THE US ECONOMY

WEBINAR PRESENTATION ON saul-eslake.com

28TH APRIL 2021

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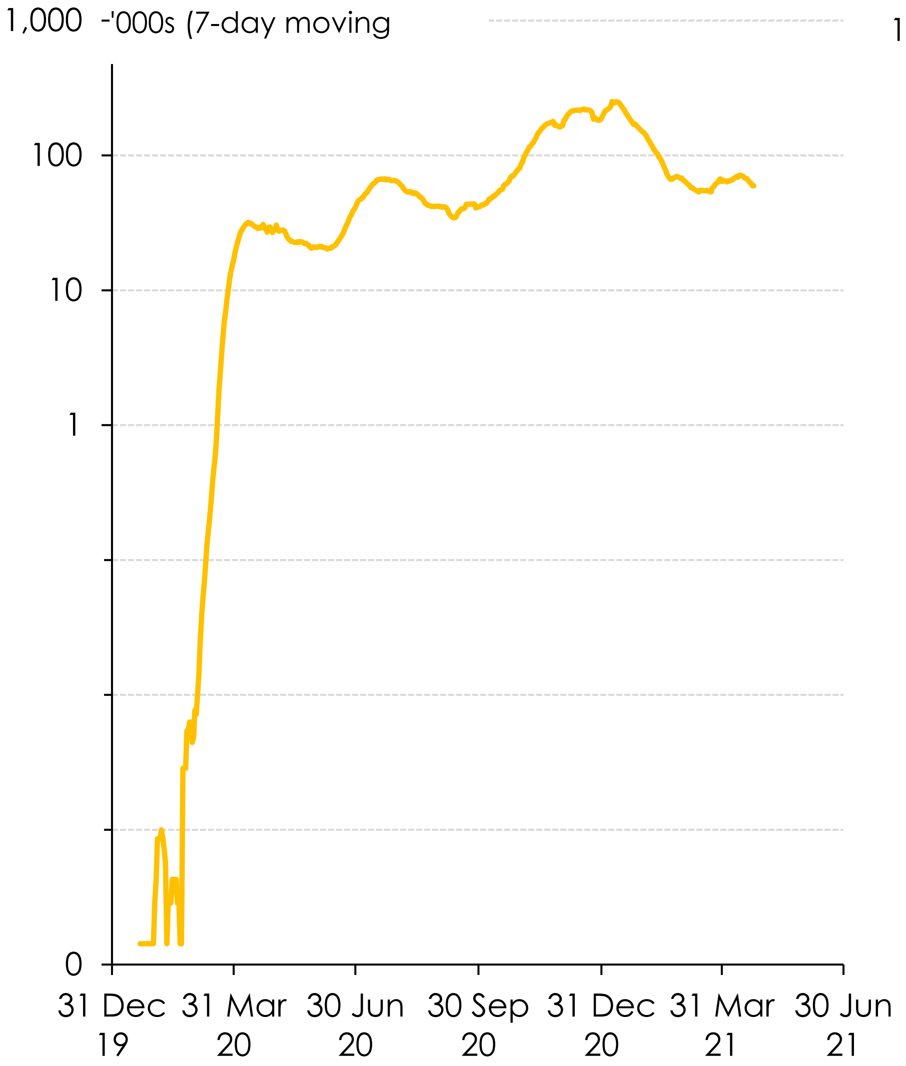
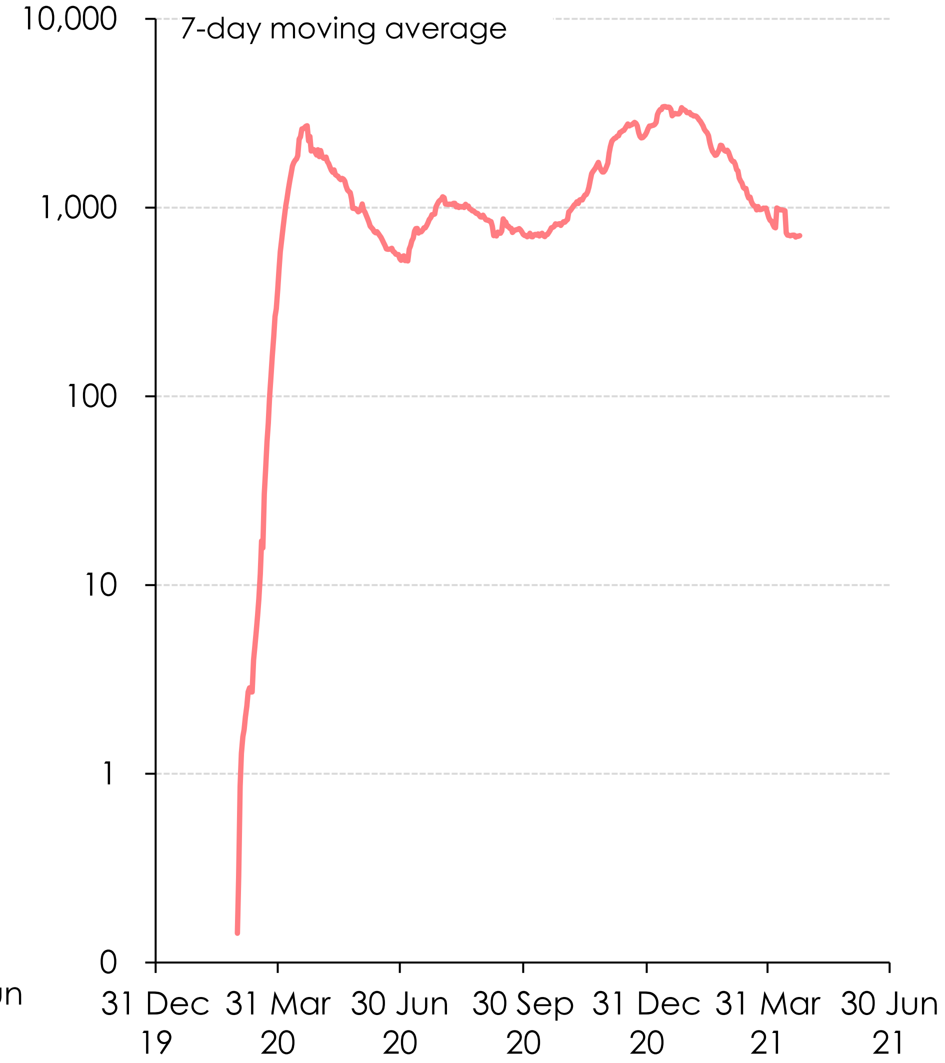
CORINNA ECONOMIC ADVISORY PTY LTD

The US now does seem finally to be 'getting on top' of the virus, with vaccinations now proceeding rapidly

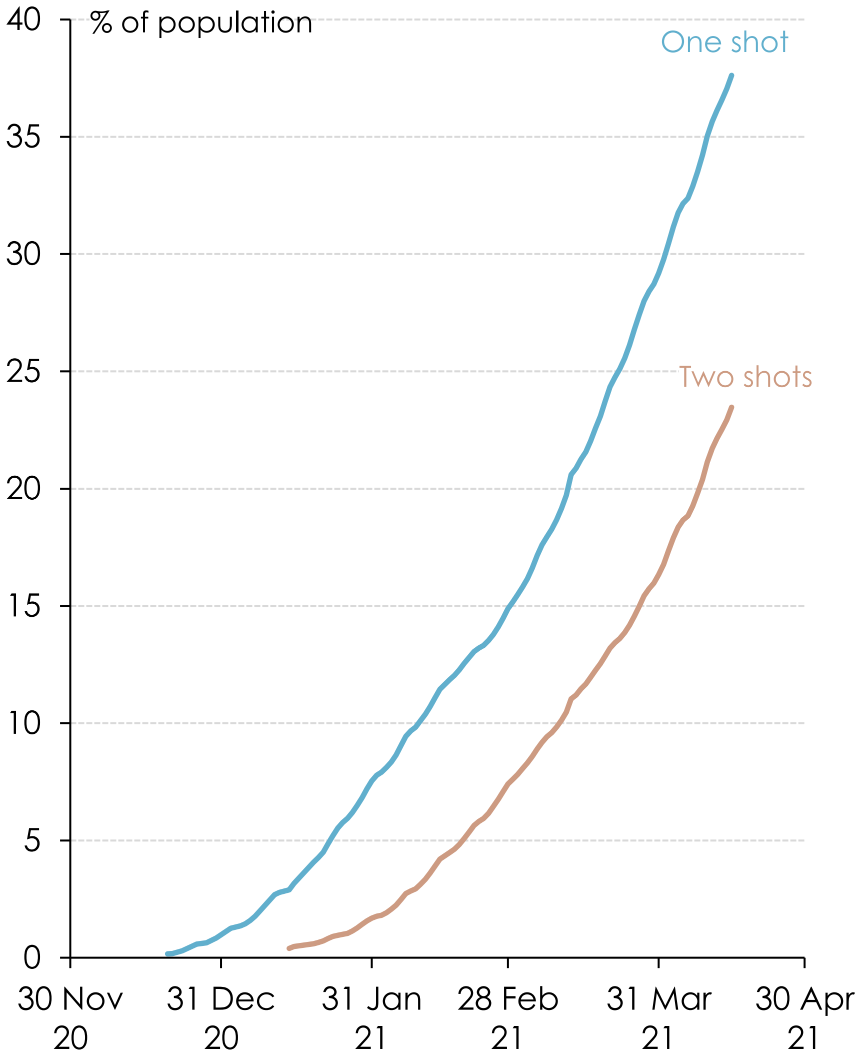
New confirmed cases



New deaths



Vaccinations



Note: All charts are on logarithmic scales. Data up to 25th April. *Source:* University of Oxford, Our World in Data.

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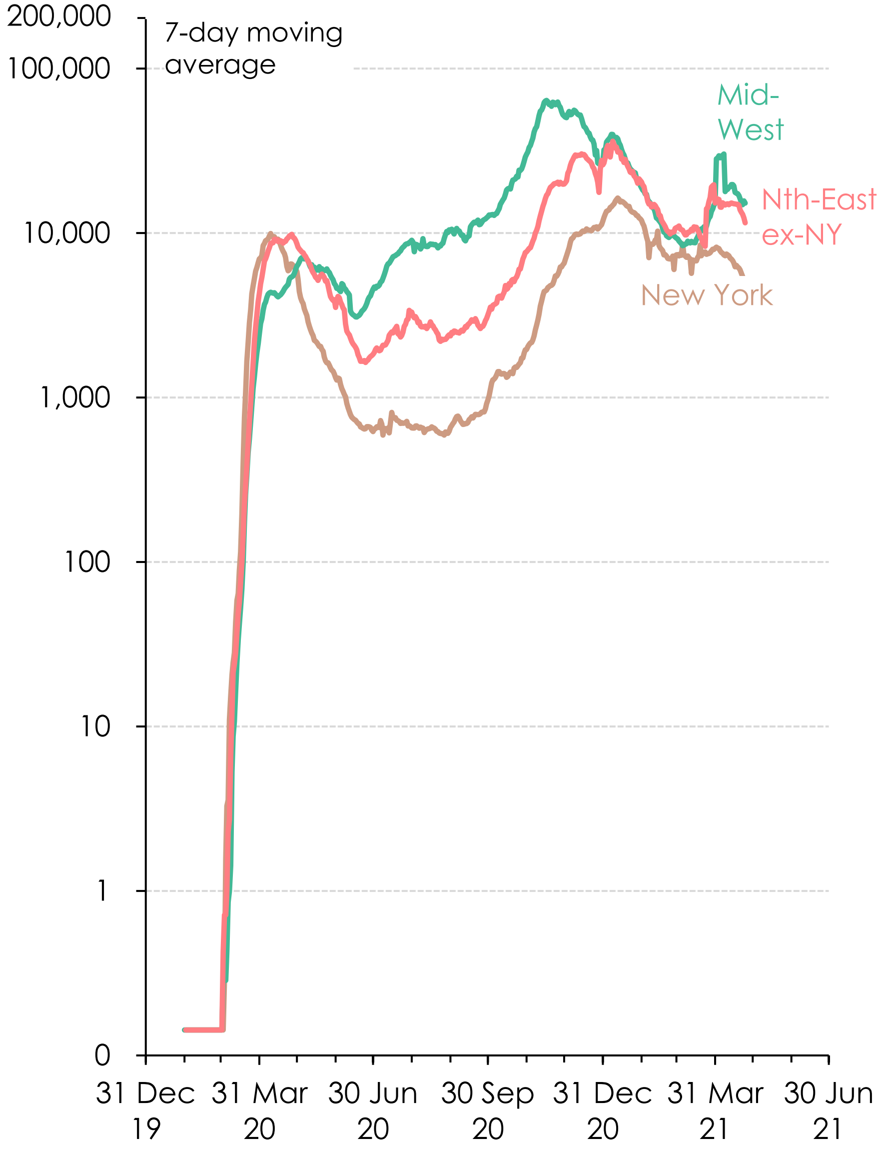
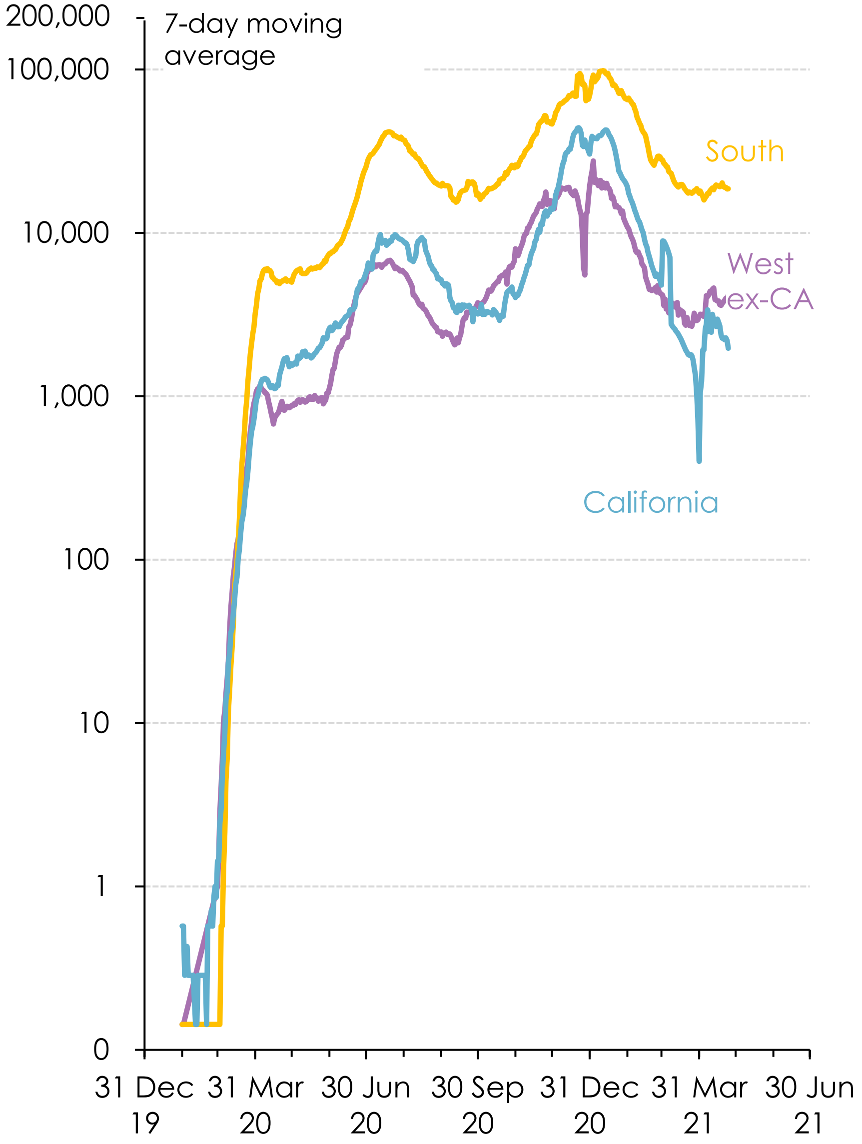
New infections are now stabilizing or falling everywhere except Michigan

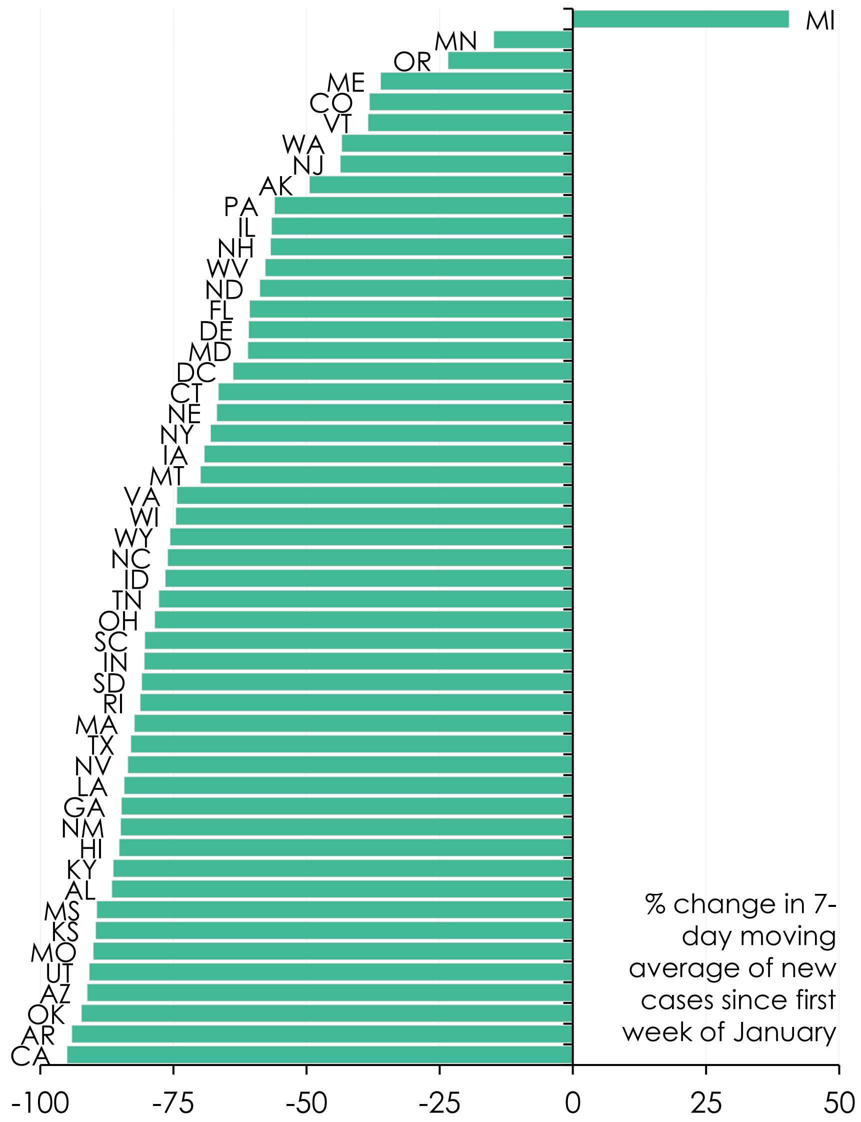
New cases – Mid-West and North-East



New cases – South and West



Change in cases since early January



Note: First two charts are on logarithmic scales. *Sources:* USAFacts; Centers for Disease Control and Prevention; *New York Times*; Corinna. Latest data are for 24th April.

