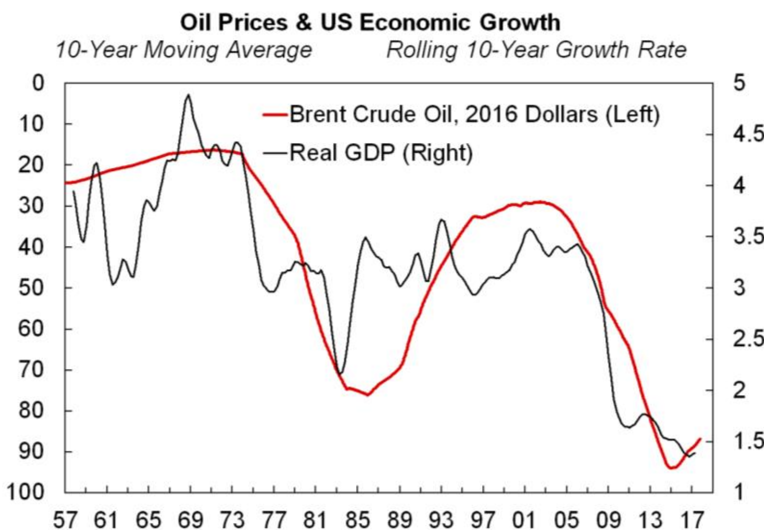
Current Economic Conditions

Robert C. Fry, Jr., Ph.D. November 20, 2017

TEMPORARY REBOUND OR LASTING UPSHIFT?

U.S. Real Gross Domestic Product grew at a 3.0% annual rate in the third quarter, the second straight quarter with growth at or slightly above 3%. This is significantly faster than the 2.0% growth of the prior four quarters, which matches the annualized growth rate that has prevailed since the initial recovery from the Great Recession ended in the fourth quarter of 2010. Has growth shifted up to a new, faster trend, or will growth soon revert to the old 2% trend (or even fall to the Congressional Budget Office's 1.8% estimate for potential GDP growth)? The answer matters for business planning, for standards of living, for the appropriate level of stock prices, and for the outcome of the 2018 and 2020 elections.

Faster growth in the second and third quarters than in the first quarter is nothing new. The Bureau of Economic Analysis routinely adjusts GDP data to remove the effect of normal seasonal fluctuations, so that any quarter can be compared with any other quarter, but "seasonally adjusted" GDP data still show "residual seasonality." Over the last decade or so, growth has generally been slower than average in the first quarter and faster than average in the second and third quarters. The apparent pickup in growth in the second and third quarters this year could simply reflect the impact of residual seasonality. If you calculate annualized growth over the first three quarters of 2017, to minimize the impact of residual seasonality, you get 2.4%. That's significantly better than 2%, but it's not 3%. (The year-over-year growth rate, which is not affected by seasonality, is 2.3%.) Early estimates for GDP growth in the fourth quarter are around 3%, which seemingly supports the upshift argument, but fourth-quarter growth will reflect recovery from the third-quarter hurricanes. We'll have a much better fix on whether growth has shifted to a higher trend and by how much when we get data on first-quarter GDP at the end of April 2018.

