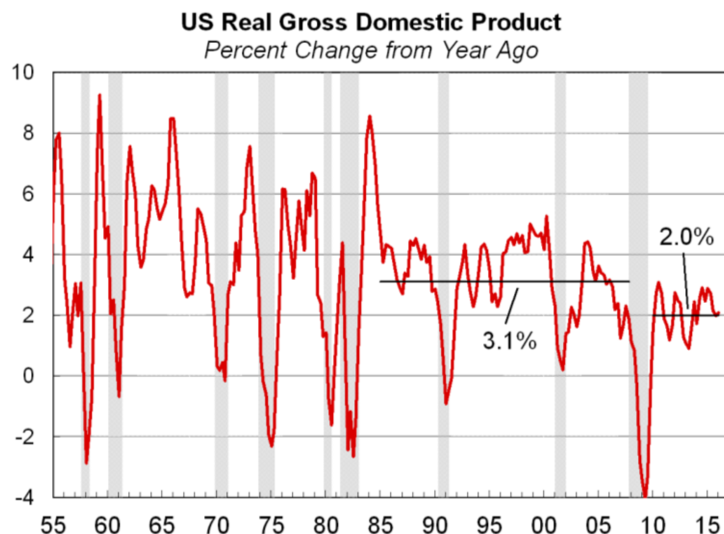
Current Economic Conditions

Robert C. Fry, Jr., Ph.D. July 21, 2016

THE NOT-SO-GREAT MODERATION

In 2002, economists James Stock and Mark Watson coined the phrase "great moderation" to describe the reduction in the volatility of U.S. business-cycle fluctuations that began in the mid-1980s. Ben Bernanke later popularized the term in a 2004 speech. From 1985 through 2007, U.S. economic growth fluctuated within a relatively narrow range, and there were only two (mild) recessions. The great moderation ended spectacularly in the "great recession" of 2008 and 2009, but since the initial rebound from recession ended in mid-2010, the volatility of U.S. economic growth has collapsed again, with growth fluctuating within an even narrower range. The difference is that the new (stable) rate of growth is much slower than before the recession. I call the more recent period of stability the "**not-so-great** moderation."



Year-over-year growth in U.S. real gross domestic product has remained between 0.9% and 3.1% for more than six years. The monthly increase in nonfarm payroll employment has been between 11,000 and 346,000 in every month since October 2010 and has been between 70,000 and 311,000 in 63 of the last 69 months. (The 12-month moving average of the monthly increase has been between 162,000 and 262,000 every month since September 2011.) The inflation rate, as measured by the year-over-year change in the personal consumption expenditures price index, excluding food and energy, has been between 1.3% and 1.7% for an amazing 42 straight months. The stability of the economy has been striking. Unfortunately, growth has been disappointingly slow. Real GDP has grown at just a 2.0% annual rate since the second quarter of 2010. Over the 1985-2007 period, real GDP grew at a 3.1% rate.

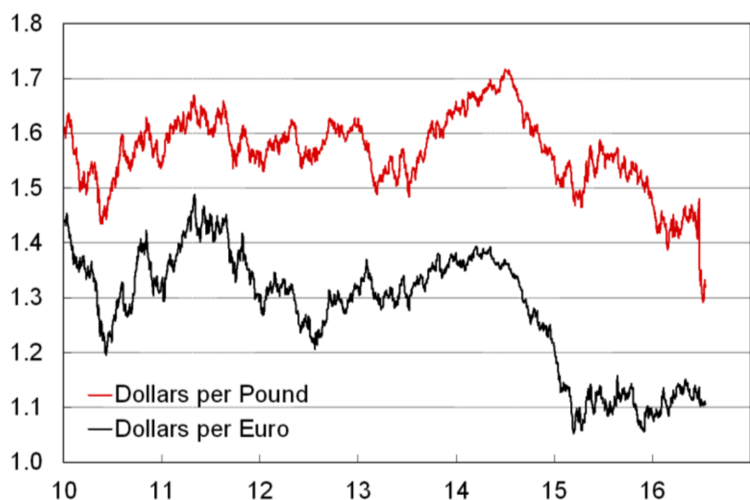
June data for employment, retail sales, industrial production, and housing starts were surprisingly strong. Payrolls grew by 287,000, the biggest increase since last October. Retail sales rose 0.6% in June and have risen 2% over the last three months. Industrial production in U.S. manufacturing rose 0.4%, its biggest increase since last July. Perhaps the economy is accelerating a little in response to low oil prices and rising wages, but most of the apparent acceleration (and the apparent weakness that preceded it) probably reflects difficulties in adjusting the data for normal cyclical fluctuations. Thus, June's strength just makes up for weakness in prior months. Growth in real GDP might rise from the 2% rate of the last six years, but any increase is likely to be small and temporary. Growth could perhaps rise to 2.5% through 2017, but given the slowdown in the rate of growth of the adult population, it won't go much higher than that or remain there for very long unless something big happens.

