Current Economic Conditions

Robert C. Fry, Jr., Ph.D.

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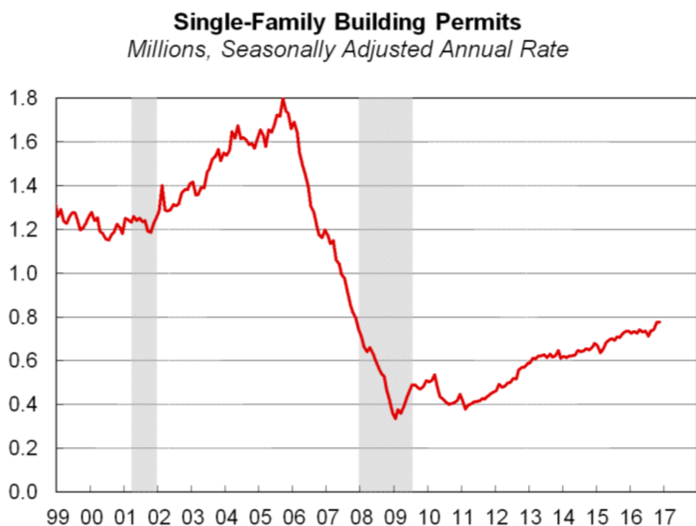
GROWTH CONTINUES TO PICK UP

Despite weaker-than-expected reports for retail sales and industrial production in November, I've raised my forecast for growth in real Gross Domestic Product in both 2017 and 2018. The downside is that I've also raised my forecasts for inflation and interest rates. The policy proposals of President-elect Trump and Congressional Republicans account for the upgrade to the growth outlook for 2018 and the higher inflation and interest rate forecasts. The upgrade to the 2017 growth forecast is due mostly to a pickup in growth that was already underway before Election Day.

Real GDP grew at an upwardly-revised 3.2% annual rate in the third quarter. While much of the growth was due to a one-time surge in soybean exports, the Federal Reserve Bank of Atlanta's GDPNow "nowcast", an estimate based on high-frequency data available before the official GDP report, is pointing to a still-solid 2.6% growth rate in the fourth quarter. Retail sales (excluding motor vehicles) rose just 0.2% in November, but that came after increases of 0.8% and 0.6% in September and October. Light vehicles sold at a 17.9 million seasonally adjusted annual rate for a second straight month in November; sales are staying closer to last fall's cyclical highs than most forecasters expected. Historically, strong vehicle sales have been tied to high levels of consumer confidence. The University of Michigan's Consumer Sentiment Index, which surged in November (both before and after the election) rose in early December to its highest reading since January 2015 and its second highest reading since 2004. Building permits for single-family homes, an important leading indicator, rose in November to their highest level in nine years.