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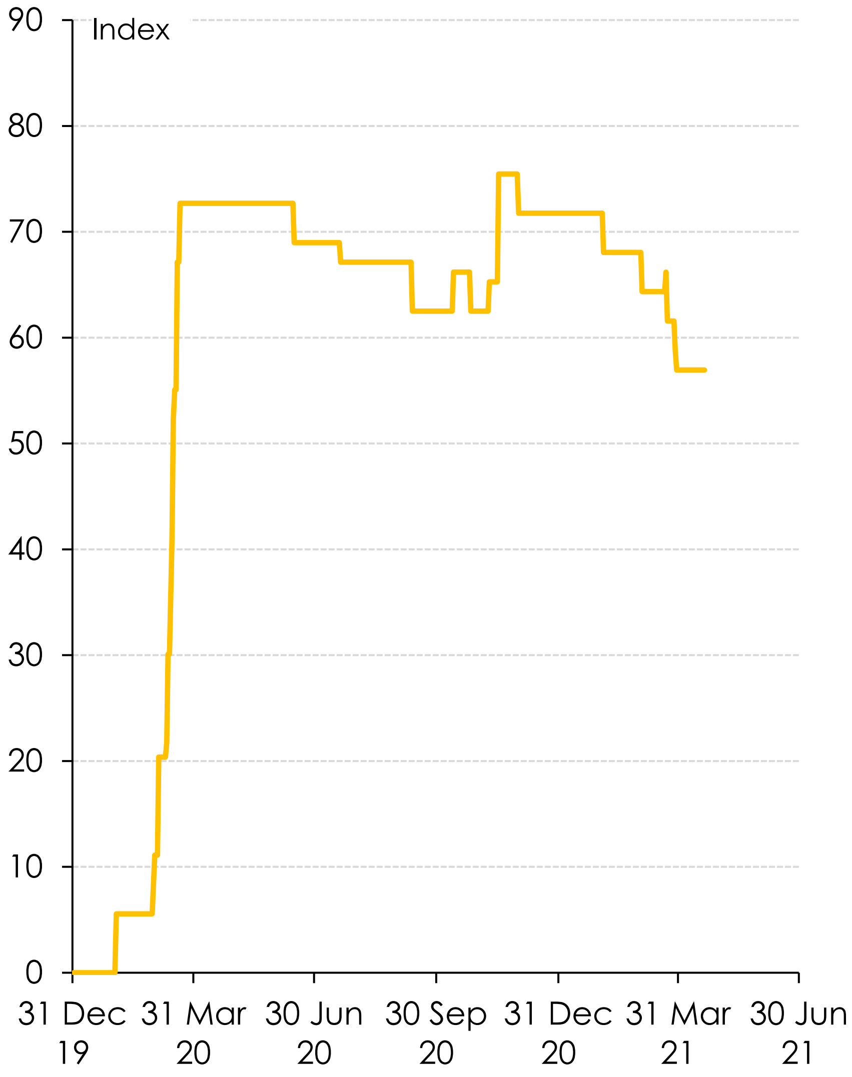
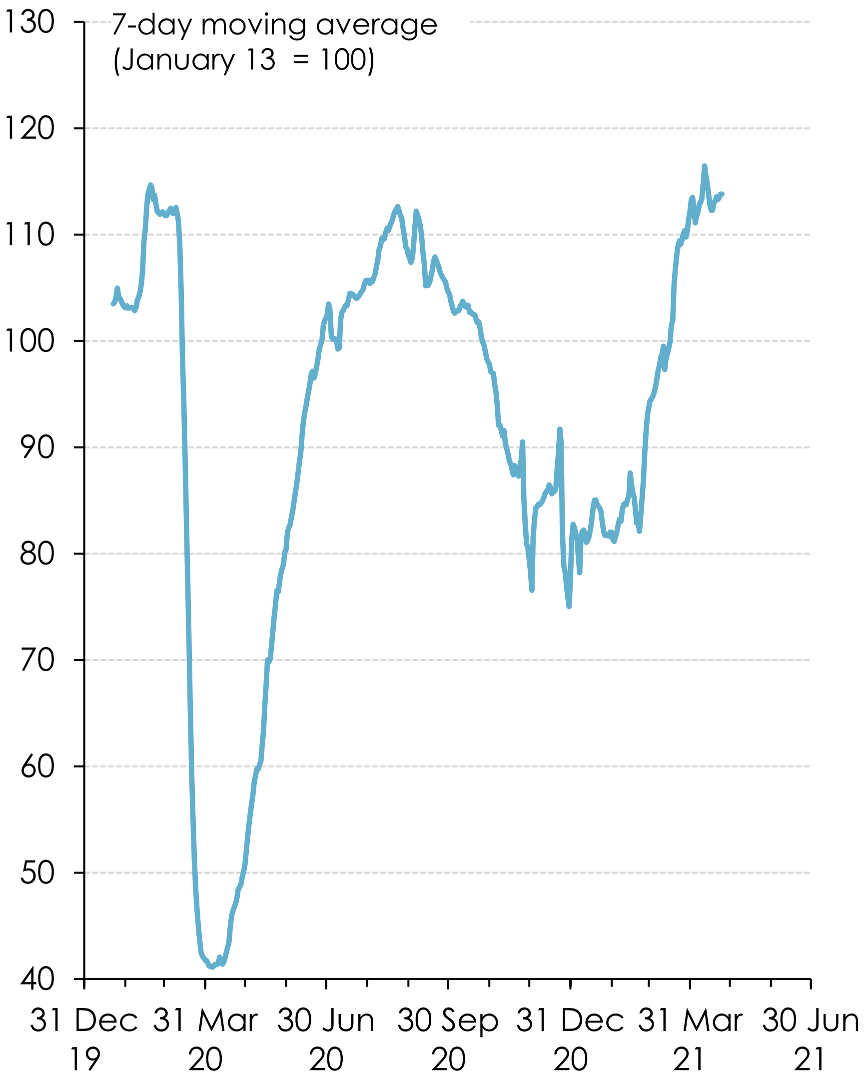
Government restrictions on gathering and movement are gradually being eased

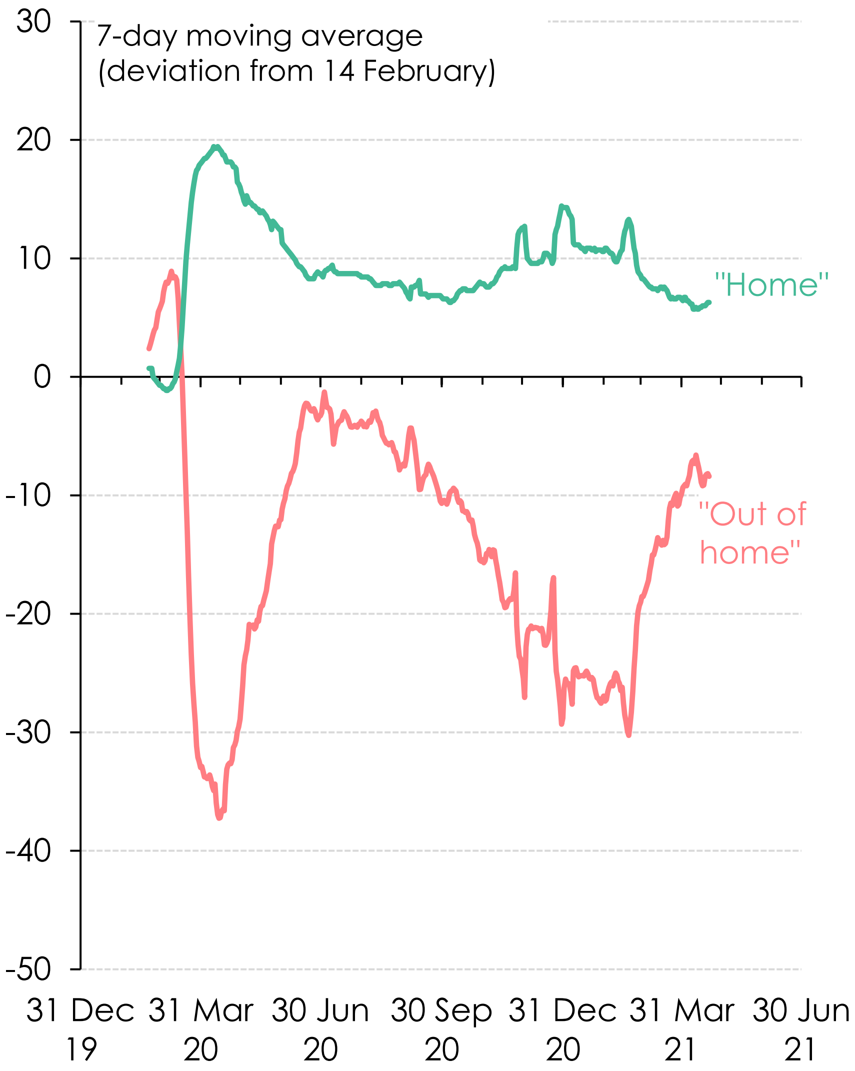
Stringency index



Apple mobility indicators



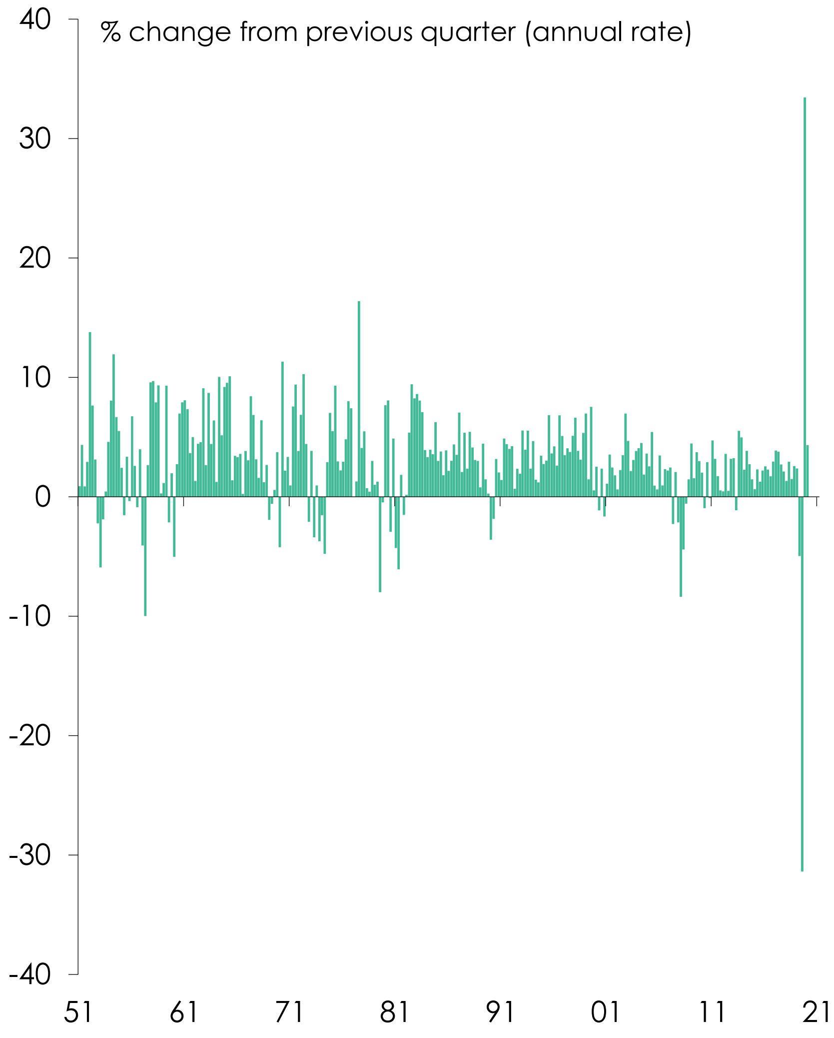
Google mobility indicators



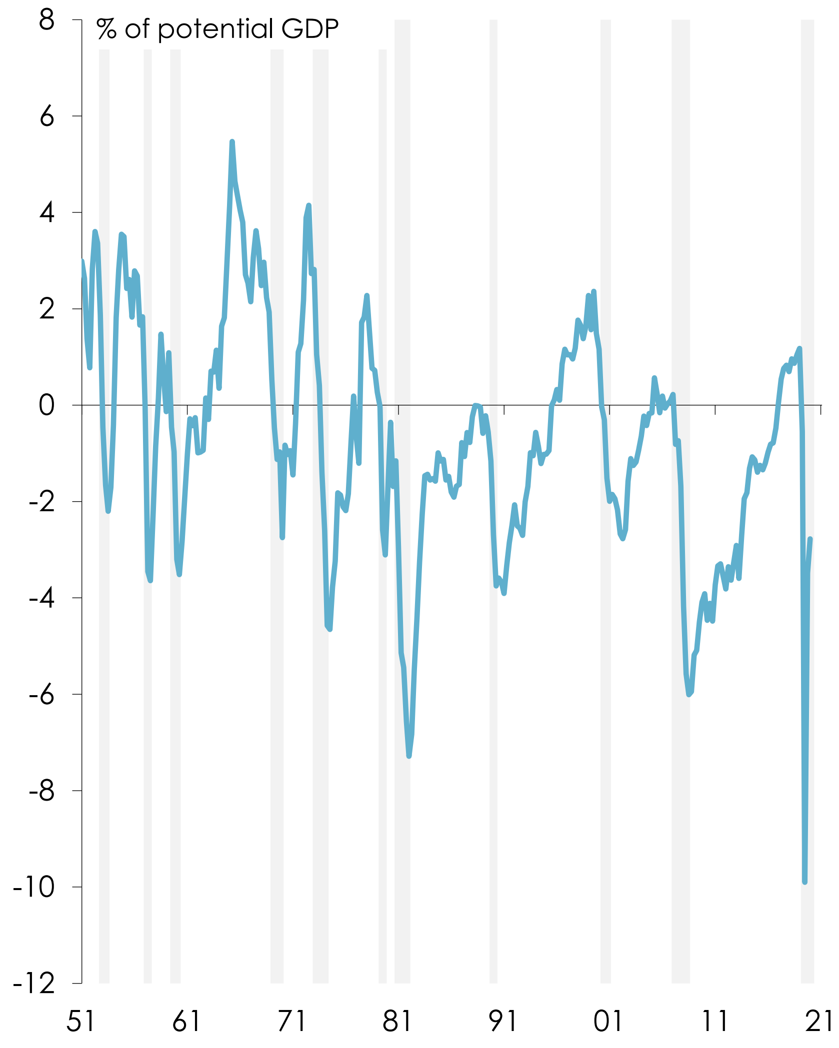
Note: 'Apple indicators' is average of driving, transit and walking measures; Google 'out of home' is average of retail & recreation, groceries & pharmacies, parks, transit and work-places, while 'home' is residential. *Sources:* Blavatnik School of Government, Oxford University; Apple ; Google.

The pandemic induced the deepest recession the US has experienced in the post-war era, followed by a strong rebound …

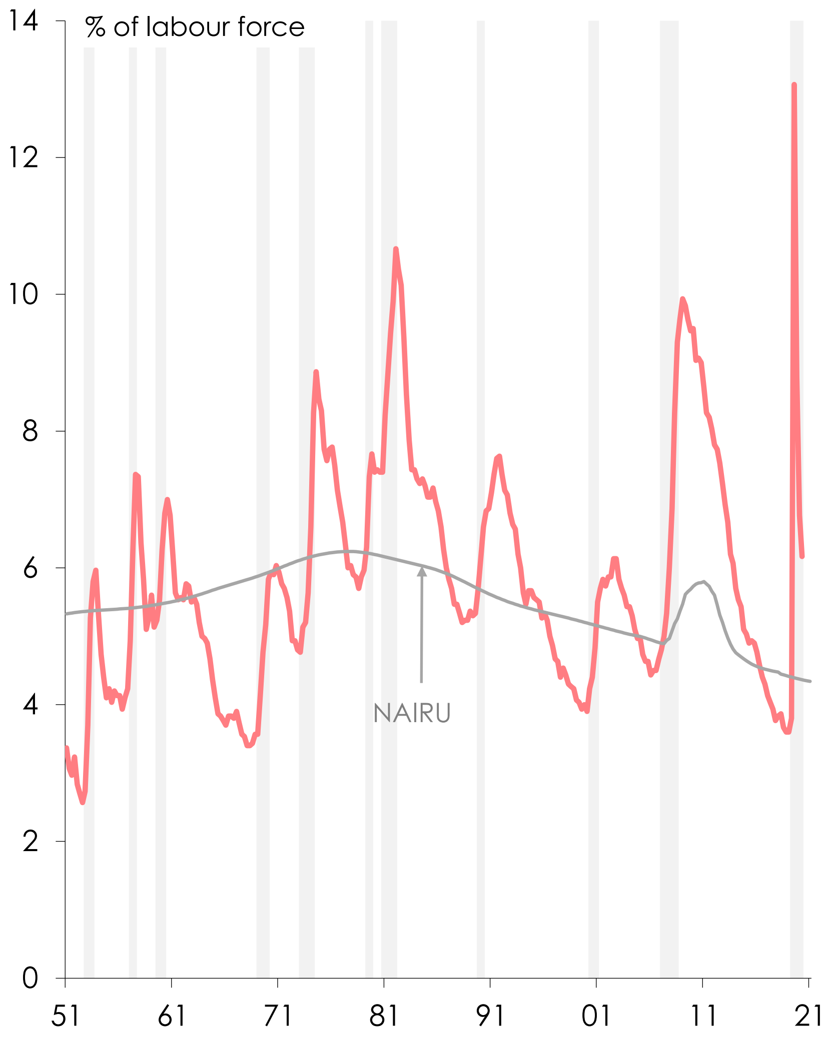
Quarterly changes in real GDP



The 'output gap' between actual and potential GDP



Unemployment rate



Note: Shaded areas denote recessions as designated by the National Bureau of Economic Research; 'NAIRU' is the non-accelerating-inflation rate of unemployment, sometimes regarded as representing 'full employment'. *Sources:* US Bureau of Economic Analysis; Congressional Budget Office; Bureau of Labor Statistics.

