Current Economic Conditions

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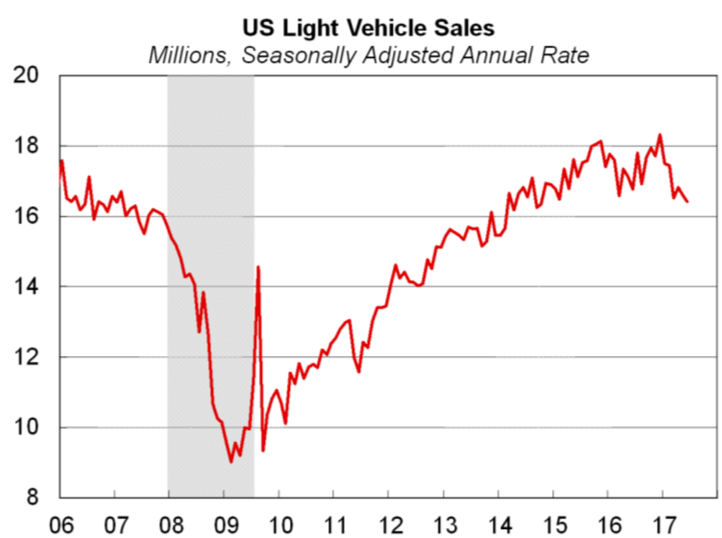
WAITING . . .

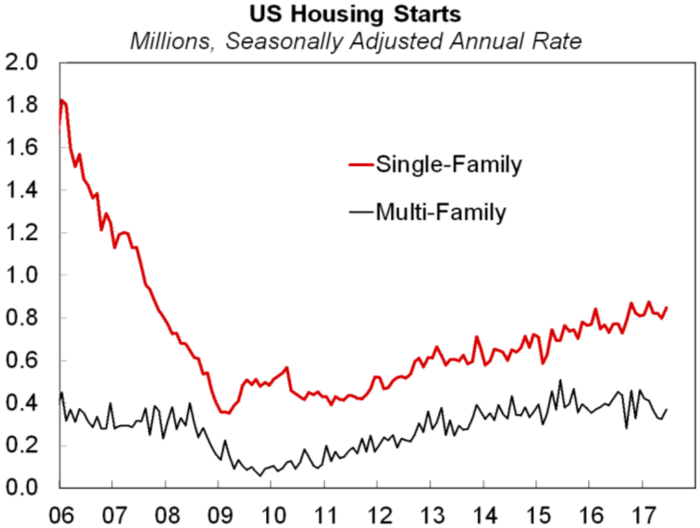
Except for the period of heightened uncertainty preceding the 2016 Presidential election, I have been expecting an acceleration in U.S. economic growth since shortly after the decline in oil prices that began in the middle of 2014. Historically, the U.S. economy in general and productivity in particular have grown much faster when oil prices were low than when they were high. So far, however, there has not been a significant acceleration in growth. Real GDP has grown at just a 2.2% annual rate since the second quarter of 2014. Industrial production in U.S. manufacturing has grown at just a 0.3% rate since June 2014. GDP growth probably improved in the second quarter, but that's likely due to bad seasonal adjustment factors. When I look at the first two quarters together, I'm still waiting for the acceleration.

I'm waiting for growth to pick up because households and businesses are also waiting. As I discussed last month, tight labor markets have failed to trigger a significant acceleration in wages and salaries. Workers are waiting for raises to give them the income (and confidence) to spend more on consumer goods and services and housing. Potential workers – those who have stopped looking for work and are not counted in the labor force but are still able to work – are waiting for pay to go up enough to encourage them to seek employment again. While consumer spending is not the main reason for the anemic growth of the current economic expansion, it accounts for 69% of GDP and will have to be part of any acceleration in growth. A decline in retail sales in June indicates that this isn't happening yet.