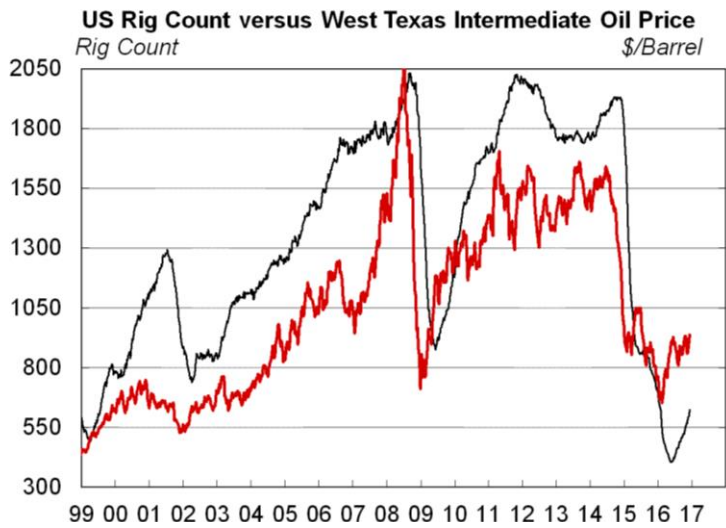


The nascent and expected pickup, which will show up in faster annual growth in 2017, is the result of an inventory rebuild after a five-quarter inventory adjustment, the end of a decline in oil and gas drilling that pulled down investment in nonresidential structures, the resumption of growth in residential construction, and an improvement in growth prospects abroad. Growth has firmed in China in 2016 after a sharper-than-reported deceleration over the previous six years. Economies are improving in Europe and Japan, and Brazil and Russia may have hit bottom. The global composite PMI (purchasing managers index) is up significantly since earlier this year. China's PMI is at its highest level since early 2013, and Chinese motor vehicle sales have surged to record highs. Chinese imports, in yuan, were up 13% year-over-year in November, the fastest growth in almost four years. German manufacturing orders and retail sales have surged in recent months. French business sentiment, historically a leading indicator of industrial production in European Union manufacturing, rose in November to its highest level since 2011.

Faster growth in 2017 can come primarily from increased labor input. Even though the headline unemployment rate fell to 4.6% in November, suggesting that the economy is at full employment, the U-6

unemployment rate, at 9.3%, suggests that labor input can be increased by shifting part-time workers to full-time work and by pulling the discouraged who have stopped looking for work back into the labor force. But as we move into 2018 and beyond, faster growth must come mostly from increased productivity growth rather than from increased labor input. In the long run, productivity growth can be boosted by education and training that improves the quality of the labor force, but in the short run, productivity growth comes mainly from boosting investment in plant and equipment – giving workers more and better capital to work with – and from shifting workers to higher-productivity tasks. These are the areas where policies are most likely to contribute to faster growth. Allowing the immediate expensing of investment will remove a disincentive to invest inherent in the current tax system. Ending or lessening the U.S. taxation of the foreign profits of U.S. corporations will lead to the repatriation of billions of dollars of foreign earnings, some of which will be used to fund investment in the United States. Deregulation will boost productivity by shifting workers to higher-productivity work. Hours spent complying with regulations rather than on developing, making, and selling products increase the denominator in productivity (output divided by hours worked), but add nothing to the numerator. Less time spent complying with overly complicated tax and regulatory regimes means higher productivity.

Oil prices, which have impeded growth for more than a decade, are likely to be supportive of growth over the next several years. High oil prices reduced the discretionary income of consumers until prices collapsed in mid-2014. The subsequent decline in drilling activity then offset the benefits of cheaper oil to consumers. Oil prices have now rebounded into a sweet spot that allows drilling activity to resume without hurting consumer spending. The jump in oil prices in response to this month's OPEC/non-OPEC agreement to limit output will further boost drilling activity. This will keep prices from rising very far; and this effective cap on oil prices could be a permanent one. An energy economist told me last month that improvements in drilling technology mean that the world might reach peak oil **demand** before it reaches peak oil **supply** and that it no longer makes sense to treat oil as a depletable resource when forecasting prices. This is great news for economic growth, but not for alternative fuels and bio-based materials.



I have boosted my U.S. GDP forecast for 2017 and 2018, but I have not yet raised my forecast for industrial production in manufacturing. I think global industrial production will pick up, due to inventory restocking and faster overall growth, but the strength of the dollar means that much of that increase will occur outside the United States. If the dollar starts declining – a frequent if counterintuitive reaction to Federal Reserve rate hikes – I will boost my forecast for industrial production in U.S. manufacturing.

The downside to faster growth in a low-unemployment economy and to President-elect Trump's trade and immigration proposals is higher inflation. I've boosted my inflation forecast for 2018 by a few tenths of a percent, putting it above the Fed's 2% target. But I expect the Fed to raise interest rates fast enough to bring inflation back to target. Higher rates will ultimately bring growth back down.

I deliberately use the term "picking up" to describe the acceleration in U.S. economic growth, not the stronger term "taking off." I don't expect annual GDP growth to exceed 3% in 2017 or 2018 – although it's possible in 2018 – and I expect growth to slow in 2019. To get above-3% growth in 2018 or to sustain above-2% growth beyond 2018 requires not just that the aforementioned tax and regulatory policies are implemented, but also that businesses react to these policies by increasing investment in plant and equipment and by shifting workers from tax and regulatory compliance to making and selling stuff.

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