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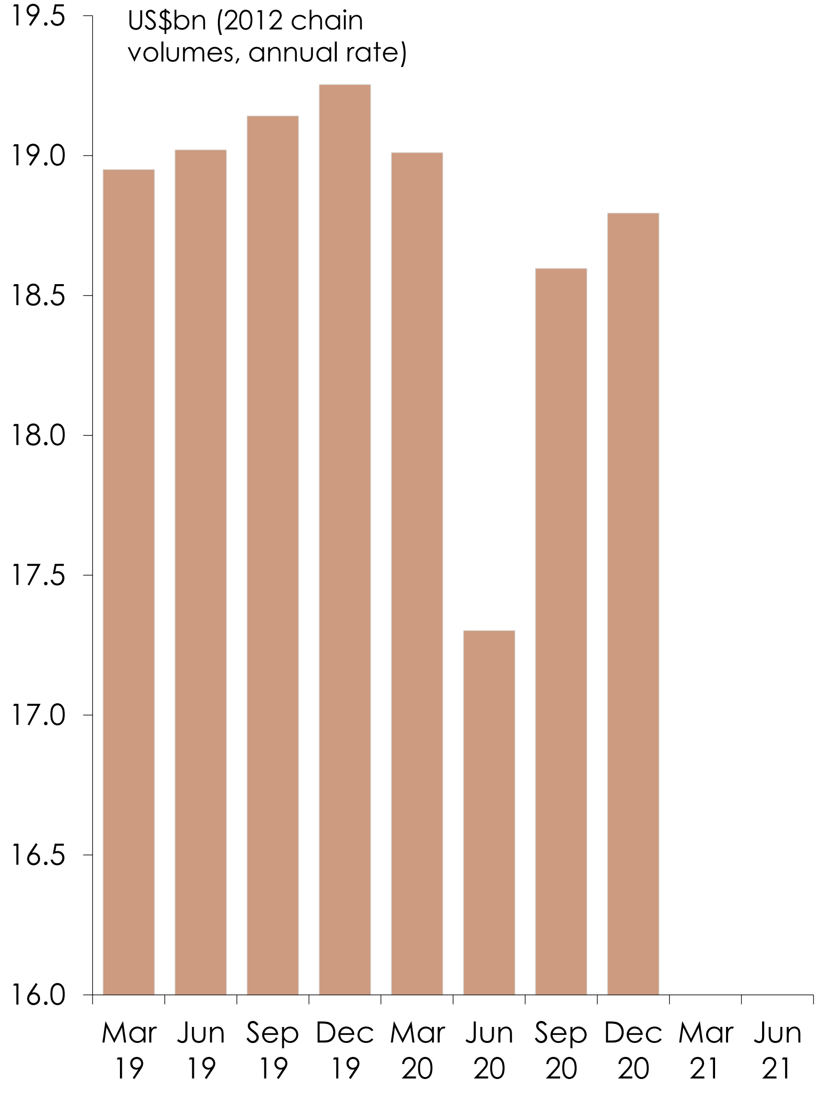
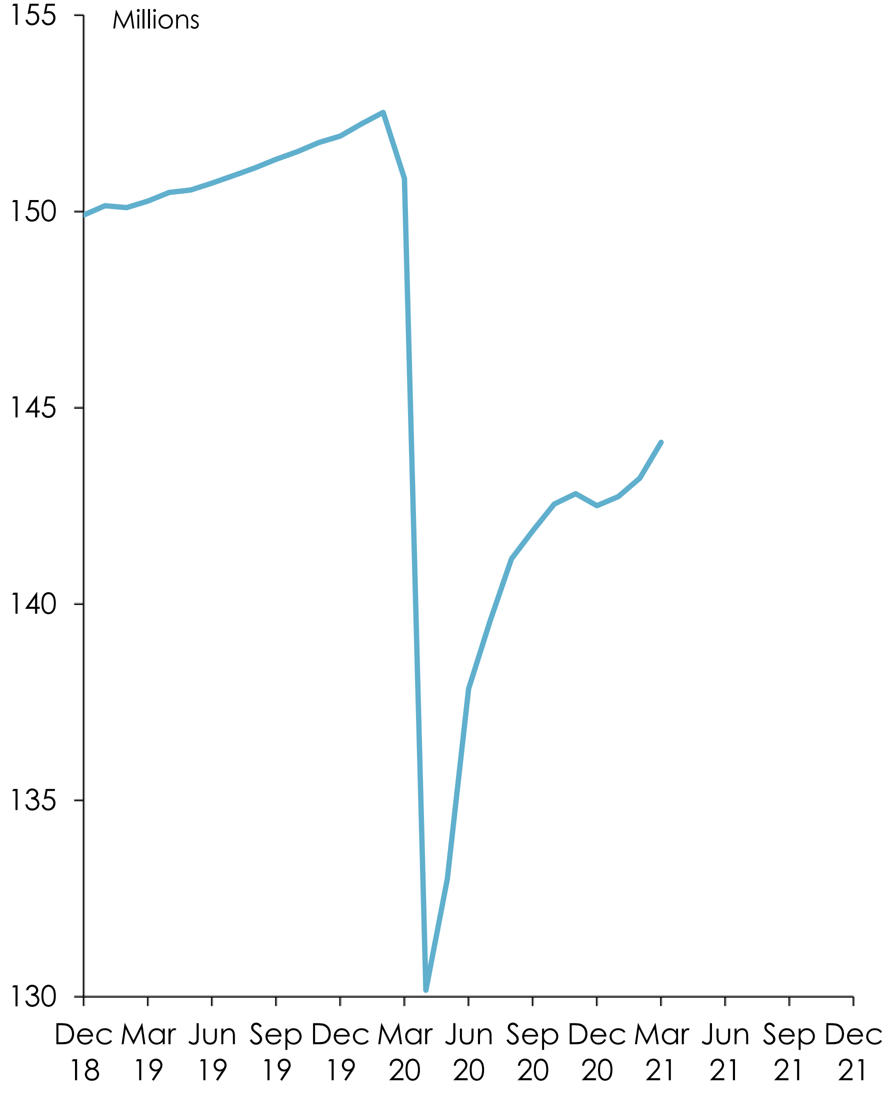
.. but the level of economic activity is still yet to regain its pre-pandemic peak – and the shortfall in employment is even greater

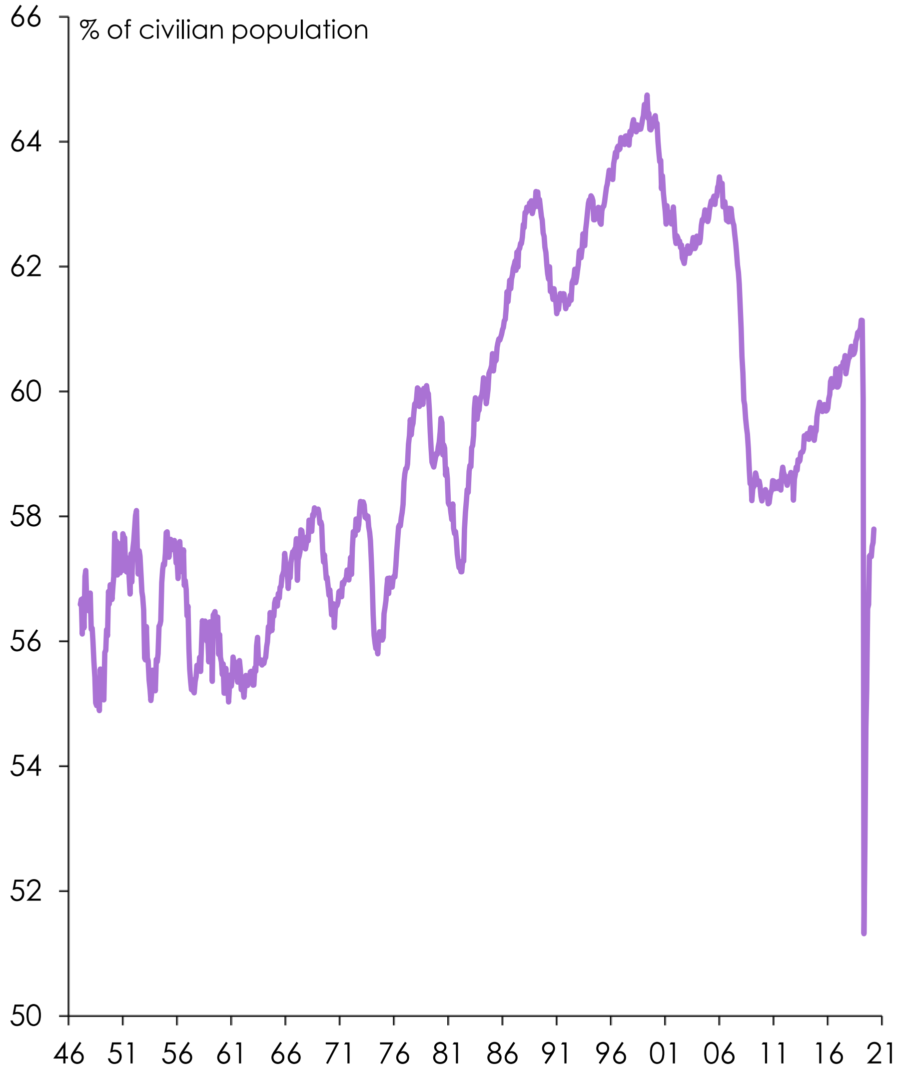
Level of real GDP



Non-farm payroll employment



Employment-population ratio



Sources: US Bureau of Economic Analysis; Bureau of Labor Statistics.

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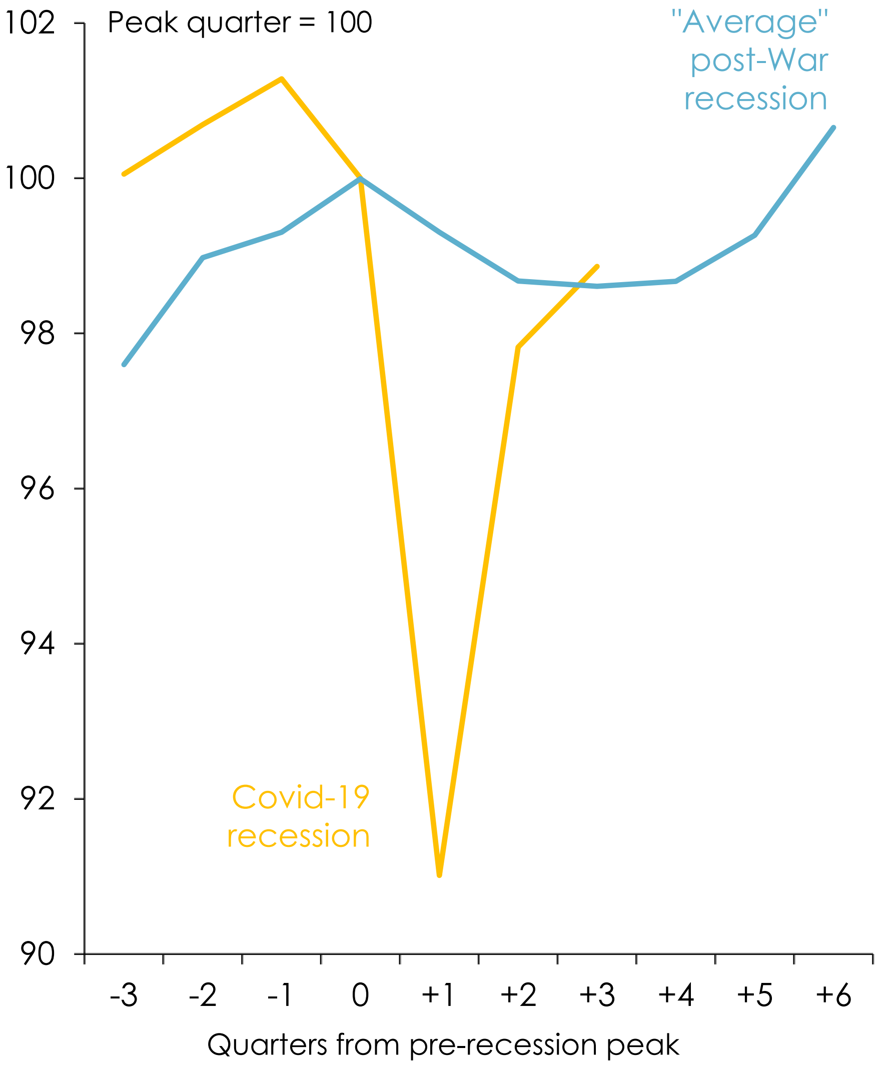
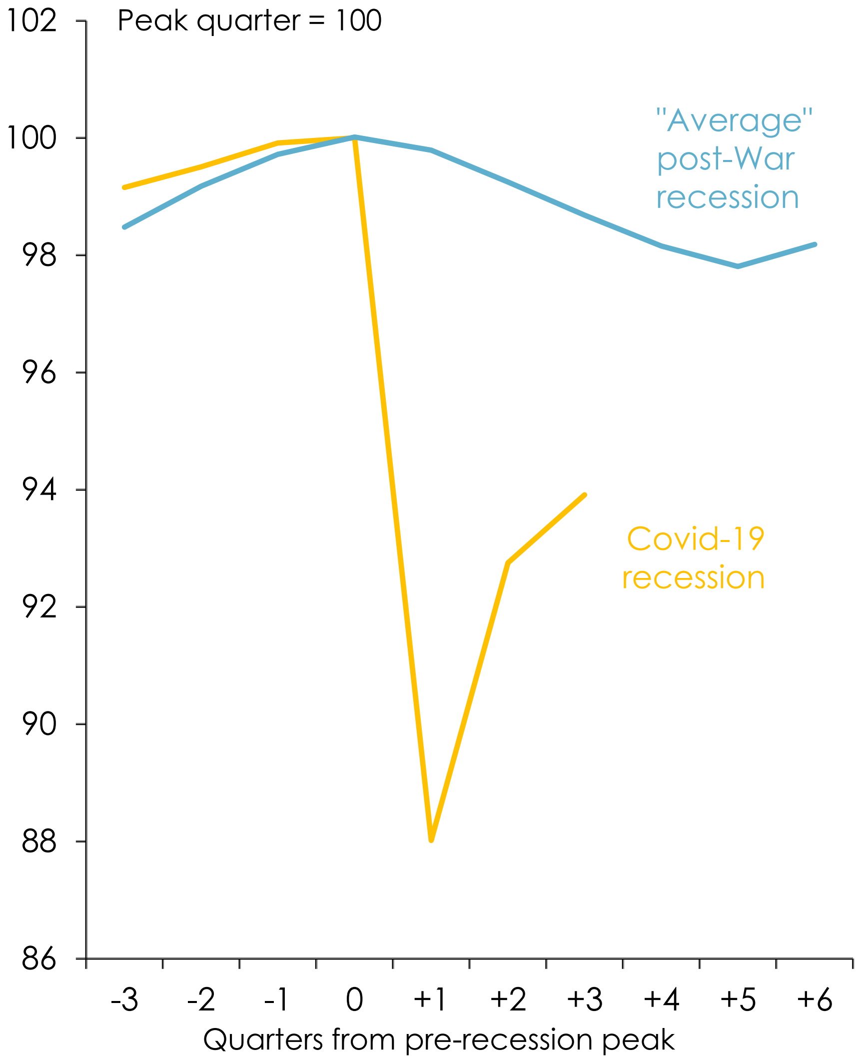
The Covid-19 recession has been quite unlike any other of the recessions the US has experienced since the end of World War II

