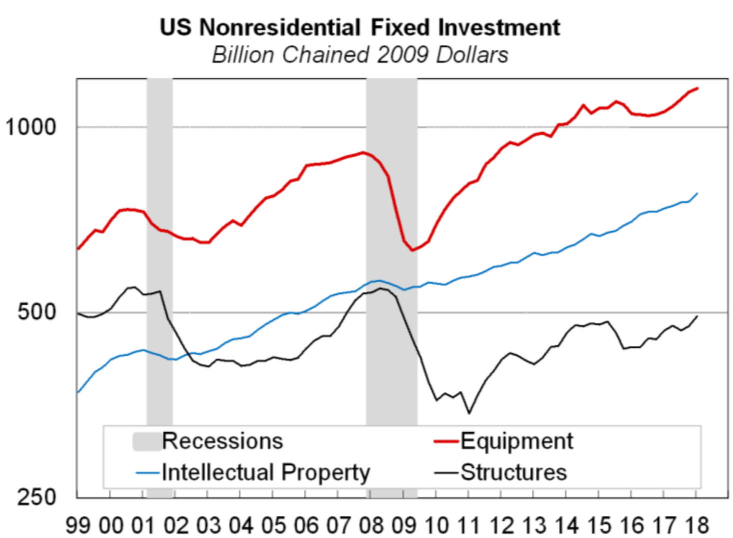
Current Economic Conditions

Robert C. Fry, Jr., Ph.D. July 23, 2018

STILL NOT FIRING ON ALL CYLINDERS

The U.S. economy grew strongly in the second quarter. The Commerce Department is likely to report later this month that annualized growth of real Gross Domestic Product exceeded 4% for the first time since the third quarter of 2014. Growth of 4% or more would mean that real GDP has grown at a 3% rate over the last five quarters, a clear upshift from the 2% growth rate of the prior 25 quarters. Strength is widespread, with consumer spending, business investment, and federal government consumption and investment all up strongly in the second quarter. However, residential construction and manufacturing continue to disappoint. If growth accelerates in these sectors, U.S. economic growth will remain strong over the next several quarters. If it doesn't, growth will be weaker, but the expansion will last longer.

Retail sales suggest strong consumer spending on goods in the second quarter. Retail sales rose 0.5% in June, and May's already-strong 0.8% increase was revised up to 1.3%. Sales have risen at an 8.9% annual rate over the last four months. Consumers are apparently spending some of the increase in take-home pay that resulted from cuts in individual income tax rates. With the economy close to full resource utilization, this boost to demand was ill-timed, but cuts in individual taxes were politically necessary to enable Congress to enact a much timelier supply-side-focused cut in corporate taxes.

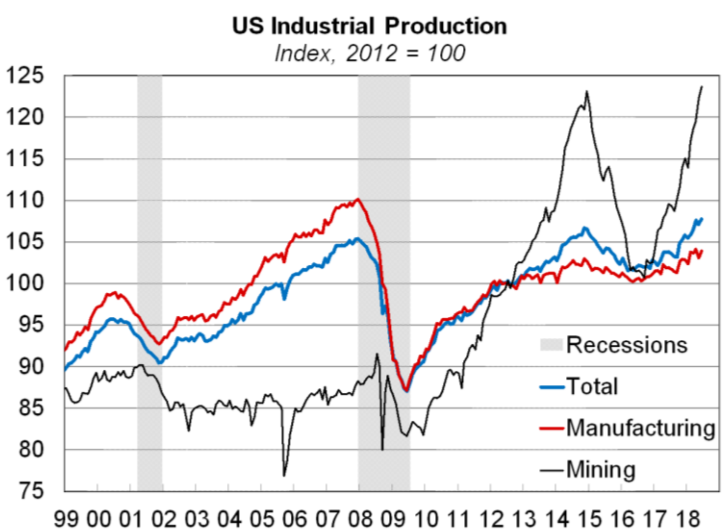


Business investment is also growing rapidly. Shipments of nondefense capital goods excluding aircraft, a monthly proxy for investment in equipment, were up 6.3% year-over-year in May. This is solid growth, but faster growth is necessary if the economy is to fully realize the benefits of tax reform. Investment in intellectual property products (e.g., software) and in nonresidential structures surged in the first quarter and likely remained strong in the second quarter. A shift to software from equipment likely reflects modernization of the economy. Investment in nonresidential structures includes drilling of oil and gas wells; drilling has continued to rise strongly in response to the rebound in oil prices from their January 2016 lows.

