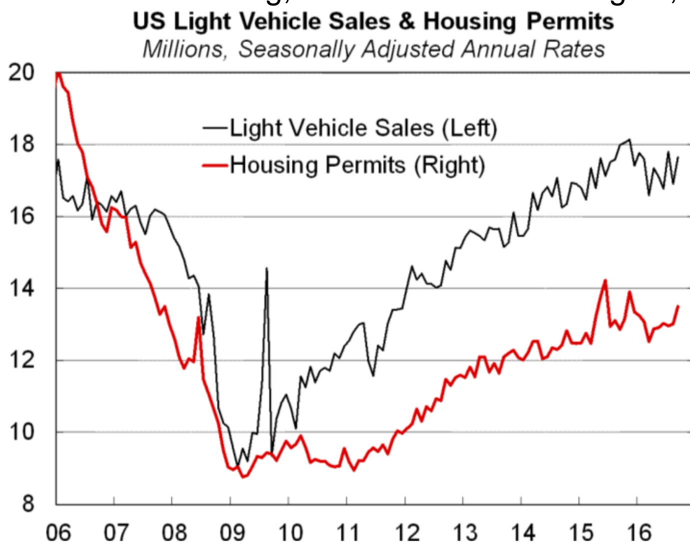
Current Economic Conditions

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

GROWTH WILL ACCELERATE, BUT NOT MUCH WITHOUT MORE INVESTMENT

August's declines in U.S. purchasing managers' indexes, motor vehicle sales, retail sales, and industrial production were largely reversed in September. The reversals leave the economy looking better than it did when the Federal Reserve decided not to raise its federal funds rate target in September and boost the chances of a December rate hike. I expect economic growth to accelerate over the next year, but before you start celebrating, keep in mind that over the last three quarters, U.S. real Gross Domestic Product has grown at just a 1.0% annual rate, and over the last 22 months, industrial production in U.S. manufacturing has declined slightly. Growth could accelerate and still remain slow by historical standards.

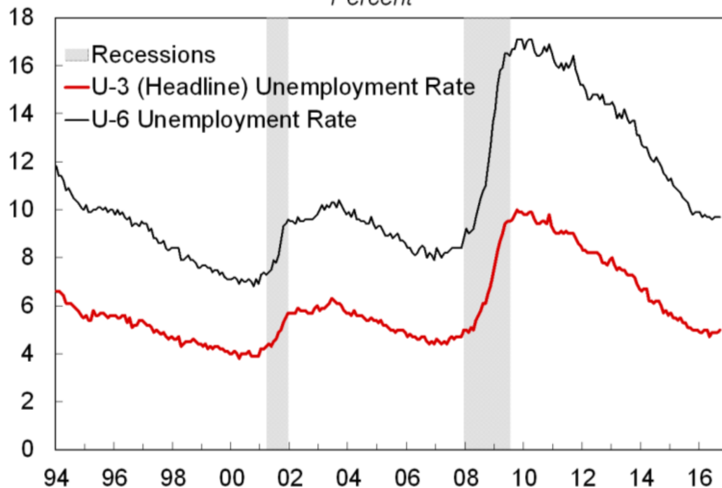
The Institute for Supply Management's August manufacturing PMI (purchasing managers' index), which fell to 49.4 in August – indicating a small contraction in the manufacturing sector – rebounded to 51.5 in September. The forward-looking new orders index, which also fell below 50 in August, rebounded strongly in September. The September readings are slightly lower than those from May through July, but are significantly higher than readings from earlier in the year and suggest moderate growth in U.S. manufacturing. The ISM's non-manufacturing PMI also rebounded in September. Industrial production in U.S. manufacturing, which fell 0.5% in August, rose 0.2% in September. Light vehicle sales, which fell from a 17.80 seasonally adjusted annual rate in July to a 16.91 million rate in August, rebounded to a 17.65 million annual rate in September. Even though the *Wall Street Journal* said that auto sales "sputtered" in September – because sales were slightly lower than in September 2015 – the selling rate was higher than last year's record high for annual sales and should be considered very strong, perhaps unsustainably strong. Retail sales rose 0.6% in in September, and August's 0.3% decline was revised up to a 0.2% decline. Payroll employment in September grew by 156,000, a big increase that is more than enough to absorb growth in the working age population, but disappointing to analysts who don't understand that.