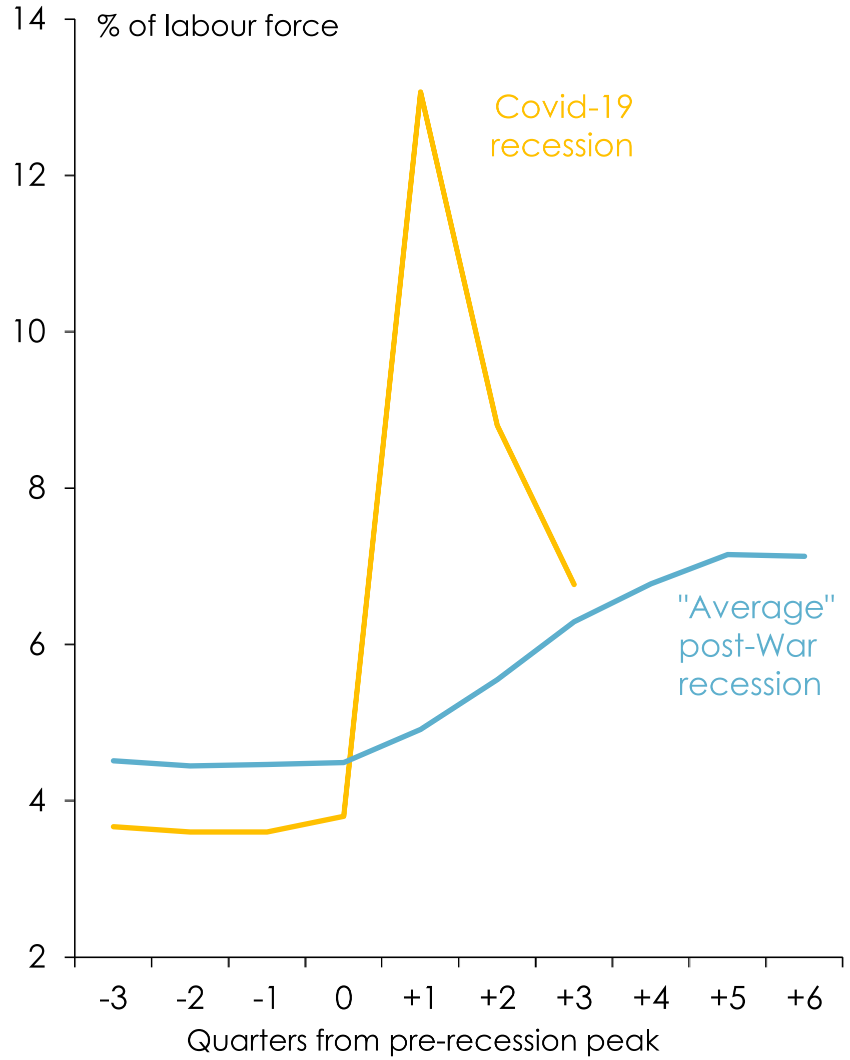
Level of real GDP



Non-farm payroll employment



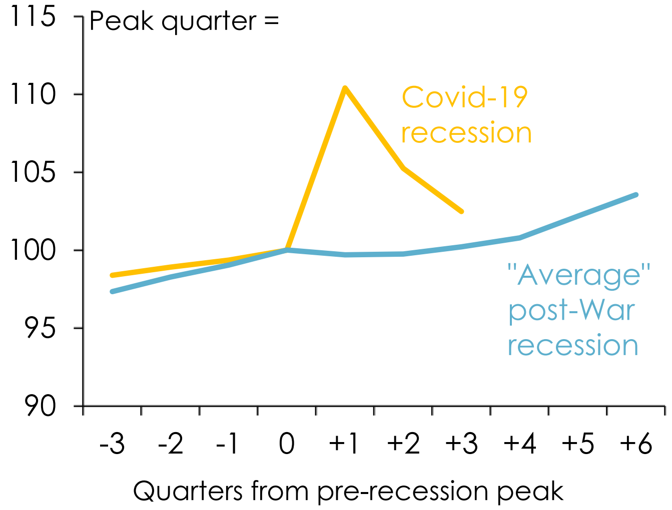
Unemployment rate



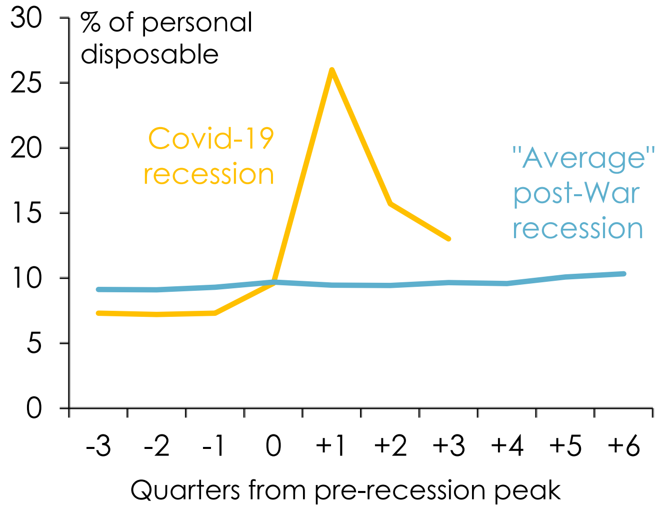
Note: 'average post-war recession' is the average of figures for each of the eleven post-war US recessions as designated by the National Bureau of Economic Research Business Cycle Dating Committee, with the exception of the recession of January-July 1980 (which was too short, and too close to the July 1981-November 1982 recession to be fully reflected in the averages shown here); 'Peak quarter' is the quarter in which real GDP attained its highest level before the onset of the recession. No recession was ever as 'smooth' as implied by the averages shown here. *Sources:* US Bureau of Economic Analysis; Bureau of Labor Statistics.

The differences between this recession and previous ones are even more apparent when you dig into the details

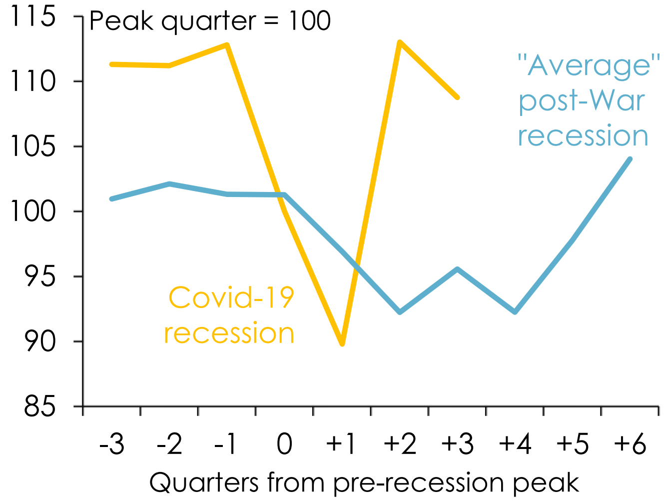
Personal disposable income



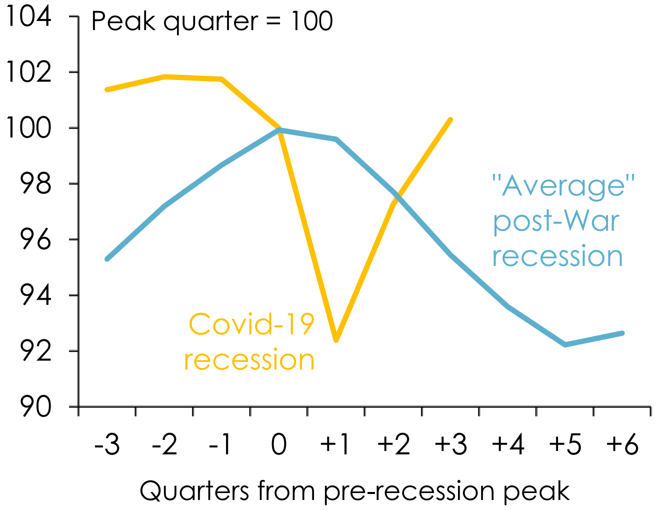
Personal saving rate



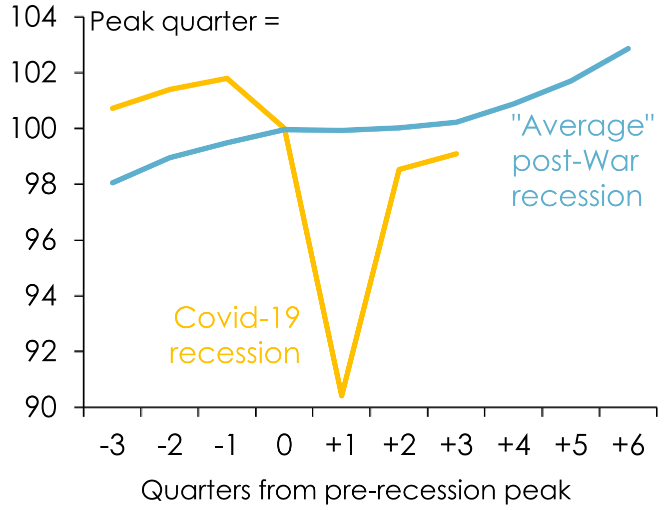
After-tax corporate profits



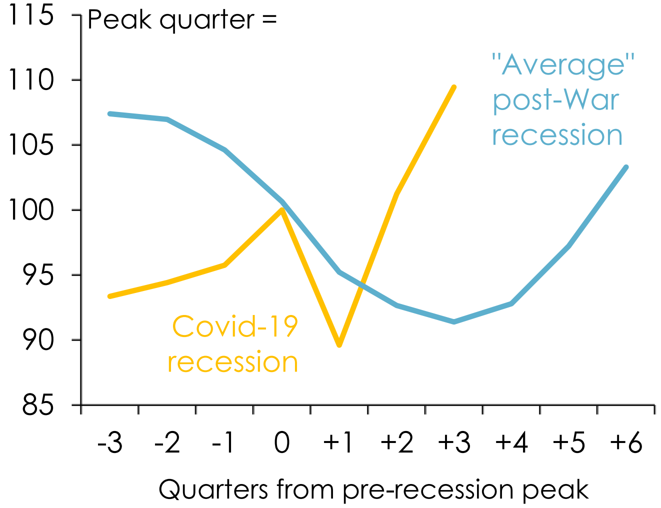
Labour productivity



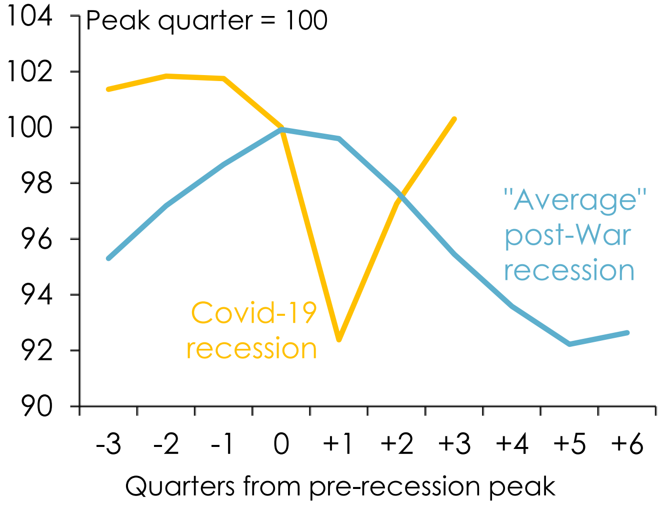
Personal consumption



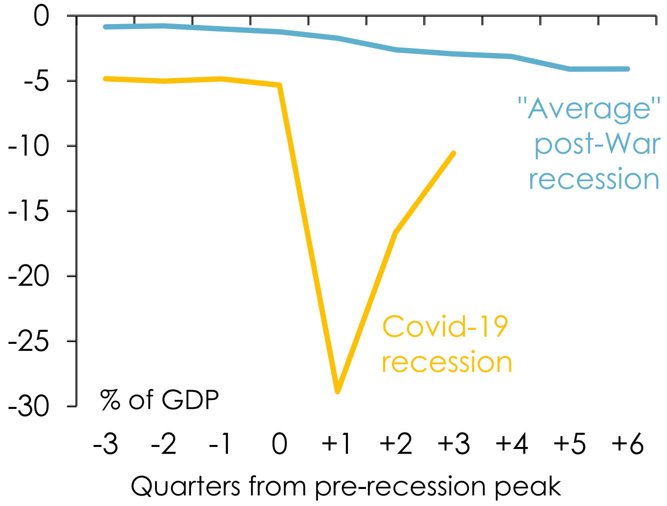
Residential investment



Business investment



Federal budget balance



Note: 'average post-war recession' is the average of figures for each of the eleven post-war US recessions as designated by the National Bureau of Economic Research Business Cycle Dating Committee, with the exception of the recession of January-July 1980; 'peak quarter' is the quarter in which real GDP attained its highest level before the onset of the recession. All variables in the charts above are in 2012 chain volumes except for the personal saving ratio and budget deficit; after-tax profits are 'economic' rather than 'book' profits; labour productivity is for the non-farm business sector. *Sources:* US Bureau of Economic Analysis; Bureau of Labor Statistics.

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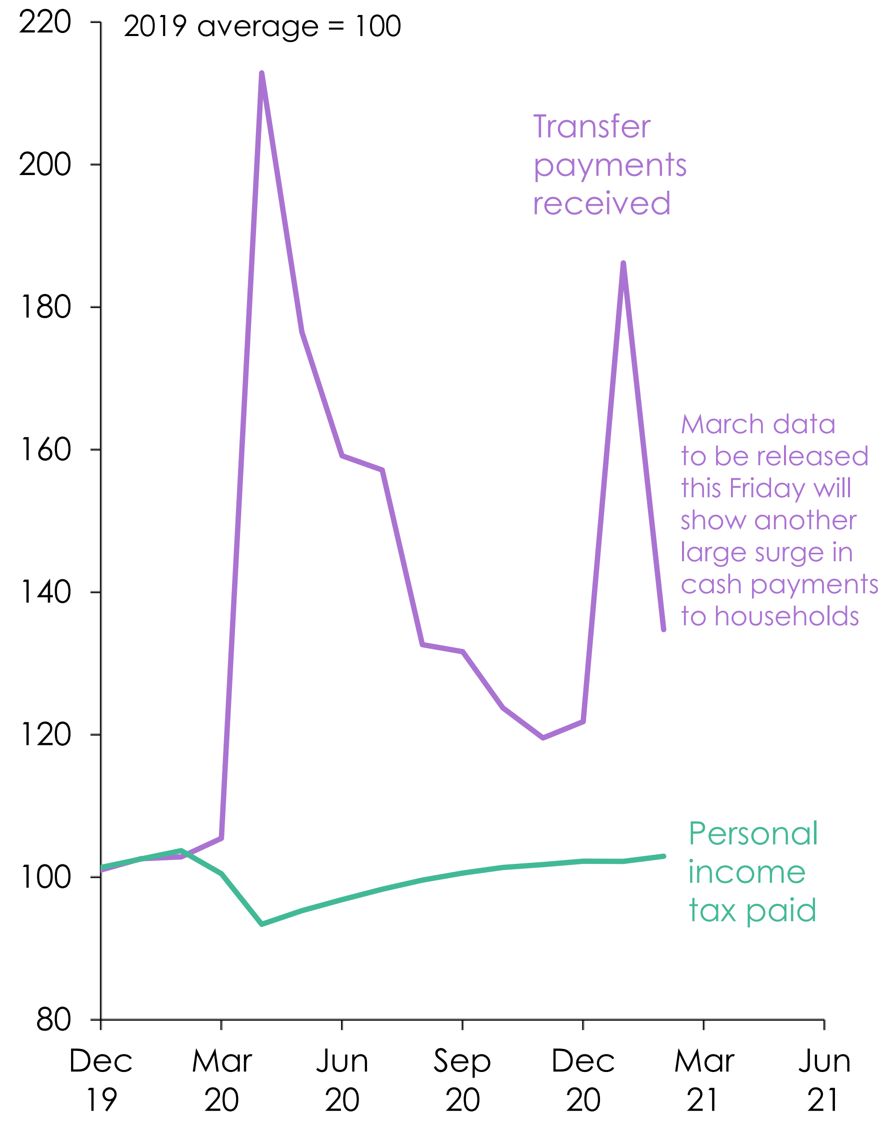
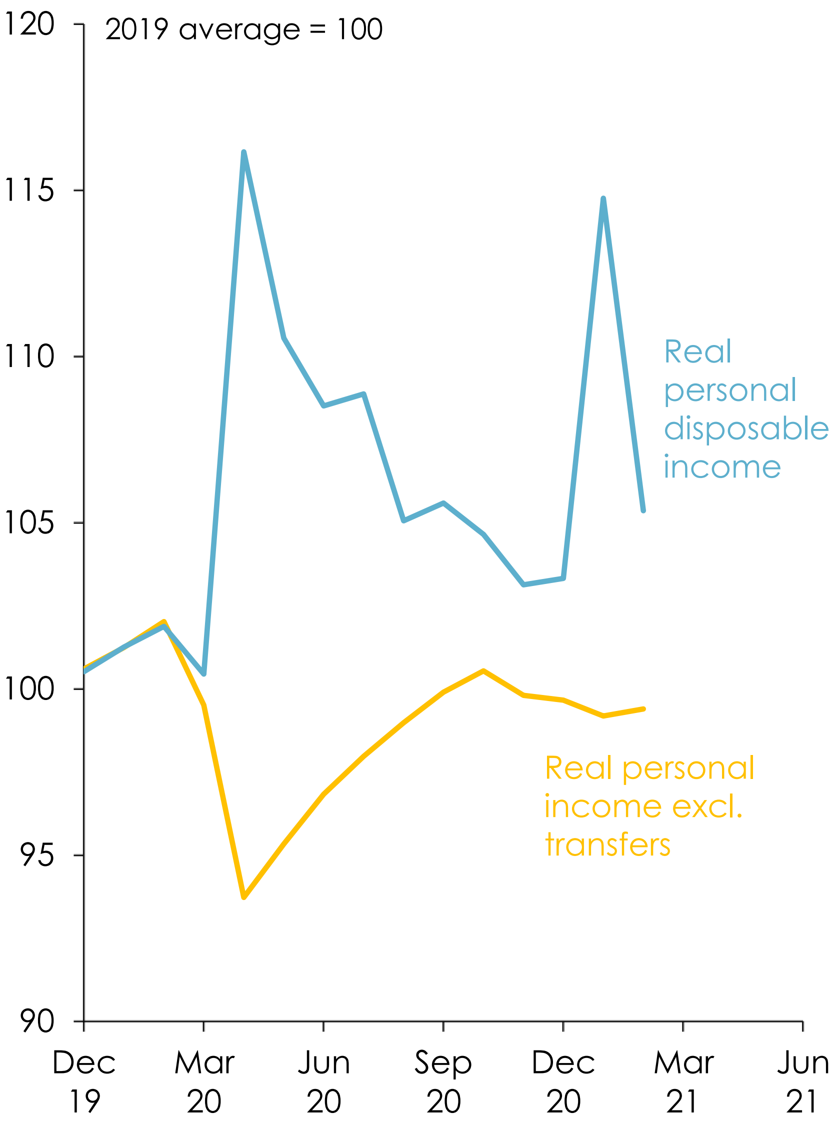
Recurring cash payments to households (combined with restrictions on movement) have had a major impact on spending patterns

