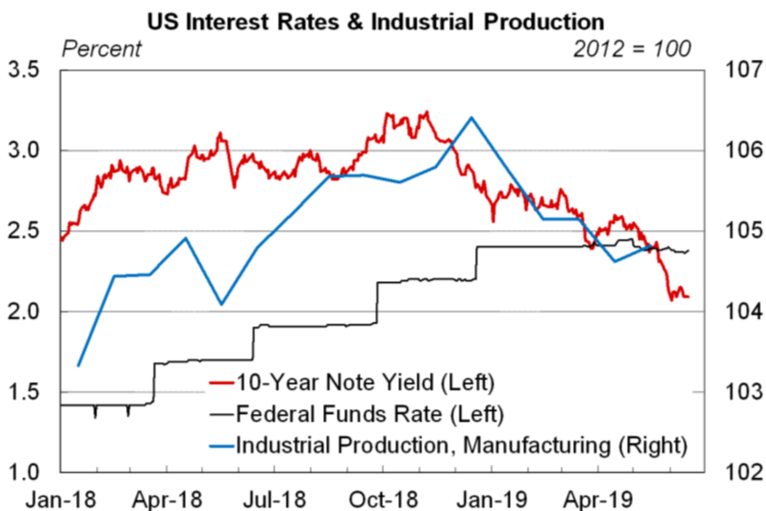
Current Economic Conditions

Robert C. Fry, Jr., Ph.D. June 19, 2019

IT DEPENDS

When an economist is asked for his or her forecast for economic growth, the most correct but least satisfying answer is always, “It depends.” The outlook for economic growth depends on a multitude of variables, some of which economists forecast routinely as part of their jobs and some that either belong to other professions or are essentially unforecastable. Currently, the outlook for medium-term growth in the U.S. economy depends heavily on Federal Reserve monetary policy and on President Trump’s tariff policy. The former is something that economists forecast all the time. The latter is inherently unforecastable.

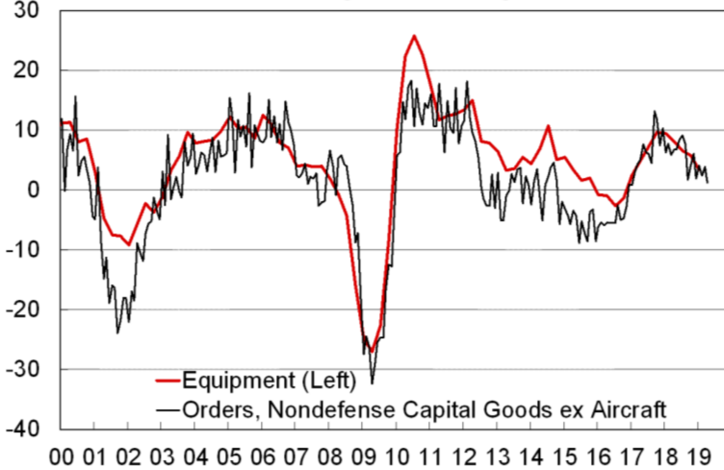


I think the Fed will cut its federal funds rate target by half a percentage point in the second half of 2019; a quarter point in the third quarter and another quarter point in the fourth quarter. A stubbornly weak housing market since early 2018, declines in industrial production in manufacturing in January, February, and April, a weak jobs report in May, inflation below the Fed’s 2% target, and (especially) an inverted yield curve suggest that the Fed erred in raising the funds rate in December and that it should cut rates this year. (A strong retail sales report for May reduced the urgency for a June rate cut.) Rate cuts usually boost economic growth and put upward pressure on inflation, but one should not expect quick results. Monetary policy works with “long and variable lags.” It affects growth with a lag of 6-18 months and inflation with a lag of 12-36 months. Rate cuts might boost stock prices this year, but they won’t boost economic growth until next year and might do little to help the Fed reach its inflation target before 2021.

One also shouldn’t expect a big boost to growth from rate cuts. Interest rates affect economic growth primarily through their impact on residential construction and spending on items that are related to home sales (e.g., paint, floor coverings, appliances, furniture and furnishings). Business investment, which accounts for most of the recent slowing in economic growth, is not very sensitive to interest rates. The housing sector has been especially weak during the current economic expansion, but this largely reflects supply constraints on labor, lumber, and land. Lower interest rates on mortgage loans won’t have their normal positive impact on housing unless something is done to ease these supply constraints.

