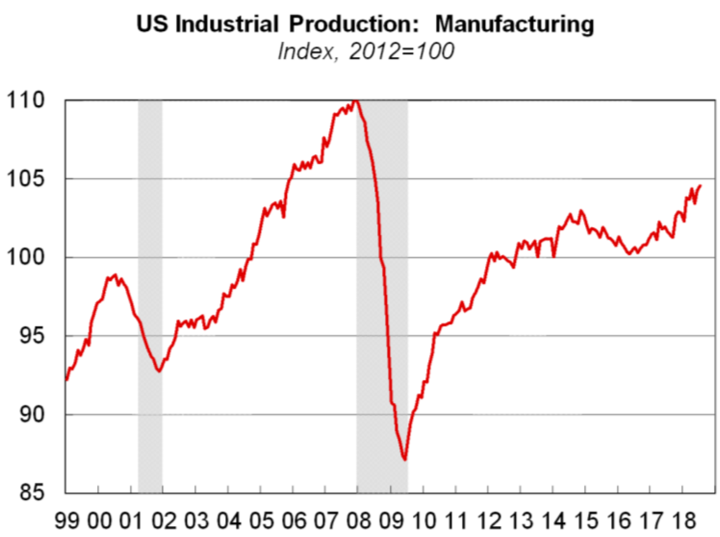
Current Economic Conditions

Robert C. Fry, Jr., Ph.D. August 17, 2018

GREAT TIMING TRUMPS BAD POLICY

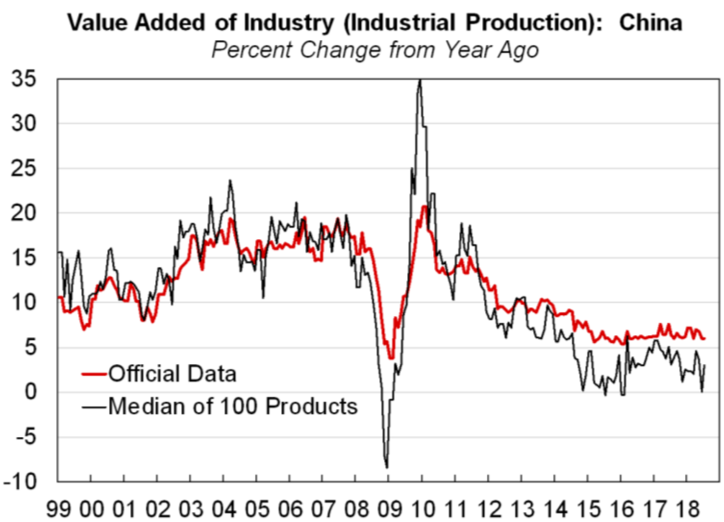
Like most economists, I'm a free trader. I think Americans, in aggregate, are better off when tariffs are low, and I believe that is true no matter what our trading partners do. President Trump apparently disagrees with me. Sometimes he says he wants free trade, but only if it's reciprocal. At other times, including in an August 15 tweet, he actually says he likes tariffs. Given this disagreement, you would think I would be very concerned about President Trump's trade policy. I do believe that the tariffs proposed and implemented by President Trump, should they stay in effect for more than a brief period, would reduce economic growth (a little), raise inflation (a little more), and make most Americans worse off, **but** I'm optimistic that the higher Trump tariffs will be very short-lived and that they will give way to lower tariffs before significant damage is done to the U.S. economy.

Recent op-eds in the Wall Street Journal have discussed two different scenarios for a quick repeal of the Trump tariffs. Roger Altman, a Democrat, argues that if tariffs hurt economic growth, U.S. stock prices will fall significantly. That would force "the impatient American President", who has "tied his political brand" to rising markets, "to declare victory, call off the war, and limit the damage." Donald Luskin, a Republican, compares the current trade war with China to a fraternity drinking game and President Reagan's arms race with the Soviet Union in the 1980s and argues that Chinese President Xi Jinping will have to "cut the inevitable deal." Either way, tariffs come back down before they do serious damage.