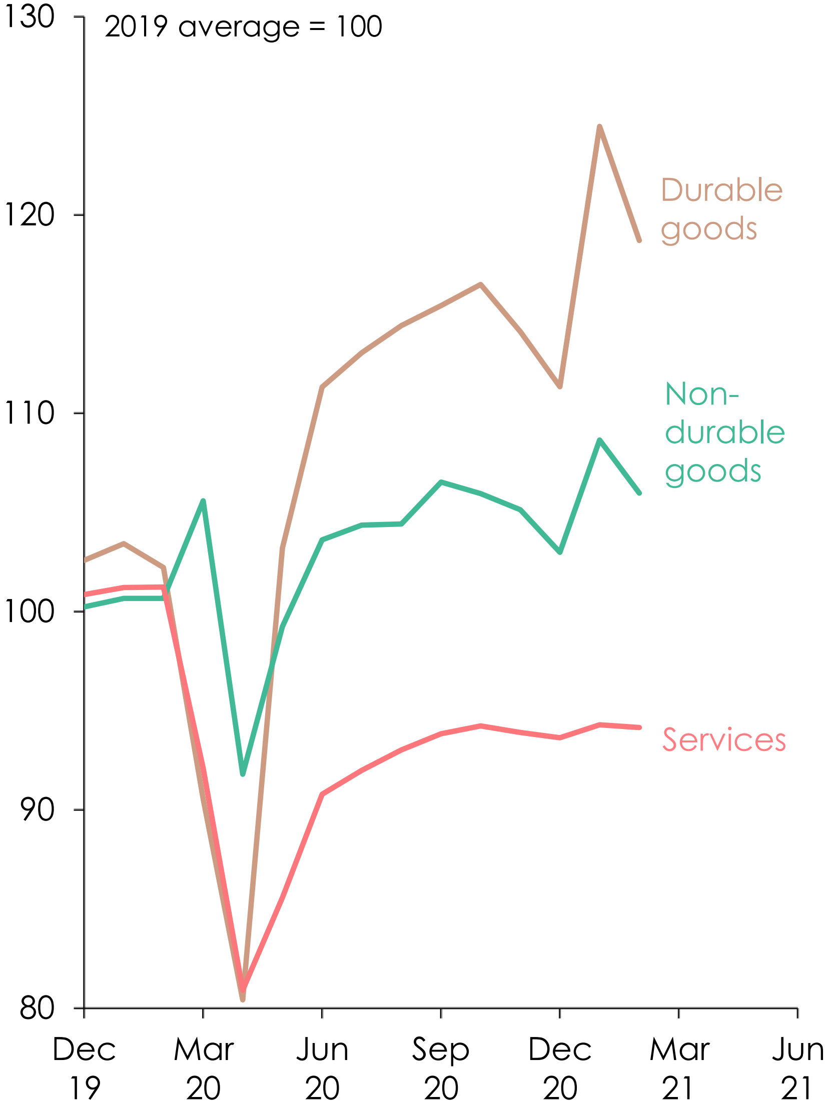
Tax and transfer payments



Real personal income



Real consumption expenditure



Source: US Bureau of Economic Analysis.

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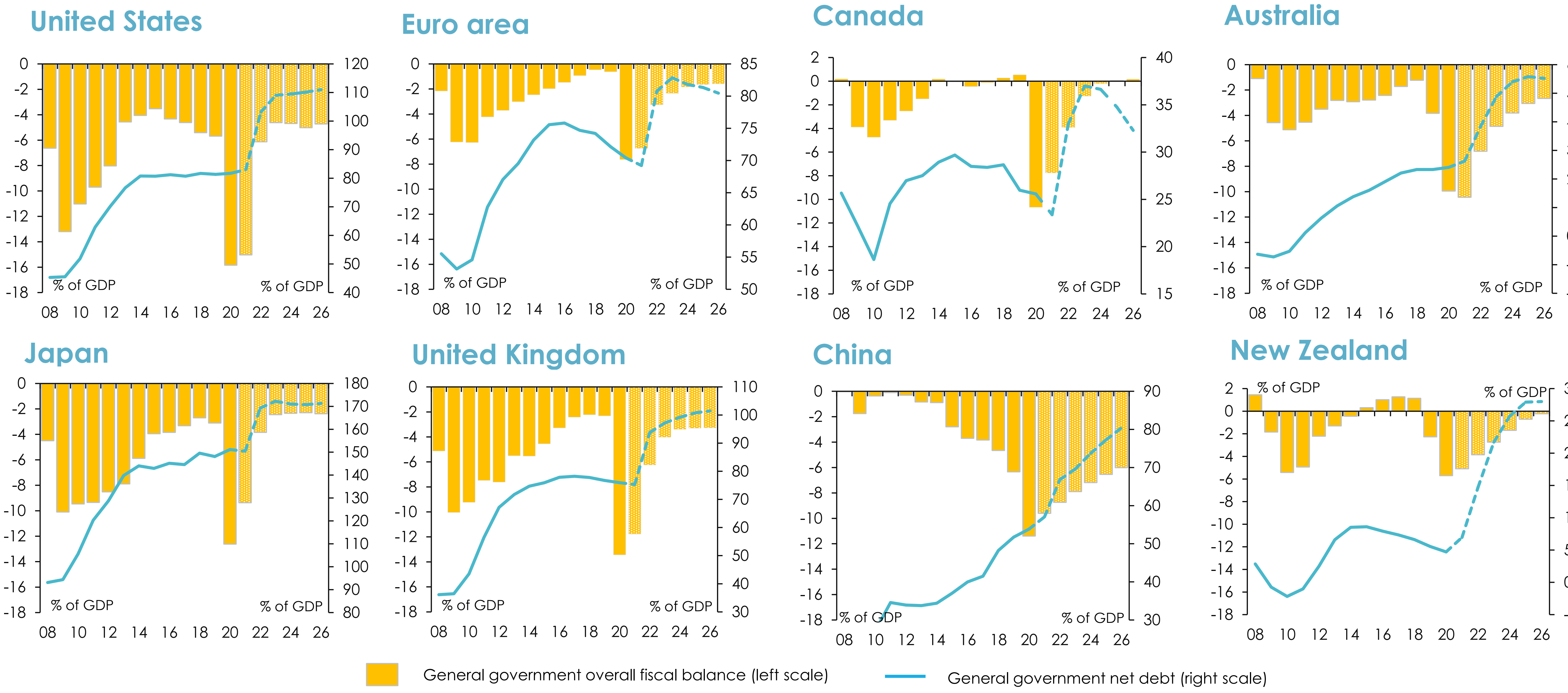
The US is undertaking more fiscal stimulus than any other ‘advanced’ economy



Note: China debt is gross debt, not net. *Sources:* International Monetary Fund, *Fiscal Monitor*, and *World Economic Outlook*, April 2021. Return to "What's New“

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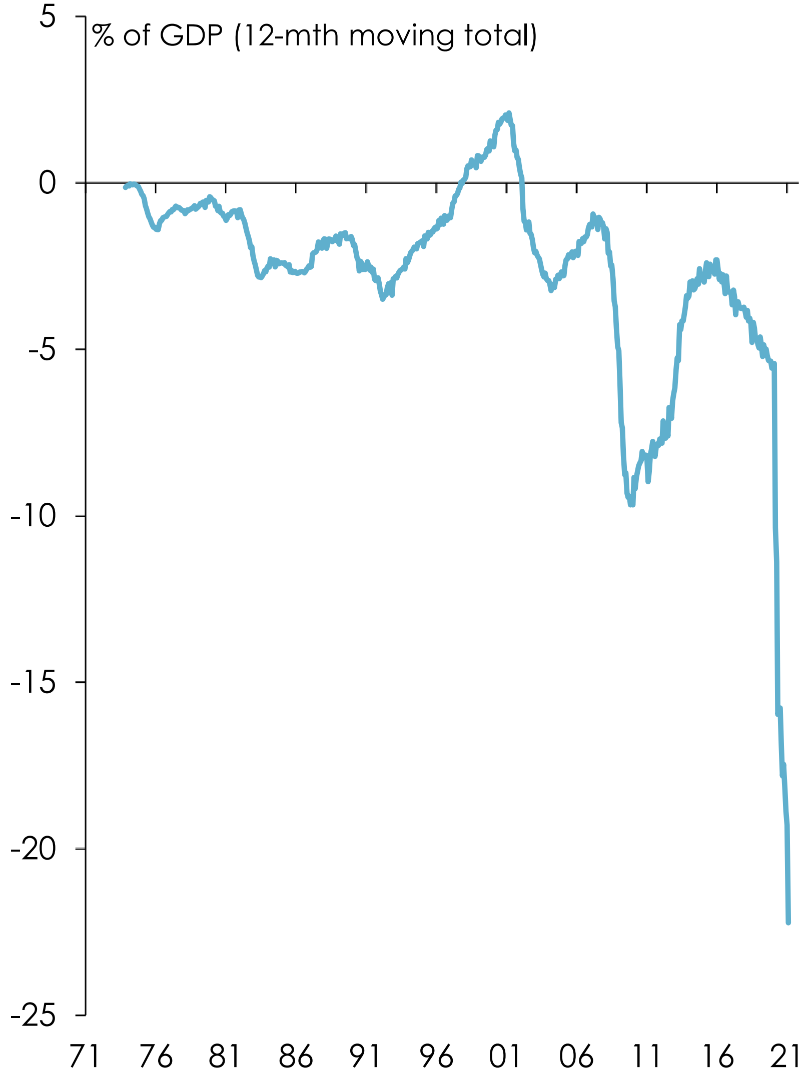
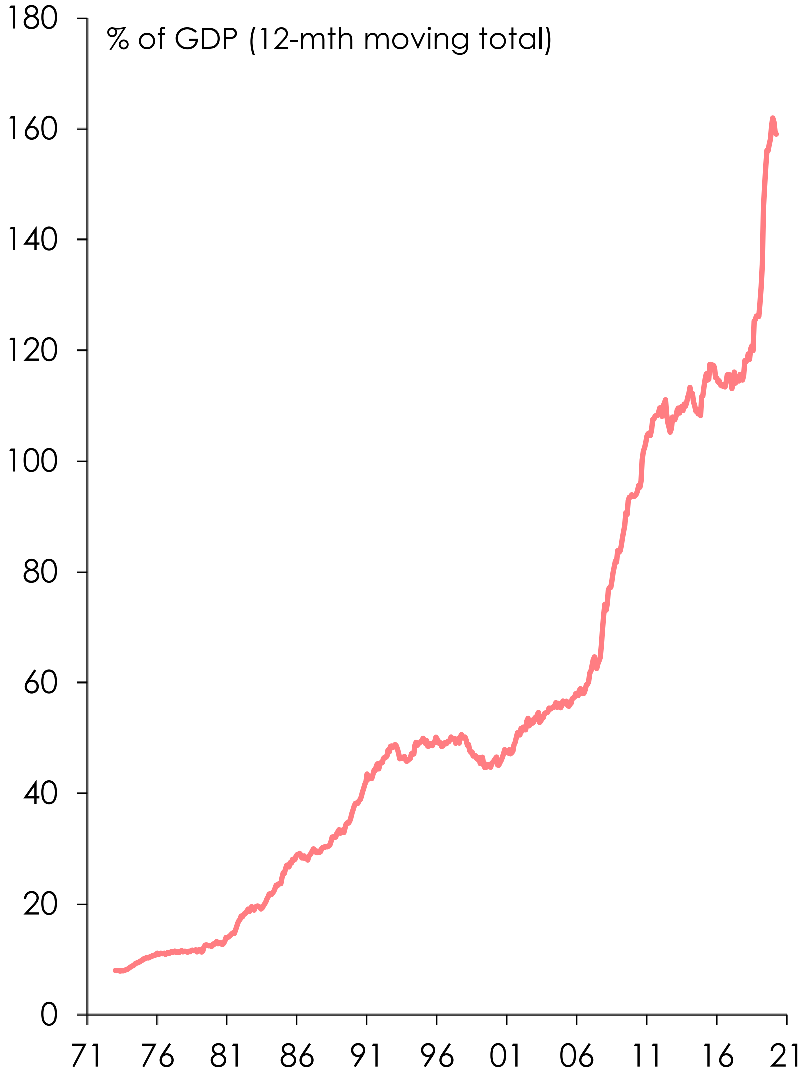
The US budget deficit reached US4.1trn (22¼% of GDP) in the 12 months to March and will likely rise further over the next three months at least

US Federal budget deficit



US gross Federal debt



- The US Federal Government incurred a budget deficit of US$660bn in March, the third largest on record (after the $738bn and $864bn deficits in April and June last year), reflecting the cash payments to households as part of the Biden Administration's first stimulus
- Over the 12 months to March, the budget deficit totalled US$4.1 trn or 22.2% of GDP – the largest (as a pc of GDP) since 1943 – with outlays in the year to March up 66% (!) and revenues down 1%
- The 'face value' of gross federal debt outstanding rose by US$230bn to US$28.1trn during March, but the market value fell by $62bn to $29.3trn (159% of GDP) because bond yields rose over the month
- 38% of the outstanding debt is held by US Government trust funds or the Federal Reserve: the amount in private (including foreign) hands is US$18.2trn (99% of GDP)
- The Administration last week proposed a 16% increase in non-defence non-discretionary spending for FY22 (cf. a 1.7% increase in defence outlays)

Note: The measure of US gross federal debt is at market value. *Sources:* US Treasury Department; Federal Reserve Bank of Dallas.

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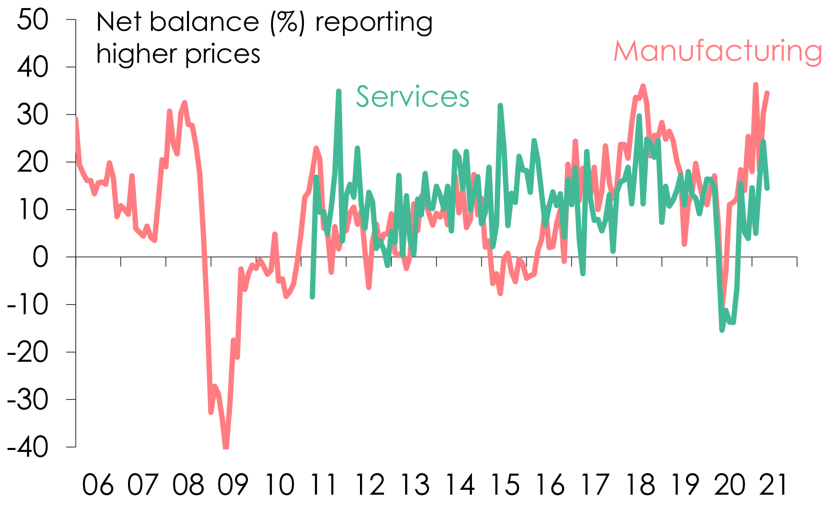
There's been widespread debate over whether the Biden Administration's US$1.9trn fiscal package is 'too big'

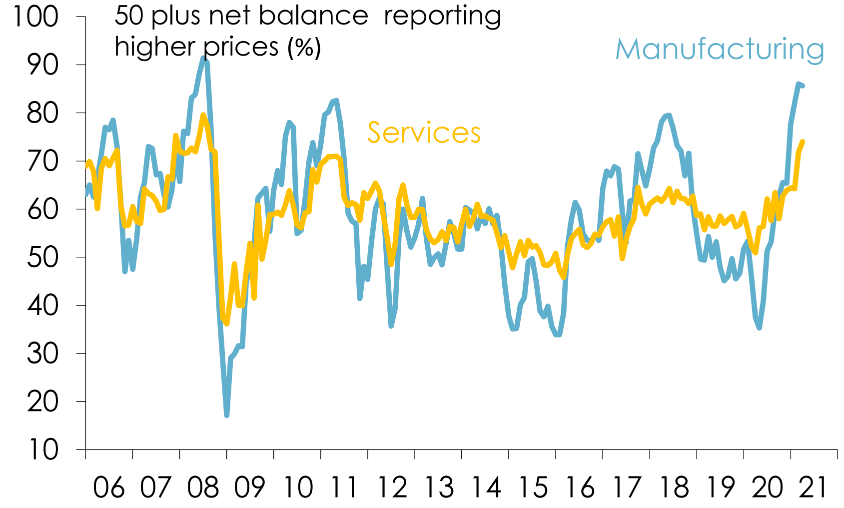
- In March, former US Treasury Secretary (in the second Clinton Administration) Larry Summers argued that the Biden Administration's US$1.9 trn stimulus plan was 'too big' and risked generating higher inflation
  - Summers calculated that the proposed stimulus was three times as large as the 'output gap' (between actual and 'potential' GDP) as recently reckoned by the Congressional Budget Office (cf. the Obama Administration's fiscal response to the global financial crisis which was only half the size of the then-projected 'output gap'
  - combined with the US$1½ trn of additional savings which US households accumulated last year, and much looser monetary policy settings now than then, Summers argued that this stimulus could "set off inflationary pressures of a kind we have not seen in a generation, with consequences for the value of the dollar and financial stability"
  - Summers was also critical of the composition of the Administration's stimulus plan, noting that it contained "no increase in public investment" to address "everything from infrastructure to preschool education to renewable energy"
- Former IMF Chief Economist Olivier Blanchard backed Summers, tweeting that the Biden program could "overheat the economy so badly as to be counter-productive"
- The OECD estimates that the stimulus package will boost US economic growth by 3¾ pc points this year, with 'spillovers' to the rest of the world boosting global growth by 1.1 pc point
- New Treasury Secretary (and former Fed Chair) Janet Yellen has defended the Administration's proposals, citing the same CBO analysis as suggesting without additional fiscal support it unemployment wouldn't fall to pre-pandemic levels until 2025, and arguing "we have the tools to deal with [rising inflation] if it materializes"
- Fed Chair Jerome Powell remains relaxed about the inflation outlook, emphasizing instead that the economy was "a long way" from the labour market conditions the Fed was seeking to achieve (and noting the 'effective' unemployment rate was still 'close to 10%' in January) – and that "achieving and sustaining maximum employment … will require a society-wide commitment, with contributions from across government and the private sector"

