the media, in contrast to the optimism shown in surveys of businesses and the general public, likely comes from extrapolating the failure of ACA repeal to tax reform. Comprehensive tax reform is likely to prove much more difficult than Speaker Ryan and President Trump thought. That's the bad news. The good news is that faster economic growth doesn't require comprehensive tax reform. Almost all the potential benefits from tax reform would come from just two sources: the immediate expensing of investment for tax purposes and the repatriation of foreign earnings, both of which would boost business fixed investment. Repatriation can be achieved through some combination of a lower corporate tax rate, a special low rate on the repatriation of accumulated profits, and a switch to a territorial tax system that doesn't tax the foreign profits of U.S. corporations. If Congress were to pass a business tax cut with only these elements, a rate in the mid-20s (versus the 20% proposed by House Republicans or the 15% proposed by President Trump), and **no** individual tax cuts, the media would likely portray it as a failure for President Trump and the Republican Party, but it would be a major victory for the U.S. economy. If President Trump accomplished none of his agenda other than business tax cuts, deregulation, and enough modification of the ACA to lower health insurance premiums for those who buy insurance in the individual market and don't get subsidies, economic growth would be much stronger than it otherwise would have been. Individual income tax cuts might be politically popular, but they would do little for economic growth and would reduce government revenue and widen the deficit. Business tax cuts could stimulate growth and boost productivity and wage and salary income enough that they actually boost revenue.

Another reason not to give up on accelerating growth because of the failure of ACA reform is that growth has accelerated globally and is not dependent on U.S. economic policies. Growth in China, the second largest economy in the world, has accelerated significantly over the last year. Real GDP was up 6.9% year-over-year in the first quarter, the best growth rate since 2015. Value Added of Industry – China's measure of industrial production – was up 7.6% year-over-year in March, the best since 2014. (Official data don't show the full extent of the acceleration because they didn't show the full extent of the deceleration from 2014 to early 2016.) Industrial production in Japanese manufacturing rose to a 37-month high in February and was up 9.7% from a weak prior-year level. Industrial production in Mexican manufacturing remained near January's all-time high in February and was up 3.3% year-over-year. To some extent, the pickup in growth is due to the end of an inventory adjustment that has left inventories relatively lean. Restocking is not a sustainable source of faster growth, but can boost growth temporarily.



Growth during the current economic expansion has been extraordinarily weak due to weak productivity growth. Since the end of 2007, output per hour worked in the U.S. nonfarm business sector has grown at just a 1.1% annual rate. Over the prior 59 years, it grew at a 2.3% rate. The **sudden** drop in productivity growth – output per hour worked grew at a 2.4% rate from 1990 to 2007 – is likely due to some combination of measurement problems, excessive regulation, and the high oil prices that prevailed for most of the 2004-2014 period. To the extent that the downshift was due to regulation and high oil prices, productivity growth is likely to pick up significantly going forward. A total failure to pass a tax cut would limit the extent of this acceleration, but even a partial success would make it larger and longer lasting. Just don't expect the acceleration to show up in first-quarter Gross Domestic Product.