Recent data show improvements in other countries as well. Industrial production in manufacturing rose sharply in both Japan and the European Union in August. Production was up 2.1% year-over-year in the EU. Financial markets were spooked by a big decline in Chinese exports in September, but those numbers are in U.S. dollars. Half of the decline was due to the depreciation in the yuan over the last year, not to a decline in the volume of exports. Other Chinese data have been more positive lately. Output of electricity, which some regard as a better indicator than broad aggregates like GDP, was up 7.8% year-over-year in August, the biggest increase since February 2014. Car sales were up 29% year-over-year in September, albeit from weak 2015 levels, and are up 15% year-to-date. The Chinese economy isn't growing as fast as aggregate data indicate and will never grow as rapidly as it did before the slowdown of the last few years, but the deceleration in Chinese manufacturing seems to have stopped for now.

An acceleration in the U.S. economy is likely for several reasons. Oil prices may have hit a sweet spot. Consumers have still not fully responded to the decline in oil prices, which saves Americans $1.43 billion per year for every one-cent reduction in the price of gasoline, but oil prices have rebounded enough that oil and gas drilling has turned up. A decline in drilling activity has been the main reason investment in nonresidential structures has declined over the last two years. Wages and salaries are finally starting to accelerate. That should further boost consumer spending. Housing starts fell sharply in September, to their **lowest** level of the year, but demographics call for a large increase over the next few years. A big jump in building permits in September, to their **highest** level of the year, suggests the increase in starts could begin this month. (Such a large disparity between starts and permits is unusual, but permits, which are less affected by weather, are the more reliable indicator, so the September housing report was much more positive than the housing starts number suggests.) Finally, a slowdown in inventory accumulation – culminating in an inventory drawdown in the second quarter – has trimmed growth over the last five quarters. That can't last forever. As firms start to rebuild inventories, growth will pick up.

In an economy that is close to full employment, a significant and sustainable acceleration in growth can't come from putting more people to work. The headline (U-3) measure of unemployment stood at 5.0% in September, just slightly above the Congressional Budget Office's 4.8% estimate for the "natural rate of unemployment." The U-6 measure of "underemployment," which includes part-time workers who would prefer full-time employment and people who haven't looked for work in the past month because they are discouraged, still shows some slack in the labor market, but not much. Pulling back into the labor force those who haven't looked for work in at least a year (not counted as unemployed, even in the U-6 measure) could boost growth a little, but many of those people have retired. Once slack in the labor market is exhausted, faster economic growth must come from faster productivity growth.



As I discussed in my May newsletter, productivity growth has been very disappointing during the current economic expansion. Some of the causes of the productivity slowdown are probably permanent, but to the extent that the slowdown is due to bad tax and regulatory policies and weak business investment, it can be reversed. While economic growth usually doesn't accelerate late in an expansion when unemployment is already low, it can happen. The unemployment rate fell to the CBO's estimate of the natural rate in the third quarter of 1987. Over the next 10 quarters, real GDP grew at a 3.8% annual rate. The unemployment rate again fell to the natural rate in the first quarter of 1997. Over the next 13 quarters, real GDP grew at a 4.8% rate. In both cases, growth was led by a big increase in business fixed investment. In the 1997-2000 period, nonresidential fixed investment grew at a staggering 10.5% annual rate, due in part to the dot.com boom/bubble. Policies that are more conducive to investment in plant and equipment (rather than buying back stock or buying other companies) could boost productivity growth and allow the U.S. economy to grow faster than it has during the first seven years of this economic expansion.

Growth in the U.S. economy has been disappointingly slow since mid-2010, when the initial rebound from the recession faded. The failure of growth to accelerate after oil prices collapsed in mid-2014 has been especially disappointing. Instead, growth has slowed, partly because of the negative impact of lower oil prices on drilling activity and partly because the positive impact of lower oil prices has been offset by the negative impact of rising health insurance premiums at home and slower growth abroad. I still believe that lower oil prices are a net positive for the U.S. economy and that growth will accelerate over the next year, but a significant and sustainable acceleration requires investment that enhances productivity growth.

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