There is clear evidence of 'upstream' inflationary pressures developing …

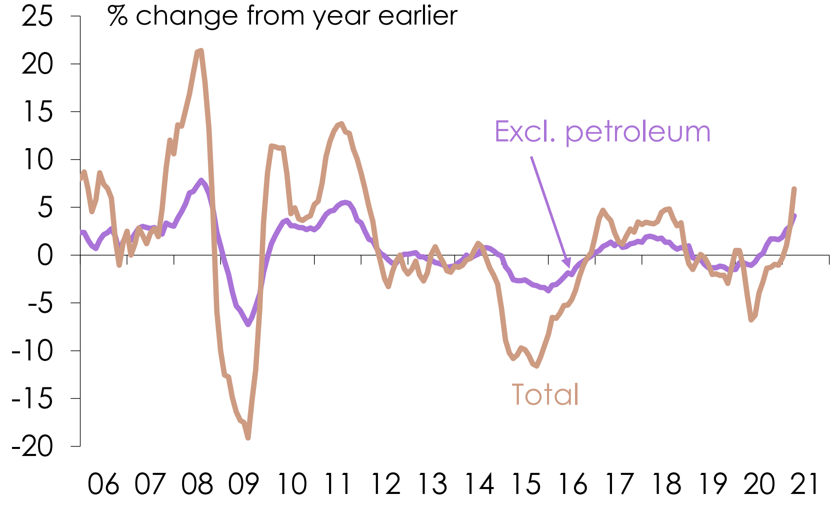
'Philly Fed' survey prices paid



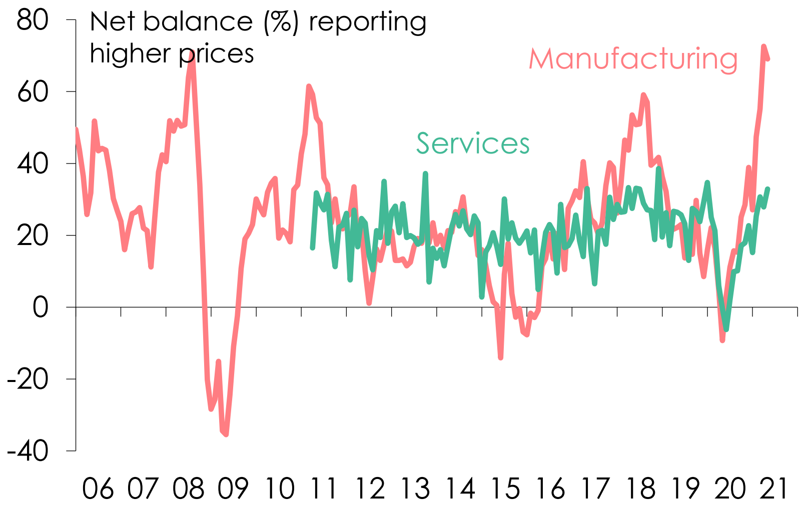
US ISM prices paid



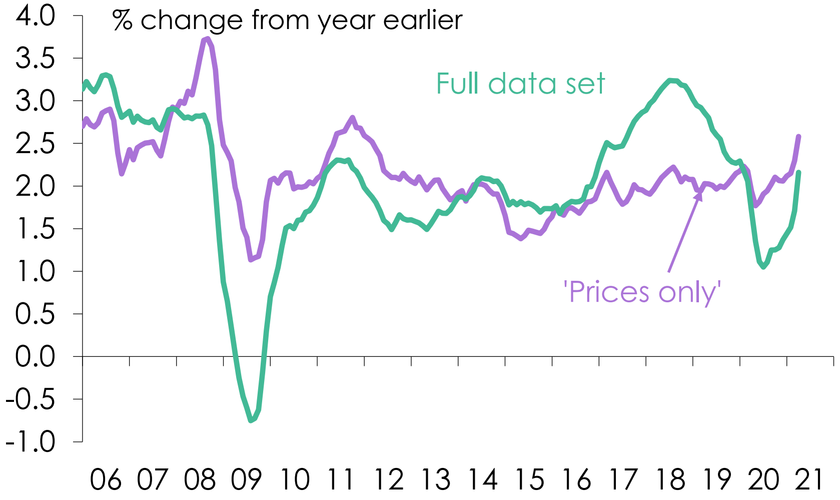
Import prices



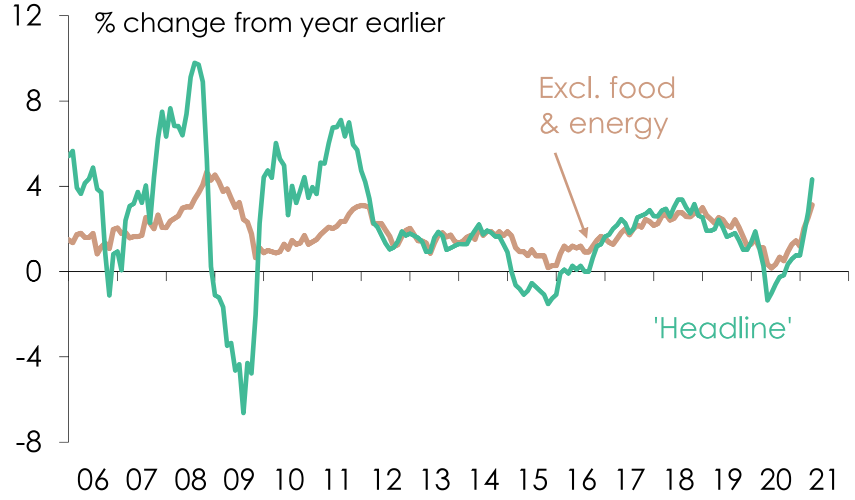
'Philly Fed' survey prices received



NY Fed underlying inflation gauge



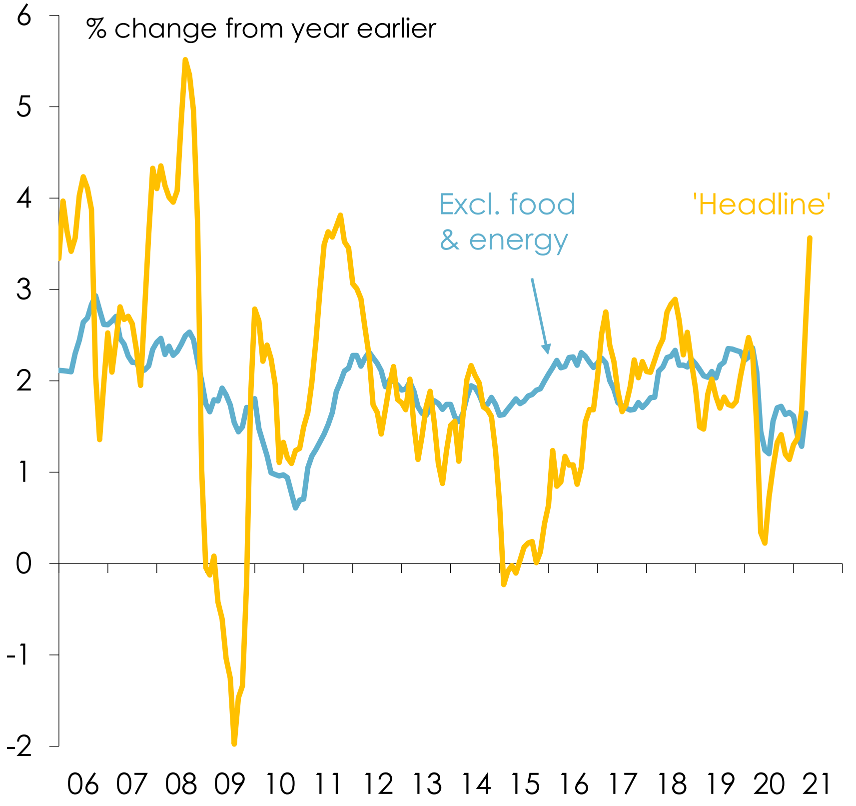
US producer price index



Sources: ; Federal Reserve Bank of Philadelphia; US Institute for Supply Management; Federal Reserve Bank of New York; US Bureau of Labor Statistics.

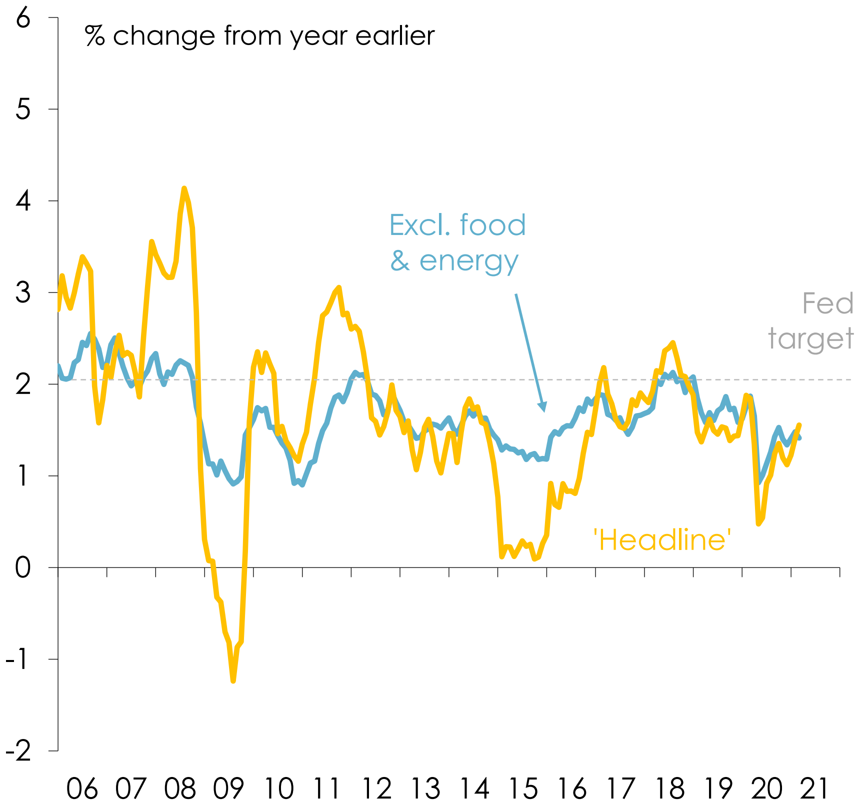
… but so far very little evidence of a sustained increase in inflation or inflationary expectations at the consumer level …

Consumer price index



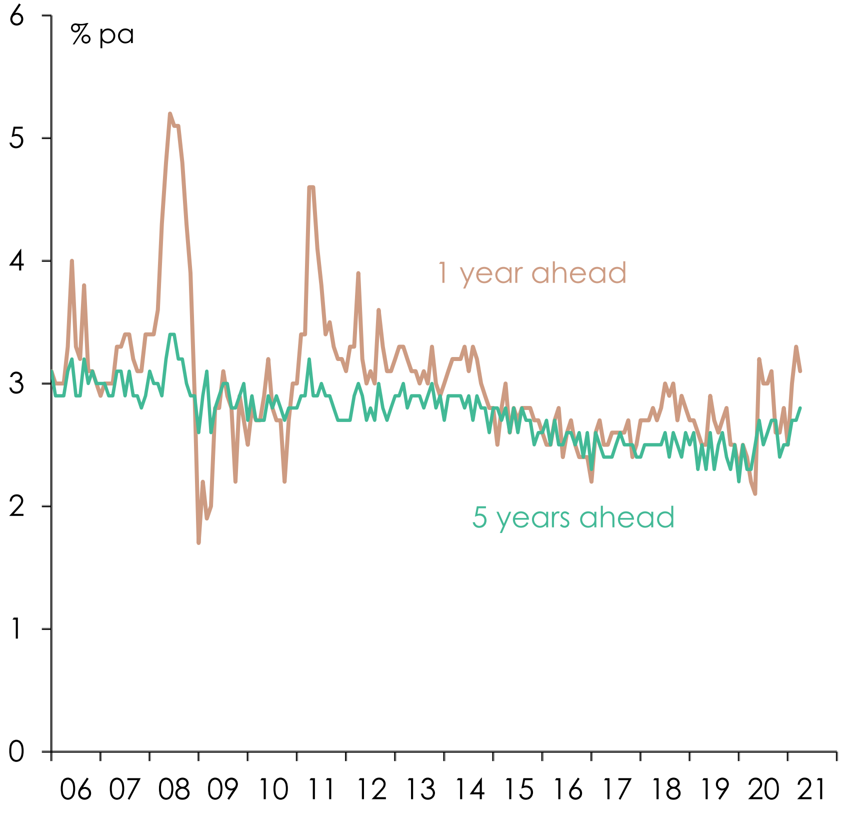
'Headline' CPI inflation rose in March – and will top 3½% in April-May – because of 'base effects' from this time last year

Personal consumption expenditure (PCE) price deflator



The Fed's inflation target is couched in terms of the PCE deflator which typically rises at about one-third less than the CPI for compositional reasons

Household inflation expectations



Central banks (including the Fed) attach a lot of importance to inflation expectations remaining 'well anchored'

Sources: US Bureau of Labor Statistics; Bureau of Economic Analysis; and Michigan University Survey Research Center.

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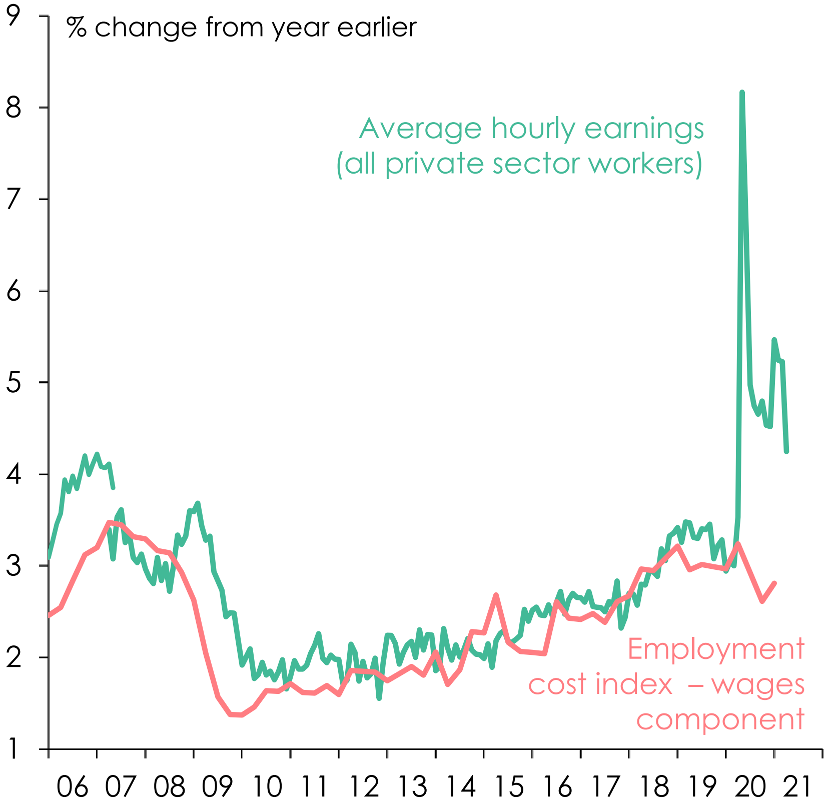
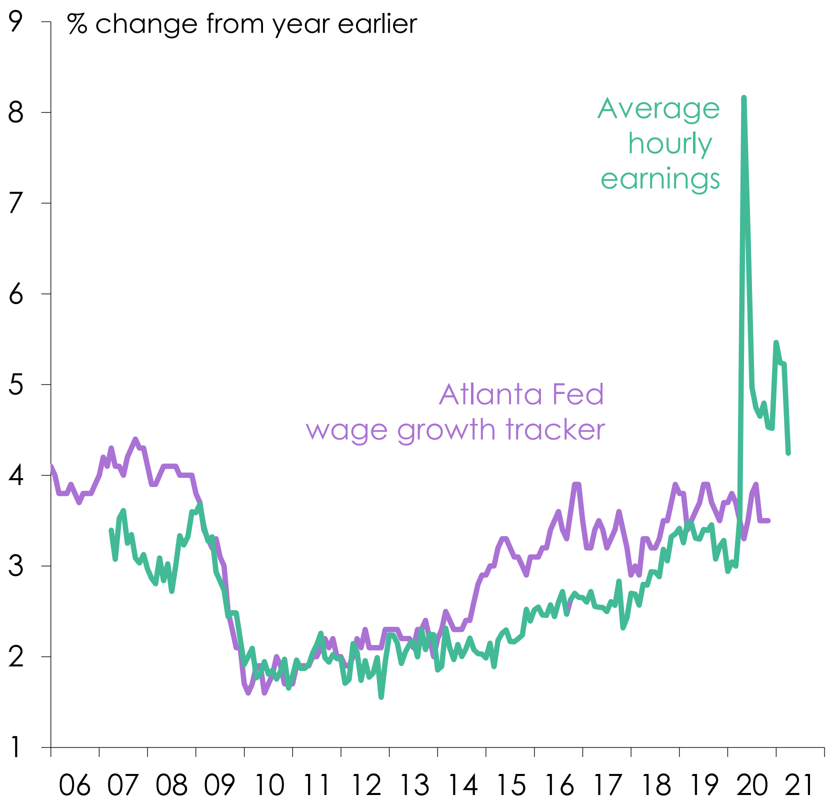
… partly (perhaps even largely) because to date there has been no clear sustained acceleration in labour costs