Investment might be boosting the productive capacity of the economy and thereby keeping pressure off inflation. Financial markets were spooked because the Consumer Price Index was up 2.9% year-over-year in June, the highest since early 2012, but this reflects rapid inflation (4.1% annual rate) from July 2017 to January 2018. The CPI has risen at just a 1.6% annual rate over the last five months. The "core" CPI, which excludes food and energy prices, was up 2.2% year-over-year in June, but again this reflects higher inflation (2.6% annual rate) from July 2017 to January 2018 and lower inflation (1.9% rate) over the last five months. Unless monthly increases in the CPI pick up in the next few months, year-over-year inflation will peak in July and then decline over the next six months. The Fed's preferred measure of inflation was above its 2% target in May (core was right on target), but it too could decline after peaking in July.

While most components of real GDP are reasonably strong, one is notably weak. Residential construction was lower in the first quarter of 2018 than it was a year earlier, and it probably rose little, if at all, in the second quarter. Housing starts, which hit an 11-year high in May, plummeted in June. (Good weather in May presumably allowed builders to start houses a month earlier than normal.) For the second quarter as a whole, housing starts came in at a 1.262 million seasonally adjusted annual rate, down from 1.317 million in the first quarter. Despite the one-quarter decline, housing starts continue to trend upwards, but slowly. As I've discussed repeatedly, homebuilding is being constrained by higher prices for building materials, difficulties in finding construction workers, limited availability of building lots, and local zoning and permitting restrictions that raise the cost of building (and limit the availability of lots). Because of these supply constraints, homebuilding is not keeping up with growth in the adult population, i.e., supply is not keeping up with demand. In the short run, this results in higher house prices. Longer term, pent-up demand for housing will prevent (or at least cushion) any downturn in home construction over the next several years. Historically, most U.S. recessions have had their genesis in the impact of rising interest rates on housing starts and home sales. The U.S. economy is unlikely to have a serious recession without a big downturn in housing starts, and it's hard to have a housing bust without first having a housing boom.

While industrial production in manufacturing (published by the Federal Reserve) is not a component of GDP (published by the Commerce Department), data on industrial production suggest that the U.S. manufacturing sector is underperforming the overall economy. Industrial production in manufacturing was up 0.8% in June, but that followed a 1.0% decline in May. Production was up just 1.9% year-over-year. (Total industrial production was up 3.8% because of a 12.9% increase in mining production!) A few industries (wood products, nonmetallic mineral products, fabricated metal products, computers and electronic products) were up by more than 5%, but several others were down. But while the weak recovery in home building is clearly real, the apparent weakness in manufacturing might reflect problems with the data. Some of the Fed's industrial production indexes are based on actual data on physical production, but many others are based on data on hours worked in an industry and an estimate (extrapolation) of productivity growth. If productivity growth has accelerated and the Fed doesn't realize it, estimates of industrial production in these industries are too low. (Eventually, the "inferred" industrial production indexes are benchmarked to data on actual production. As a result, IP data that are more than a few years old are very good, but those from the last two or three years should be viewed as preliminary.) Data from purchasing managers' indexes (from ISM and IHS Markit) and surveys from the Federal Reserve Banks of Philadelphia and New York suggest that manufacturing output is growing much faster than industrial production data indicate.



Concerns that President Trump's tariffs on steel, aluminum, and a variety of goods from China – and retaliatory tariffs from other countries – will offset the economic benefits of tax reform and deregulation are valid but exaggerated. Tariffs have adverse macroeconomic effects, raising measured inflation and reducing **aggregate** standards of living, but their main impact is distributional. Tariffs will result in a few big winners (e.g., those who make steel and aluminum), a few big losers (e.g., those who use steel and aluminum), and lots of small losers. That's the opposite of free trade, which conveys small benefits on the vast majority of people but imposes huge costs on a few trade-sensitive industries and their workers. Barring an escalating trade war, with much higher tariffs than currently envisioned, tariffs are unlikely to have a big negative impact on near-term economic growth. However, to the extent they raise measured inflation (and clog the relief valve that allows trade to hold down inflation when domestic markets are tight), tariffs could push the Fed to raise interest rates faster and end the economic expansion sooner.