What could get the economy out of its 2% rut and into a higher groove? With the possible exception of infrastructure spending, conventional fiscal and monetary policy has been exhausted. Given the size of the federal debt, large tax cuts or spending increases would be fiscally irresponsible. Low interest rates,

because they force people to save more to fund their retirements, have become counter-productive, and negative rates would be extremely harmful. Tax reform – particularly a cut in the corporate tax rate and a transition to a territorial tax system – and regulatory simplification are likely the only ways to significantly boost growth in the United Sates. (Notice that I said tax **reform**, not tax **cuts**. Advocating net tax cuts without advocating **specific** spending cuts to pay for them is fiscal fraud. Ditto for advocating spending increases without advocating **specific** tax increases to pay for them.) While there are good reasons for upgrading America's infrastructure (roads, bridges, railroads, airports, etc.), one shouldn't expect much of a boost from infrastructure spending unless it's paired with the repeal of prevailing-wage legislation. Decisions about infrastructure should ultimately be based on microeconomic (cost/benefit) analysis, not on macroeconomic ideology; the repeal of prevailing-wage legislation would significantly increase the number of infrastructure projects with benefits that exceed their costs.

I usually try not to get too political in this publication, and I'm not going to endorse a candidate in this month's newsletter, but I think it's fair to characterize this year's Presidential election as a choice between sticking with the status quo and taking a chance. One candidate promises more of the same – meaning the not-so-great moderation continues – while the other offers the possibility of an upside economic breakout, but with plenty of risk and uncertainty. The way you vote will likely reflect how risk-averse you are and how dissatisfied you are with the status quo.

I'd like to close with a few comments on the Brexit vote and exchange rates. I believe the United Kingdom's vote to leave the European Union, which was largely driven by immigration concerns, not by economics, will have a negative impact on economic growth in both the United Kingdom and the rest of the EU, but that the impact will be extremely small if the leaders of the UK, the EU, and the United States put negotiating the necessary trade deals at the top of their to-do lists instead of cutting off their noses to spite their faces because they feel like jilted lovers or sending long-time allies to "the end of the queue." "Leaders" who argue that the Brexit vote will be a major negative are implying that they, their successors, or their counterparts in other countries are too incompetent, too petty, or too lazy to do what needs to be done. The impact of Brexit on the U.S. economy will be trivial unless it strengthens the dollar versus the Euro (as it has against the pound).



I spent some time in Europe earlier this month. Based on the prices I saw there, I believe that the Euro is significantly undervalued versus the U.S. dollar. I also believe the European Central Bank has persistently bad-mouthed the Eurozone economy to justify its negative interest rate policy (NIRP) and that that policy is best understood as an effort to keep the Euro weak and thereby boost the competitiveness of European companies. The Federal Reserve should be pushing back against NIRP, and the U.S. Treasury Department should be pressuring the ECB to allow the Euro to strengthen. The conventional wisdom is that currency manipulation is mostly an Asian phenomenon. In recent years, that hasn't been the case. Europeans have been guilty as well.

The great moderation (an economy in a groove) is sometimes blamed for lulling financial market participants into a false sense of security, encouraging lending to homebuyers and homebuilders who ultimately defaulted on their loans, triggering a recession and global financial crisis. The not-so-great moderation (an economy in a rut) has created a pervasive pessimism that has held back consumer spending, residential investment, and especially investment in plant and equipment. Unless the economy has an external force applied to it – think Newton's first law of motion – growth will remain slow but positive.

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