Average hourly earnings and employment cost index



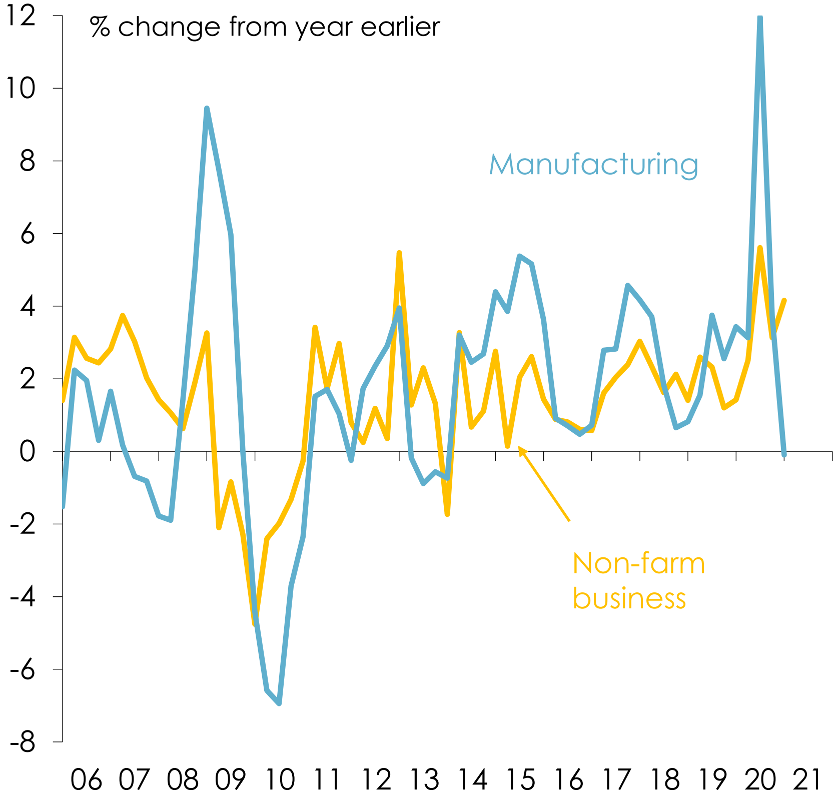
The average earnings measure is distorted by compositional changes in the work force (especially during Covid-19)

Atlanta Fed 'wage growth tracker'



The Atlanta Fed's 'wage growth tracker' measures the median change in the hourly wages of individuals derived from micro-data, and abstracts from changes in the work force

Unit labour costs

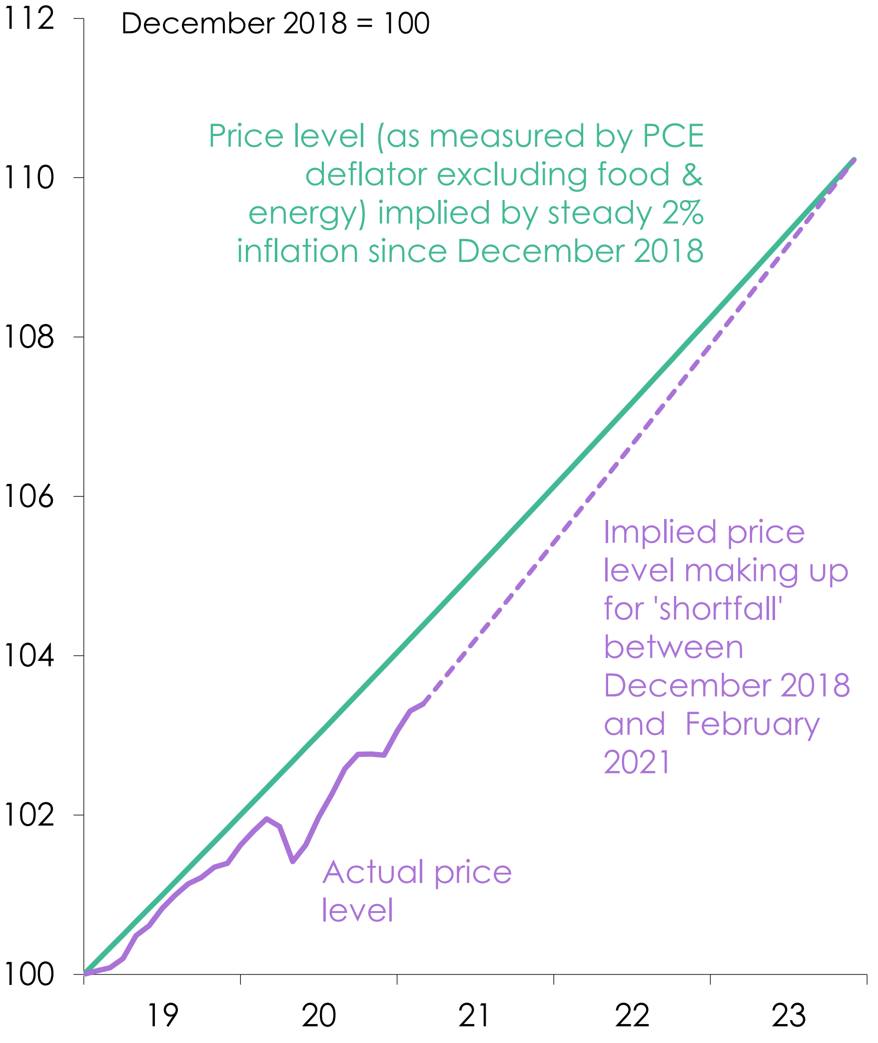


Measures of unit labour costs have been distorted by the impact of Covid-19 on measured labour productivity – it's not clear they have accelerated sustainably

Sources: US Bureau of Labor Statistics; Federal Reserve Bank of Atlanta.

The Federal Reserve has modified the way it interprets its mandate (and the way it will conduct monetary policy) in two important respects

Hypothetical path for the 'price level' implied by new Fed target framework



- In August last year, the Federal Reserve adopted a new Statement on Longer-Run Goals and Monetary Policy Strategy in which it modified its interpretation of both legs of its "dual mandate"
- The Fed has adjusted its inflation target from "2%" to "an average of 2% over time"
  - which it spelled out means that "following periods when inflation has been running persistently below 2% … appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time"
  - this would appear to amount to *de facto* 'price level' targeting
  - by way of illustration since inflation (as measured by the 'core' PCE deflator) has averaged 1.6% pa since December 2018 (when it was last at 2%), the Fed's new target implies that if it was aiming for 2% inflation on average over the period 2019-2023 it would be comfortable with inflation averaging 2.4% pa between now and December 2023
- And the Fed has changed the way it interprets the "maximum employment" part of its "dual mandate"
  - monetary policy decisions will be informed by its assessments of the "*shortfalls* of employment from its maximum level" rather than (as in the past) by "*deviations* from its maximum level" (emphasis in the original)
  - what this appears to mean in practice is that the Fed will no longer tighten monetary policy merely because unemployment is below its estimate of 'full employment' (or the 'non-accelerating inflation rate of unemployment, NAIRU) – as it did in the past – but that it will ease policy (or maintain easy policy) if unemployment is above this level
- The Fed has repeatedly indicated that will keep its target range for the Fed funds rate at 0-¼% "until labour market conditions have reached levels consistent with [its] assessments of maximum employment and inflation has risen to 2% and is on track to moderately exceed 2% for some time"

Sources: Bureau of Economic Analysis; Board of Governors of the Federal Reserve System.

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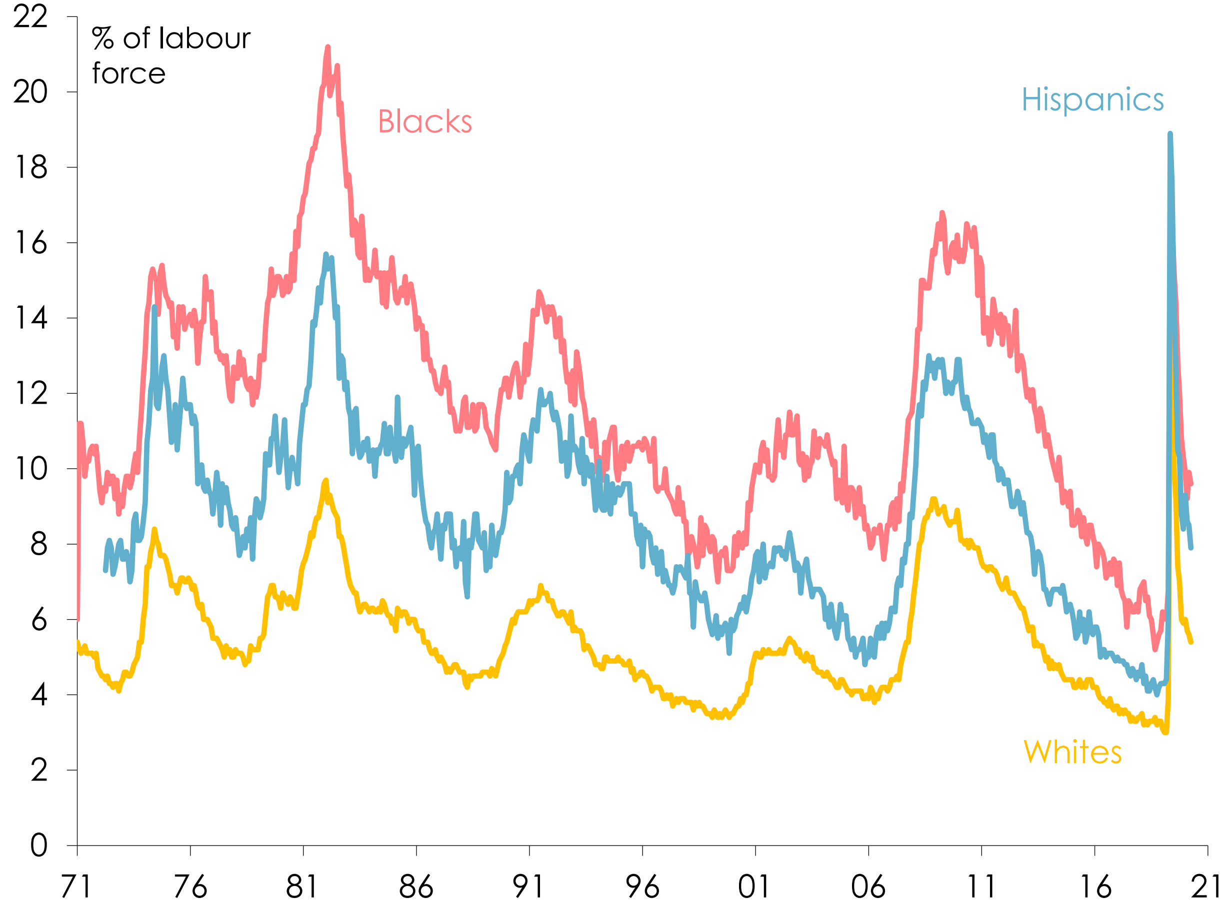
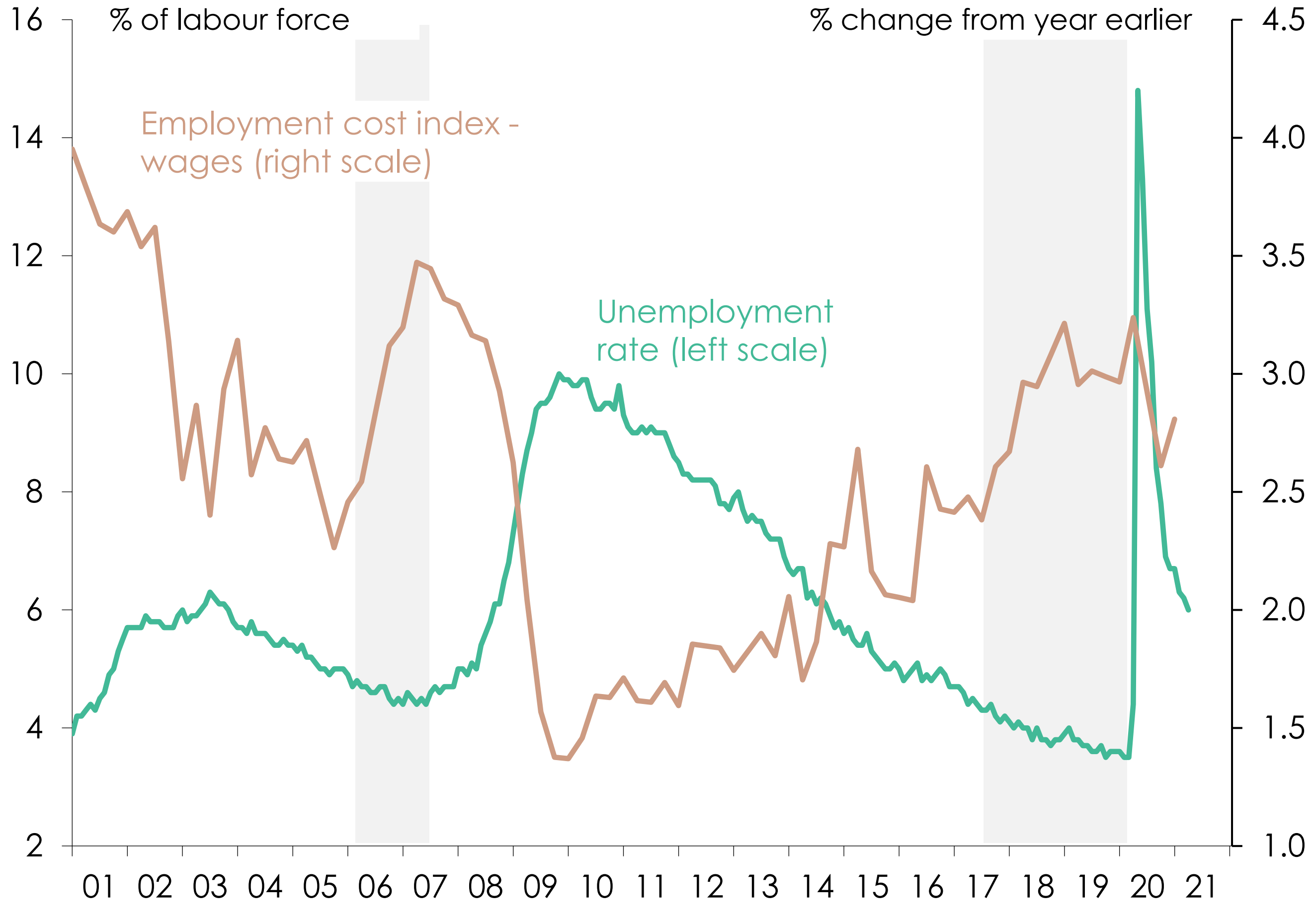
Among the Fed's motives for changing its employment target are to reduce unemployment among minorities and to boost wages growth

Unemployment rates by racial group



The Fed has been quite explicit that one of the reasons for the change in how it interprets its employment target is to reduce unemployment among racial minorities

Unemployment rate and wages growth



In the past two decades, wages growth has only ever sustainably exceeded 2½% when the unemployment rate has been less than 4%

