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The Growth Outlook

Kathleen Stephansen, Independent Economist, New York, USA

Synopsis

Once the pro-cyclical effects of US fiscal policy will have run their course and monetary conditions will have tightened further, the US and thereby the global economy will be increasingly vulnerable to policy mistakes. The biggest risk is US trade policy.

Yesterday's tailwinds lead to tomorrow's headwinds

US growth is robust, with Q2:18 GDP advancing at an annual clip of 4.2%, following a 2.2% rise in Q1:18. In the tenth year of the business cycle, the economy is likely to reach a strong 3% growth rate in the second half of the year, leaving growth for the full year also at around 3%. This performance follows average growth of 2.2% between 2010 and 2017. How sustainable is this stronger trend? In an attempt to answer this question, we examine the main drivers of growth, the tailwinds and headwinds of the cycle against deeper structural changes and major risks.

A confluence of tailwinds has contributed to the Q2 4%+ growth rate, of which policy is the main driver. The fiscal stimulus of tax cuts and spending, supportive financial conditions emanating from a still accommodative monetary policy, ensuing rising risk appetite, positive wealth effect from elevated equity prices and rising housing valuations have brought strong advances in consumer spending and employment, a pick-up in investment spending, and multi-year highs in consumer and business sentiment. The net result is an economy growing well above its potential growth rate of about 1.5–2.0%, and thereby exerting pressure on its resources, most notably labour. A 3.7% unemployment rate is well below the 4.5% perceived 'neutral rate' (NAIRU or 'the non-accelerating inflation rate of unemployment').

Looking ahead, headwinds to the current strong growth path will emerge, shifting the balance of risks to the downside:

- The fiscal stimulus impact, which affects mainly the demand side of the economy, will fade over the next two years, leaving large budget deficits, rising financing needs and less effective stimulus power for the next economic slowdown.
- Monetary policy will continue on the path of gradual increases in real interest rates and exert pressure on financial conditions. In light of the cyclical strength, the risk is for an overshoot in rates followed by a sharper-than-intended slowdown in growth.
- The interest rate differential with other economies, as foreign central banks lag behind the Federal Reserve in normalising their monetary policies, may push up the USD, thereby eroding US competitiveness and export growth. This trend is already taking place. Despite their small rebound in September, exports posted a decline in Q3 relative to the prior quarter.

At best, economic growth will slow over the next two years from the 2018 peak to 2–2.5% in 2019 and to the economy's potential growth of 1.5–2.0% in 2020. Such a slowdown leaves the economy more vulnerable to a policy mistake.

While boosting short-term economic growth, current fiscal policies fall short of addressing the longer-run structural challenges, which largely affect the supply-side of the economy and the underlying growth of productive capacity:

- Demographics, such as aging of the population and immigration, limit labour input growth.
- New technologies will affect business models (e.g., asset-light) and the type and supply of future jobs, while the government's share of R&D to its total share of assets has barely changed over the past 19 years, from 24% to 25%.
- A potential shift in value chains may slow down global growth which has already become less synchronised. Growth in global trade volume has slowed to below global real growth, the effect of which is weaker positive second round effects on growth from trade. The more uncertain geopolitical outlook for emerging markets, China, and Brexit reinforces this dynamic.

Trade policy is a major risk in our view. Already, global GDP growth forecasts for next year are being adjusted down. Both the OECD and IMF call for downside risks to growth, citing the global trade war. The CEO economic outlook survey has come off its multi-year high and business leaders express concern about threats to global value chains from tariffs, while market volatility rose considerably in October.

In a narrow sense, trade does not represent a big portion of US GDP: The total 2017 GDP export component is 12%, the import component is 15%, while the share of imports of goods from China amounts to 3%. As of August, annual tariff revenues totalled $22 billion, still a relatively small amount. An additional 10% tariff on $200 billion of imports from China brings the total to $42 billion. An additional 25% on $250 billion imports brings the total to $63 billion in tariff revenues. If the US goes ahead next year with this threat, it will have gone from the lowest weighted tariff imposed country in the G7 to the highest.

It is difficult to model tariff-led trade shocks. Part of the difficulty is measuring the lag between the imposition of a tariff and its effect on the real economy, business and consumer confidence, capital flows and second round trade effects and ensuing exchange rate volatility (the exchange rate effects is very insensitive in the major global macro models). The adjustment of logistics and supply chains, as many traded commodities are fungible, are also difficult to assess. Then there is the uncertainty associated with potential retaliation from the major trading partners. Consequently, estimates on tariff effects vary greatly. In the US, consensus calls for a tariff-led GDP shortfall of 0.2–0.3% in 2019 and 2020. In Europe, projections are direr: In a recent research piece the ECB estimates that 10% tariffs on the US would reduce US economic activity by 2% during the first year of tariff imposition. A scenario in which the US imposes a 10% tariff on all imports and its trading partners retaliate with a 10% tariff on their US imports would favour China, as Chinese exporters would gain market share.

Beyond the short-term growth effects, we view any further escalation of trade war as a serious risk to the global and US outlook. For a quick reminder of the recent escalation, we cite *Trump's Trade War Timeline: An Up-to-Date Guide*, by Chad Brown and Melina Kolb, at the Peterson Institute for International Economics (24 September 2018):

- Battle #1: Solar panel and washing machine imports injure US industries – started October 2017;
- Battle #2: Steel and aluminium as national security threats – started April 2018;
- Battle #3: Unfair trade practices for technology, intellectual property – started March 2018;
- Battle #4: Autos as national security threat – started May 2018.

Against this crescendo, market relief emerged with the agreement on NAFTA, renamed USMCA. It leaves the NAFTA structure largely intact. The major changes are higher rules of origin and higher wage requirements for the auto sector and a slightly greater US access to the Canadian dairy market. That being said, the US's posturing during the negotiations and over trade policy in general signals a more fundamental change in the post-WWII international trade framework and a shift towards US isolationism.

US isolationism is not in the US's long-term interests. It encourages US allies to diversify away from the US and may prompt other countries to form international agreements without the US. As an example, Europe, Russia and China are already working on a system to make payments to Iran. Disruptive dynamics of change tend to bring uncertainty and volatility, an environment that is not conducive for longer-run investment decisions and growth prospects.

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