While I believe the Fed went too far in hiking rates last year, I don’t believe that monetary policy is the main reason growth has slowed and I don’t believe it will be the key determinant of economic growth going forward. That distinction belongs to President Trump’s tariff policy and the uncertainty it has engendered. Since November 2017, President Trump has imposed tariffs on softwood lumber, washing machines, steel and aluminum, and $234 billion in imports from China. He has also threatened the cancellation of the North American Free Trade Agreement (until a new agreement, the USMCA, was negotiated) and tariffs on imports from Mexico and another $300 billion of imports from China. While there

is little evidence that tariffs have raised prices to consumers, they have reduced the profits of importers, which have absorbed much of the cost of the tariffs. U.S. corporate profits (in the National Income Accounts) declined slightly in the fourth quarter of 2018 and more significantly in the first quarter of 2019.



Lower profits tend to translate into weaker business investment in plant, equipment, and intellectual property products. Uncertainty about the future course of tariffs amplifies this impact. Uncertainty is the enemy of investment (and of stock prices). New orders for nondefense capital goods ex aircraft, the monthly series that economists use as a leading indicator for the quarterly data on business investment in equipment in Gross Domestic Product, peaked in July 2018 and have been trending downward since. (Tariffs were imposed on $34 billion in imports from China on July 6, 2018; tariffs on an additional $200 billion were announced on July 10 and imposed on August 23.) Investment in business equipment fell in the first quarter of 2019. It is likely to fall again in the second quarter, due to the impact of tariffs and to the cessation of shipments of Boeing 737-MAX aircraft in the aftermath of two crashes.

The outlook for investment and for U.S. economic growth in general depends on the resolution of the current trade dispute with China (and other disputes that might crop up). I recently lowered my forecast for the last three quarters of 2019 because tariffs on $200 billion of Chinese goods were raised from 10% to 25% on June 1. As I've discussed before, 25% tariffs are 6.25 times as harmful as 10% tariffs, not 2.5 times as bad. I now expect growth at or below the 2% rate that prevailed before President Trump's election. If tariffs are extended to another $300 billion of Chinese goods, growth will be even weaker. These tariffs might not cause a recession by themselves, but they'd slow growth to the point than any adverse shock could push the economy into recession. If, on the other hand, the United States and China were to reach a trade agreement that eliminated special tariffs on Chinese goods and protected the intellectual property of U.S. companies (and the USMCA were ratified), investment would reaccelerate, and growth would rise to 3% for a few quarters before settling into a long-term trend much stronger than the sub-2% rate assumed by the Congressional Budget Office and other pessimists who think of the 2010-2017 period as the new normal rather than the great aberration. I'm still optimistic that this best-case scenario will ultimately play out, but I now think it will take longer to get here than I previously assumed. I've pushed my forecast of 3% growth from the second half of 2019 to the first half of 2020. If President Trump and President Xi reach an agreement in late June, perhaps in response to a worsening Chinese economy, I might move that up a few months. If trade tensions escalate and tariffs are extended, I'll push the strength further into the future.

Even though uncertainty about tariffs hurts the economy, it is not unintentional. Creating uncertainty, even chaos, is part of the negotiating strategy outlined in President Trump's book, *The Art of the Deal*. (Niccolo Machiavelli advocated the same approach in 1513 in *The Prince*, a book the President has recommended in his own books.) If imposing and threatening tariffs helps President Trump get a better deal, especially on the protection of intellectual property, it's worth some short-term harm. Unfortunately, he loves his tariff hammer, and "if all you have is a hammer, everything looks like a nail."

I still believe that deregulation, corporate tax cuts, and a decline in oil prices from their 2011-2014 plateau are raising the potential growth rate of the U.S. economy to a level that is much higher than the CBO's 1.9% estimate, but stronger potential growth requires more investment, and investment has been put on hold until trade disputes are resolved and tariffs are reduced. Lower interest rates can offset some of the negative impact of tariffs – albeit not quickly – but they can't fully reverse it. We need a trade deal.

Copyright © 2019 Robert Fry Economics LLC. All rights reserved.
Distribution, reproduction or copying of this copyrighted work without express written permission of Robert Fry Economics LLC is prohibited.