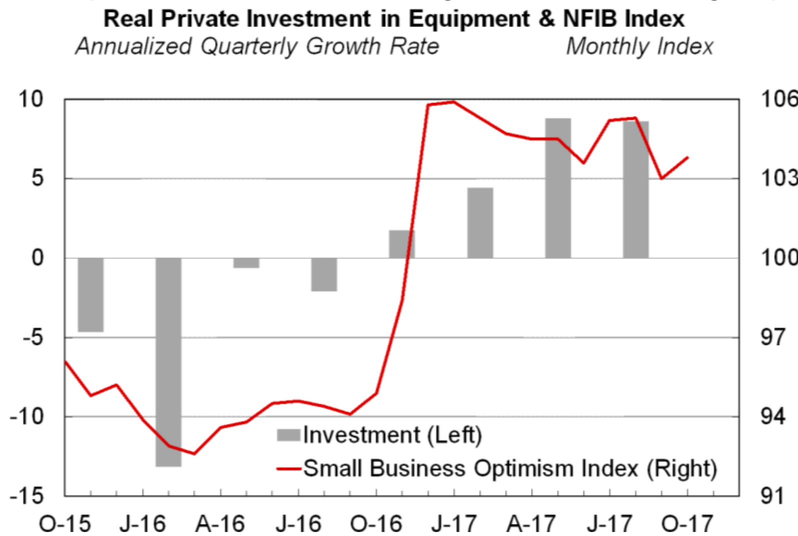


The case for a lasting upshift in growth relies on two things: lower oil prices and better economic policies. As I have argued repeatedly in this newsletter, the U.S. economy grows much faster when oil prices are low than when they are high. The price of Brent Blend crude oil averaged more than $100/barrel in every month from February 2011 through August 2014. Prices fell sharply into January 2015 and have stayed well below 2011-2014 levels since. The positive impact of lower oil prices on economic growth was initially masked by their negative impact on drilling activity and oil production, but drilling and production rebounded after prices bottomed, and the benefits to the overall economy have become more apparent.

While President Trump and Congressional Republicans have not (yet) had any success in repealing and replacing Obamacare and enacting a pro-growth tax-reform bill, they have had lots of small successes on the regulatory front. Congress has used the Congressional Review Act to eliminate at least 15 Obama-era regulations. Through executive action, President Trump has postponed or withdrawn hundreds of

proposed rules. But perhaps more important than repealing existing regulations has been putting a halt to the addition of new regulations. Regulations are especially burdensome to small companies that don't have the corporate lawyers and accountants needed to deal with them. That's why there was no group that felt more beleaguered by the policies of the Obama Administration or more excited about the prospect of a Trump Administration than the owners of small businesses. That shows up in the National Federation of Independent Business's Small Business Optimism Index, which surged by a record amount in November and December 2016 and has held onto most of its gains since.

The jump in small business optimism helps explain the strength in business investment in equipment this year. Real private investment in equipment, which had fallen for four straight quarters through the third quarter of 2016, has now grown for four straight quarters. Over the last two quarters, it has grown at an 8.7% annual rate. Tax reform that includes the immediate expensing of investment and an incentive for the repatriation of foreign-source income would further boost investment in 2018 and broaden the benefit of pro-growth policies from small companies to all companies. That's important because an upshift in economic growth won't be permanent unless its driven by business investment (in equipment, structures, and intellectual property). Unlike consumer spending, which boosts GDP only once, investment boosts GDP when an investment is made **and** as the assets purchased produce output for years thereafter. Investment is the economic gift that keeps on giving.



A shrinking net-export deficit over the last three quarters, and especially over the last two, also helps explain the pickup in growth. I'm skeptical of the Trump Administration's ability to shrink the trade deficit significantly through tougher trade policies; the United States will run a large trade deficit as long as the dollar is the world's reserve currency, and Americans benefit from reserve-currency status. I think pulling out of the Trans-Pacific Partnership and threatening to pull out of NAFTA are big mistakes, but if a little moral suasion from the President convinces a U.S. company to source domestically or a U.S. or foreign company to build a plant in the United States rather than somewhere else, that might not be a bad thing. The most likely reason for the shrinkage in the net-export deficit, though, is the decline in the value of the U.S. dollar from the peak reached in January. A weaker dollar makes U.S.-produced goods and services relatively cheaper in international markets and helps them take market share from goods produced elsewhere. Despite this year's declines, the dollar is still strong by historical standards. A further decline could further shrink the net-export deficit, making the pickup in GDP growth more persistent.

The case against a lasting pickup in growth is based largely on the argument that the U.S. economy is at full employment. But while both the headline and U-6 unemployment rates are consistent with full employment, the ratio of employment to population is low by historic standards because of a decline in the labor force participation rate. Employment could increase significantly if working-age adults who are not currently in the labor force were to go (back) to work. That would require some combination of carrots (higher wages, expanded Earned Income Tax Credit) and sticks (cuts in food stamps and unemployment benefits, tougher enforcement of eligibility requirements for disability insurance). Much more importantly, growth can accelerate without growth in employment if productivity growth picks up. Productivity growth matched a record low in the 25 quarters ending in the first quarter of 2017, suppressed by high oil prices and regulations that reduced productivity. (Hours spent working on regulatory compliance add to the denominator when calculating productivity, but not to the numerator.) The so-called "new normal" is not normal. A return of productivity growth to historic norms would provide a lasting boost to economic growth.

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