I think the second scenario is more likely. That's because President Trump's tariff threats have been issued while U.S. growth is strong and the Chinese and Turkish economies – the two main targets of the Trump tariffs – are getting wobbly. Industrial production in U.S. manufacturing has risen at a 3.9% annual rate since last September, the month the Trump Administration, House Ways and Means Committee and Senate Finance Committee unveiled the Unified Framework for Tax Reform that led to passage of the Tax Cut and Jobs Act. Production had declined 2.7% from November 2014 to May 2016 before an initially-tepid recovery. Real Gross Domestic Product rose at a 4.1% annual rate in the second quarter, the strongest growth since 2014. The Federal Reserve Bank of Atlanta's GDPNow "nowcast" for third-quarter growth currently stands at 4.3% after a strong retail sales report for July. The National Federation of Independent Business's Small Business Optimism Index rose in July to a level that has been exceeded only once in the history of the index, in 1983. The U.S. economy currently has enough momentum that it can withstand the headwinds from the Trump tariffs and any retaliatory tariffs imposed by other countries and continue to grow.

Other countries, particularly China and Turkey, aren't doing as well. Everyone knows now that the Turkish economy is a mess, but it was a mess **before** President Trump imposed tariffs after Turkey reneged on a deal to release an American pastor. What people don't seem to know is that the Chinese economy – the primary target of President Trump's trade policy – is also in trouble, something you would never glean from the Chinese economic data that most people track. According to official data, Chinese real GDP was up 6.7% year-over-year in the second quarter. Year-over-year GDP growth has been between 6.7% and 7.0% for 14 straight quarters. No economic time series in the world is really that stable. Year-over-year growth in Value of Added of Industry, China's measure of industrial production, was at 6.0% in July. Growth has fallen to 6.0% seven times in the last 27 months, but has never gone lower, suggesting that the National Bureau of Statistics is not allowed to report a growth rate below 6%. My preferred measure for Chinese industrial production, the median year-over-year growth rate for the 100 industrial products for which China reports physical production, fell to just 0.1% in June. It has been lower in only a few months, in 2008-09 and 2015-16, since data started in 1997. It rose to 3.0% in July, off a weak prior-year comparison.



My preferred measure of Chinese growth is consistent with the cautionary messages being sent by Chinese stock prices and the value of the Chinese yuan. Prices on the Shanghai stock exchange are down 25% from their all-time high. (U.S. stock prices, as measured by the S&P500, are down just 0.2%.) The yuan is nearing a 10-year low versus the U.S. dollar. Well-informed Chinese investors, who know the Chinese economy isn't doing well, are trying to get their money out of China. China has devalued its currency in the past to boost exports and stimulate growth but is trying to dampen the current decline. If China were to allow the yuan to fall too quickly, capital outflows would accelerate, and the Trump Administration would accuse China of currency manipulation and use that to justify even higher tariffs.

In both Turkey and China, autocratic leaders have turned their backs on what had worked for their countries, secular democracy in Turkey and a growing reliance on markets in China. Both have used debt-financed spending to boost their economies. Neither understands the link between freedom and economic performance. In 2010, I went to China with a delegation of U.S. business economists. We met with Chinese economists and bureaucrats in Beijing and Shanghai. Many of them mouthed respect for Mao Zedong, but you could tell they didn't mean it. They expressed genuine gratitude towards Deng Xiaoping, who started the Chinese economic miracle in 1978. Unfortunately for the Chinese people and the Chinese economy, President Xi seems to have chosen Mao as his role model, rather than Deng.

President Trump says some crazy things about trade. Perhaps he simply doesn't know what he's talking about. However, there are two other possibilities. Niccolo Machiavelli, in *The Prince*, and Donald Trump himself, in *The Art of the Deal*, have advocated creating the impression that you're crazy to improve your bargaining position and "get a better deal." If Trump's threats (and tweets) about trade were to induce China to lower its trade barriers, U.S. miners, manufacturers, and farmers would benefit, though most of the benefits from lower Chinese trade barriers would accrue to Chinese consumers. U.S. companies would benefit more if China agreed to eliminate forced technology transfers and the theft of intellectual property. But maybe it's just about politics. President Trump's approval rating has risen significantly since he started raising tariffs. If he were to get President Xi to lower Chinese tariffs and non-tariff trade barriers (or President Erdogan to release Pastor Brunson), his approval rating would rise further, even if the economic benefits were trivial. (The economic benefits of a renegotiated and extended North American Free Trade Agreement would be much larger.) The odds of a trade deal that helps the United States economically or helps President Trump politically are elevated now because the U.S. economy is strong and the Chinese and Turkish economies are not. Great timing could "trump" an otherwise bad policy.