Motor vehicle sales, which had been one of the few bright spots in this economic expansion, have fallen from last year's record high. Light vehicles sold at a 16.6 million seasonally adjusted annual rate over the last four months, down from annual sales of 17.5 million in 2016. A reduction in subprime loans made by auto finance companies accounts for some of the decline. Another reason for the decline is that potential car-buyers are waiting for clarity about fuel prices and automotive technology so they can decide what to buy. Do you buy a gasoline-powered vehicle, a hybrid, or an all-electric vehicle? If you're uncertain about the future of oil and electricity prices, fuel-economy standards, and environmental regulations, you might choose to wait. Do you buy a vehicle you drive yourself or do you wait for a self-driving vehicle? Many of us have already purchased the last vehicle we will drive ourselves. Uncertainty is paralyzing; if you can't decide what to buy, you won't buy anything. Without more clarity and certainty, vehicle sales are likely to stay below 2016's record high.

Despite an increase in housing starts in June (ending a four-month decline), the slow recovery in housing starts and home sales remains one of the biggest disappointments of this expansion. Single-family housing starts have been especially disappointing. Home prices have risen to new highs, indicating that the problem is a lack of supply rather than a lack of demand. (The record-low inventory of homes for sale confirms that the problem is on the supply side.) Potential home-buyers are waiting for builders to build some houses. Part of the problem is that home-builders are waiting for changes in zoning and permitting regulations that would reduce the cost of building and alleviate the tight supply of building lots. (They're also waiting for changes in immigration laws to alleviate the tight supply of construction labor, but given the immigration policies of the current administration, they'll probably have to keep waiting.) The increased domination of homebuilding by large national builders also helps account for the slow recovery in housing starts. As I teach in my managerial economics class, sellers in a concentrated industry are likely to produce less and charge higher prices than sellers in a competitive industry composed of many small companies.



Business fixed investment has also been disappointing during this expansion and is another potential source of faster growth over the next few years. Investment is disappointing because businesses are waiting for three things: stronger demand, higher wages, and tax reform. No matter how low interest rates go, businesses are unlikely to invest unless demand is strong and capacity utilization is high. This might not be consistent with profit-maximizing behavior – it might make sense to invest in new technology or new capacity even if there is plenty of spare capacity in an industry if some of that capacity is obsolete – but it's the way most businesses behave. Businesses have been able to delay investment in automation because wage growth has been so slow. Higher wages (or the inability to find workers at current wages) will spur businesses to invest in automation and other labor-saving technology. Uncertainty about future tax reform might be the biggest reason businesses are waiting to invest. Any tax reform proposal worth considering will include the immediate expensing of investment in plant and equipment. If a business has a choice between buying a piece of equipment (or opening a new plant) in 2017 and depreciating the investment over many years and making that same investment in 2018 and writing it off immediately, it probably makes sense to wait. This will continue to hold down investment until either tax reform passes or businesses give up hope that it will pass. (And even if tax reform passes this year, investment will remain weak until January 1, 2018 unless expensing is made effective immediately or retroactively.)

Companies might also be waiting for stronger demand and higher prices to push expected returns on investment into double-digits before they invest. If that's the case, they're in for a long wait. Given the abundance of savings in the world and the low inflation discussed in my May newsletter, we're living in a single-digit world. Companies with double-digit hurdle rates for new investments are likely to cede market share to more-aggressive competitors at home and abroad. The companies that are gaining market share and contributing the most to economic growth are the ones that aren't waiting. Investment in nonresidential structures, still 15% below its 2000 peak, would be much weaker if it weren't for a category called "mining exploration, shafts and wells," which includes oil and gas drilling. The drilling-rig count, which plummeted from late 2014 to mid-2016, has rebounded strongly since then; U.S. oil production is likely to be back at record highs by the end of the year. Jeff Bezos, CEO of Amazon, isn't waiting for anything either.

A few things would help end the wait for faster growth. Higher wages would boost consumer spending and provide an incentive for businesses to invest in automation and other productivity-enhancing technology. Tax reform that includes immediate expensing and an incentive for repatriation of foreign earnings would boost investment more generally; a small reform passed now would be better than a big reform passed later. Regulatory changes that make it easier to build houses would unleash an important sector of the economy. I still believe the economy will accelerate as productivity growth returns to normal in response to the decline in oil prices, but it could use a nudge to get it out of this slow-growth rut.