Current Economic Conditions

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REST OF WORLD COULD LIFT U.S. GROWTH

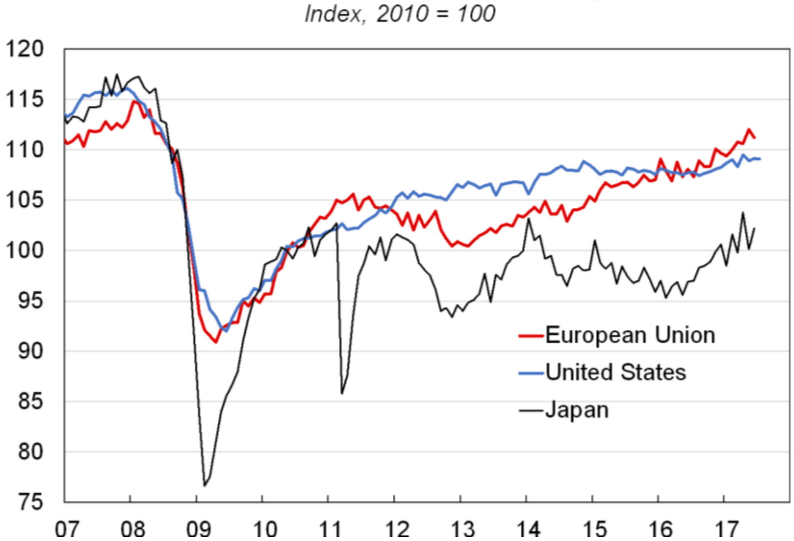
For much of the economic expansion that began in mid-2009, slow growth in the rest of the world has held back growth in the United States. Europe fell back into recession in 2011 and 2012, long before it had fully recovered from the 2008-2009 global recession. Japan has suffered two recessions since the global recession ended and was in recession for most of the 2011-2015 period. Official aggregate data show a gradual deceleration in China from 2010 through 2016, but underlying detail show a sharp downshift in 2014, leaving actual growth much slower than reported growth in 2015.

Recessions in Europe and Japan and slower growth in China, combined with a very strong dollar, reduced demand for U.S. exports, slowing growth in real Gross Domestic Product and causing the trade deficit to swell. Real (inflation-adjusted) exports of goods and services declined from the fourth quarter of 2014 through the first quarter of 2016, and the real net-export deficit grew by more than 71% from the fourth quarter of 2013 to the fourth quarter of 2016. Weak demand for U.S. exports is partly responsible for the 1.3% decline in industrial production in U.S. manufacturing from November 2014 to August 2016.

Economic activity turned up in Europe in early 2013; industrial production in European Union manufacturing has grown at a 2.4% annual rate since February 2013, much faster than the 0.5% growth rate in the United States over the same period. Year-over-year growth in real GDP has been faster in the EU than in the United States for seven straight quarters, despite much slower population growth in Europe. In per capita terms, growth has been considerably faster in Europe.

Industrial Production, Manufacturing

Index, 2010 = 100



The upturn in Europe wasn't enough to offset the impact of recessions in Japan and South America and the slowdown in China and so did little to boost U.S. exports. But growth in China began to rebound in early 2016. China's official measure of industrial production shows only a moderate acceleration, from 5.4% year-over-year growth in the first two months of 2016 to 7.6% growth in June 2017, but underlying detail show a much larger acceleration. The median year-over-year growth rate for the 100 industrial products for which production is reported rose from below zero in the first two months of 2016 to 5.1% in June 2017. Motor vehicles sales in China have been especially strong; they rose to a 29.9 million seasonally adjusted annual rate in July, much higher than the 16.7 million annual rate in the United States. The International Monetary Fund has revised its forecast for real GDP growth in China in 2017 from 6.2% to 6.7%. Industrial production in Japanese manufacturing turned up simultaneously with the Chinese rebound and rose 7.2% from February 2016 to June 2017. Real GDP rose at a 4.0% annual rate in the second quarter, the best in two years, and was up 2.1% year-over-year, matching U.S. growth despite a shrinking Japanese population.

The acceleration of growth in Japan and the continuation of growth in Europe after a brief slowdown in mid-2014 are at least partly the result of the sharp decline in oil prices that began at that time. The U.S. economy hasn't benefitted as much because oil production is much greater in the United States, and declines in oil drilling and related production of metals and machinery offset the positive impact of lower oil prices on oil consumers until drilling turned up in late 2016. But faster growth abroad could herald faster growth in the United States, due both to the long-awaited benefits of lower oil prices and to increased demand for U.S. exports. Real exports have grown in four of the last five quarters, and the real net export deficit has shrunk for two quarters in a row. Industrial production in U.S. manufacturing has risen 1.6% since August 2016. The decline in the trade-weighted value of the U.S. dollar from the 14-year peak reached in December will further boost U.S. exports, shrink the trade deficit, and help U.S, manufacturing, but because the value of the dollar affects trade with a considerable lag, that impact hasn't been felt yet.

Recent data suggest that U.S. economic growth is accelerating. Payroll employment grew by 231,000 in June and another 209,000 in July. Retail sales rose a better-than-expected 0.6% in July, and data for May and June were revised up. Nominal and real retail sales were both up 4.2% year-over-year in July. Federal and state government tax receipts have accelerated in recent months, indicating that economic activity is accelerating. Industrial production in U.S. manufacturing fell 0.1% in July, but excluding motor vehicles and parts was up 0.2%. On the weak side, housing starts continue to stagnate.

The global economy is experiencing a synchronous global expansion. Although growth is not particularly strong, most economies are growing. The Organization for Economic Cooperation and Development's global leading indicator points to continued growth. The expansion is likely to continue until interest rates rise sharply in response to higher-than-expected inflation or shrinkage of central banks' bond portfolios. Other possible expansion-enders include an oil price shock, the bursting of an asset bubble, and a hard landing in China. While China has boosted its growth rate since early 2016, it has done so by delaying its transition to consumption-led growth and returning to its traditional model of export- and investment-led growth. Investment has boosted growth in the short run, but has left China with an enormous government debt. When the IMF boosted its forecast for Chinese GDP growth in 2017, it also warned about the heavy debt burden. At some point in the next few years, perhaps in the next few months, the combination of debt and demographics (a shrinking working-age population) will cause a further downshift in Chinese economic growth. China will be tempted to counter the downshift by devaluing its currency to boost its exports, but this is likely to meet strong resistance from the Trump Administration. (Year-over-year growth in industrial production, whether measured by official data or the industrial-product data I follow, declined sharply in July, but this could be a one-month blip rather than the beginning of the expected downshift.)

So far, U.S. economic growth has accelerated little, if at all, in response to the decline in oil prices that began in mid-2014. Not only did a decline in drilling activity offset the positive impact of lower oil prices on motor vehicle sales and consumer spending; recessions and economic slowdowns abroad and a much-too-strong U.S. dollar hurt U.S. exporters, particularly manufacturers. But global growth started to pick up in early 2016, and the global economy is now experiencing a synchronous global expansion. Better growth abroad is boosting U.S. exports, and that boost will soon be amplified by a declining dollar. That will lift economic growth and manufacturing output, offsetting the recent downshift in motor vehicle production, but the U.S. economy won't shift into high gear without faster growth in housing starts.