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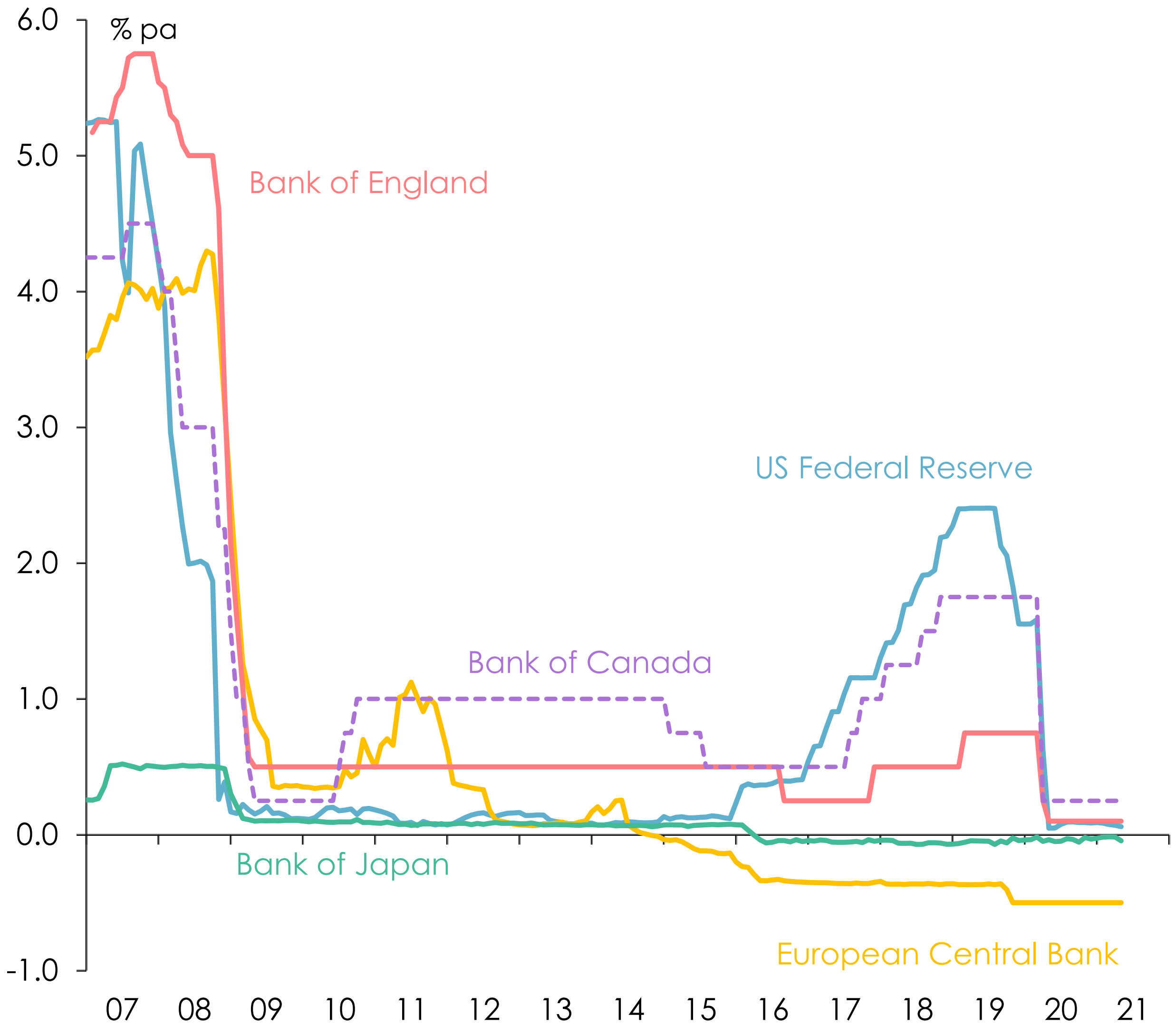
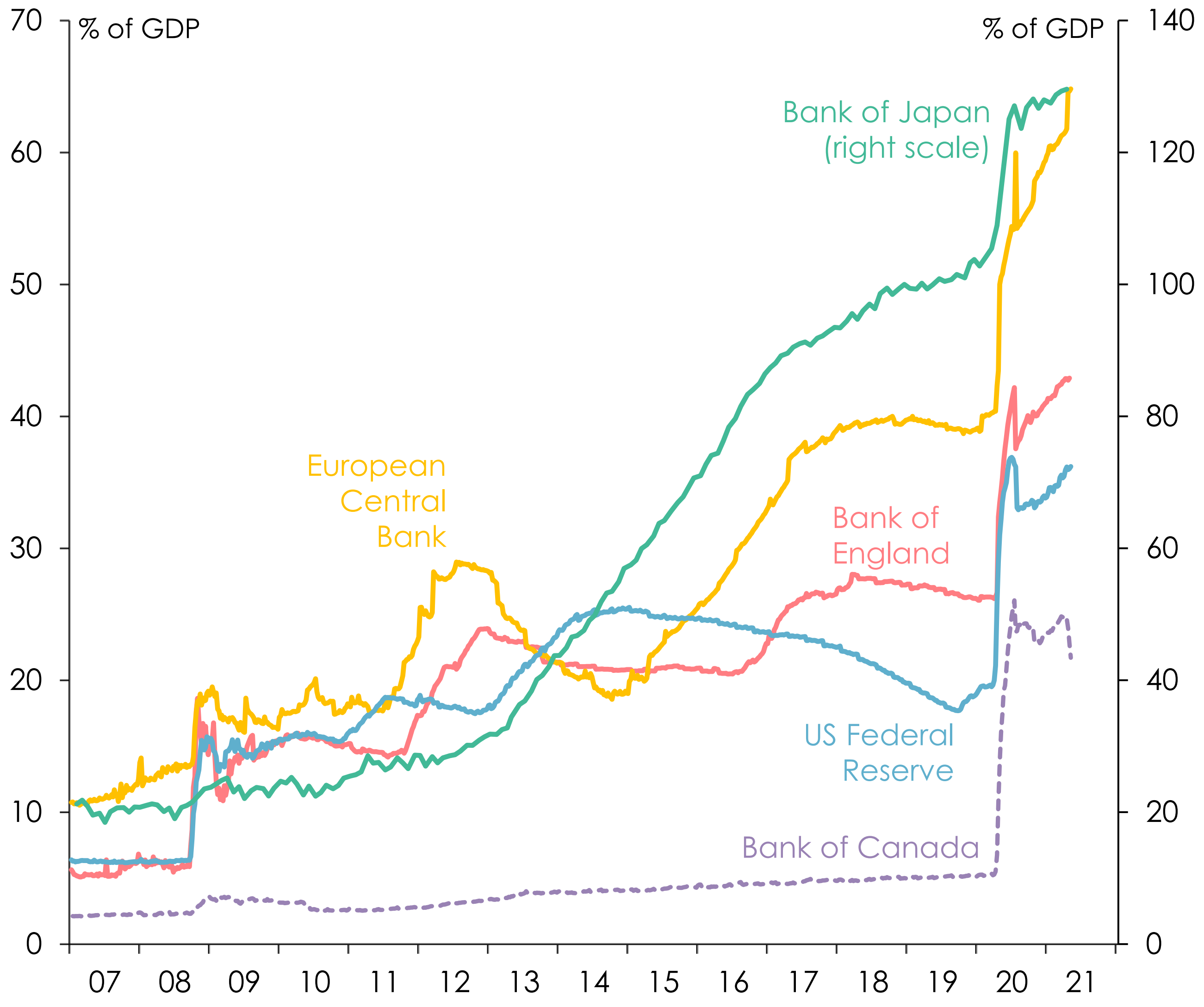
The Federal Reserve hasn't pushed its monetary policy pedals as 'flat to the floor' as most other 'advanced' economy central banks

Major central bank policy interest rates



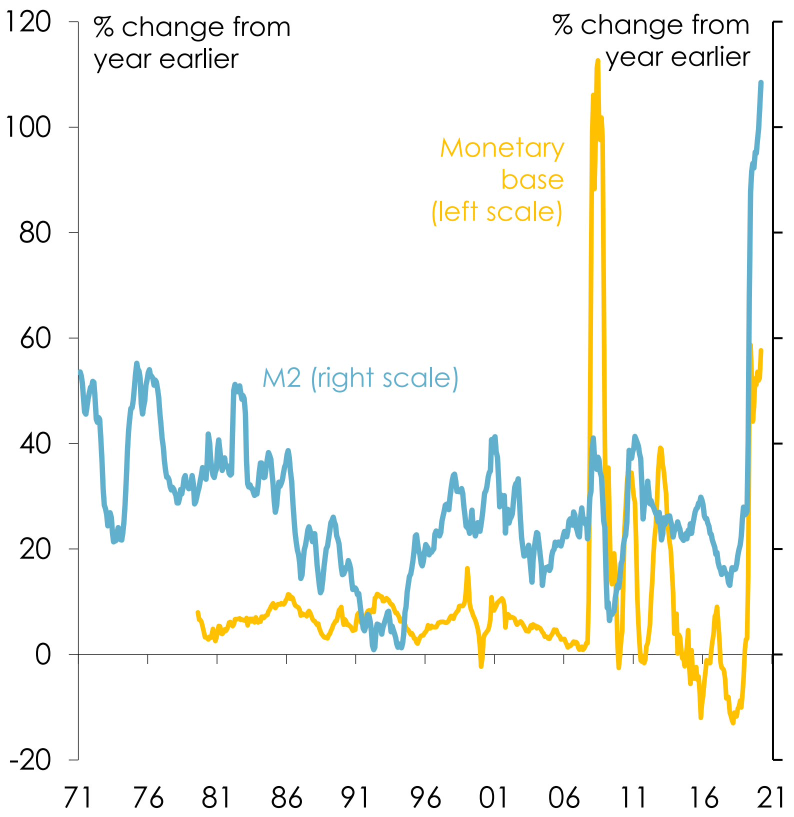
Major central bank balance sheets



Note: estimates of central bank assets as a pc of GDP in Q2 2020 were inflated by the sharp drop in nominal GDP in that quarter: conversely, declines in estimates of central bank assets as a pc of GDP in Q3 are in large part due to rebounds in nominal GDP. *Sources:* US Federal Reserve; European Central Bank; Bank of Japan; Bank of England; Bank of Canada; national statistical agencies; Corinna.

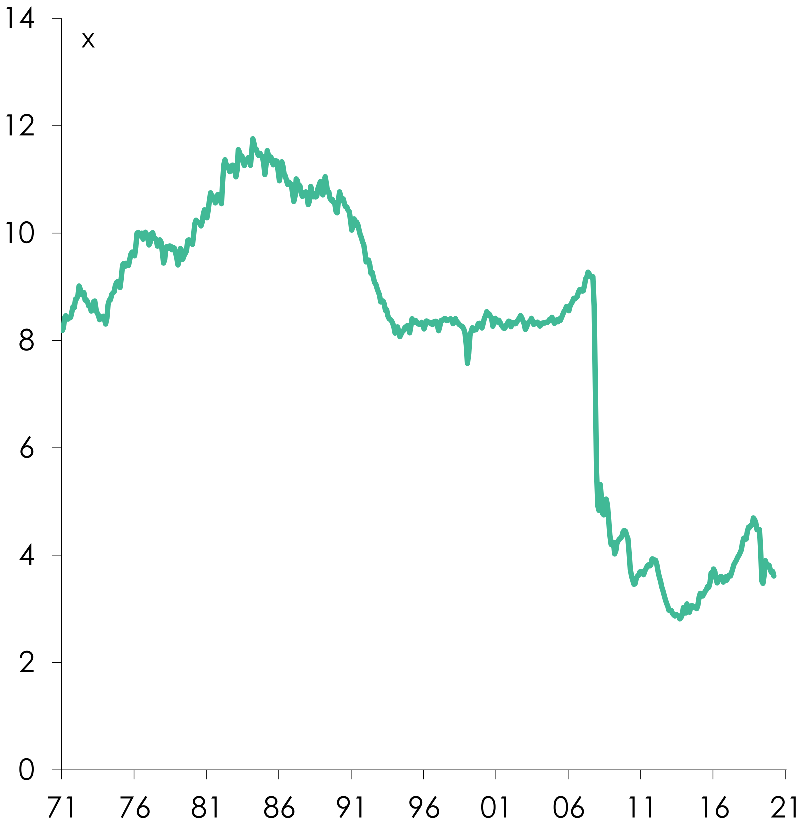
A 'monetarist' interpretation of why ultra-easy monetary policy hasn't (and probably won't) generate markedly higher inflation

'Money supply' measures



M2 is growing more rapidly than at any time since 1860 (even though base money has been growing less rapidly than during the financial crisis)

The 'money multiplier'



M2 didn't accelerate at all during the GFC because the 'money multiplier' (the rate at which the banking system turns base money into credit) had collapsed

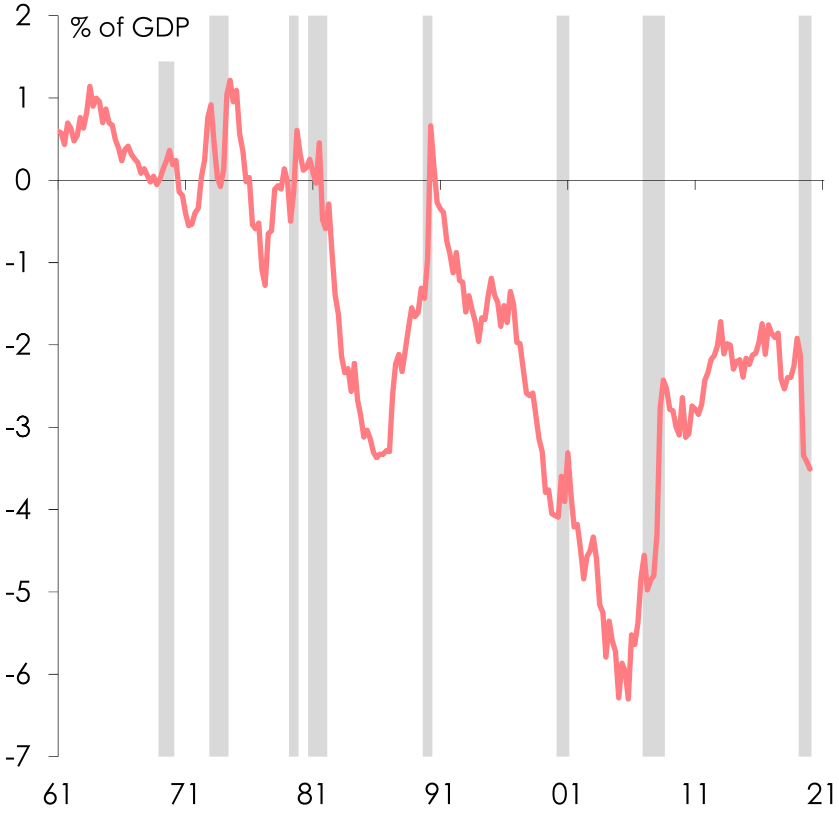
The 'velocity of money'

Rapid money supply growth isn't generating higher inflation because the 'velocity of money' has collapsed – the money is 'sitting' at the Fed

Note: The monetary base is currency in circulation plus reserve balances (held by banks at the Federal Reserve); M2 is currency and demand deposits held by the non-bank public plus savings deposits, time deposits of less than US$100,000 and balances in retail money market funds (excluding IRAs). The 'money multiplier' is the ratio of M2 to the monetary base; and the 'velocity of money' is the ratio of nominal GDP to M2. *Sources:* US Federal Reserve; Bureau of Economic Analysis.

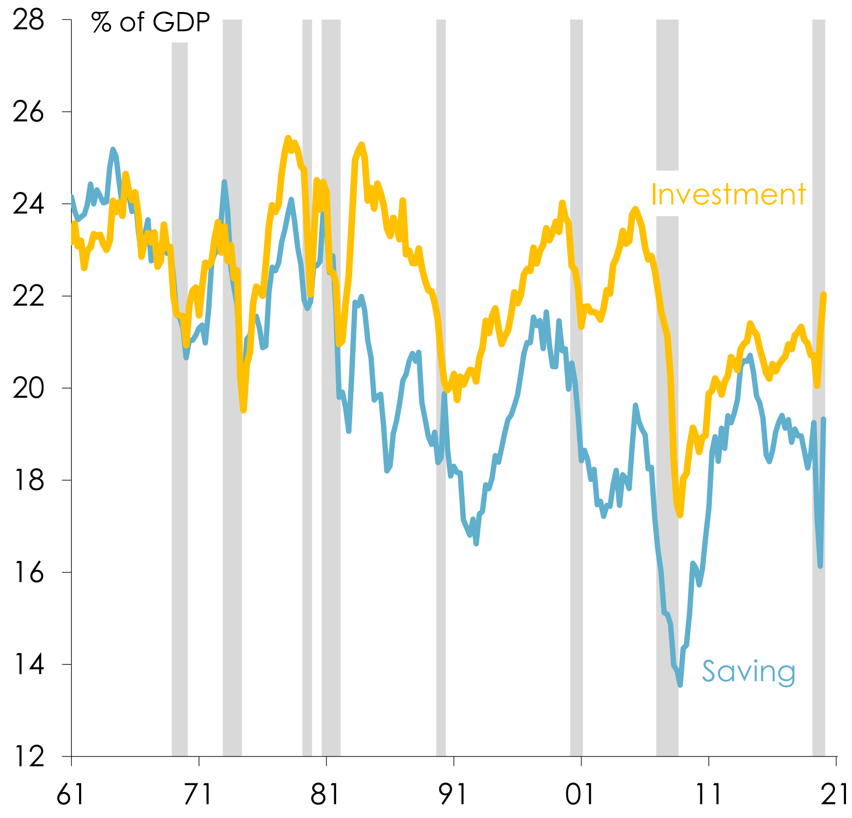
History strongly suggests that 'excess demand' resulting from 'excessive' stimulus is likely to be reflected in a widening US current account deficit

US current account balance



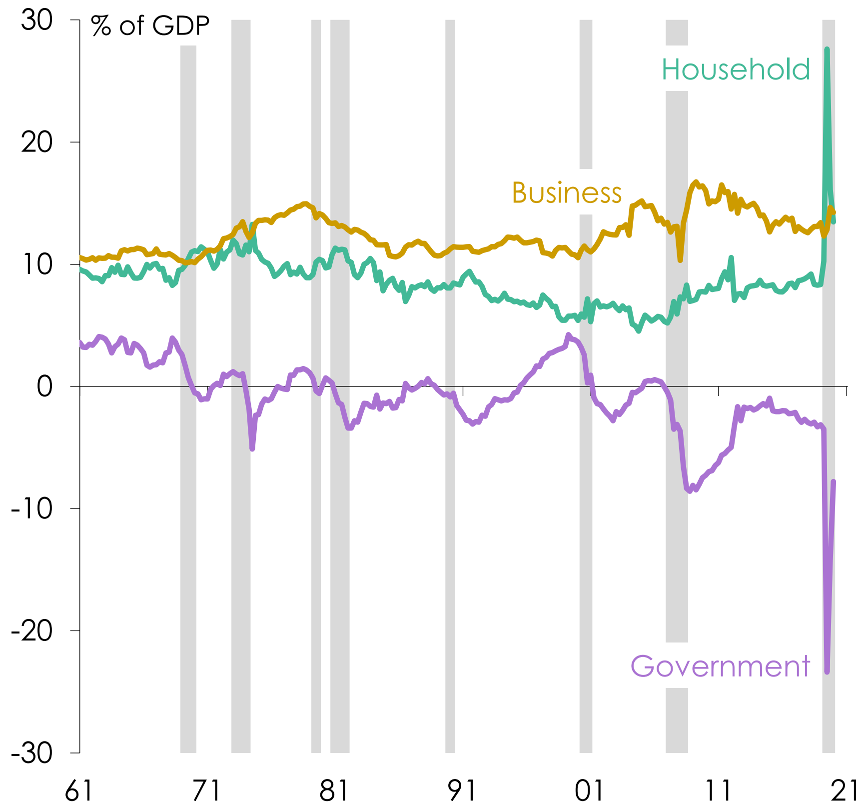
The US current account balance normally improves (ie, the deficit usually gets smaller) during recessions – but in this one it has (so far) widened

Gross saving and investment



Investment *didn't* fall much during this recession – perhaps because it didn't rise as much as usual during the preceding expansion (corporate tax cuts notwithstanding)

Gross saving by sector



The dramatic increase in the budget deficit has been largely (but not totally) offset by an increase in household saving

Note: shaded areas denote recessions as designated by the US National Bureau of Economic Research.
Source: US Bureau of Economic Analysis.

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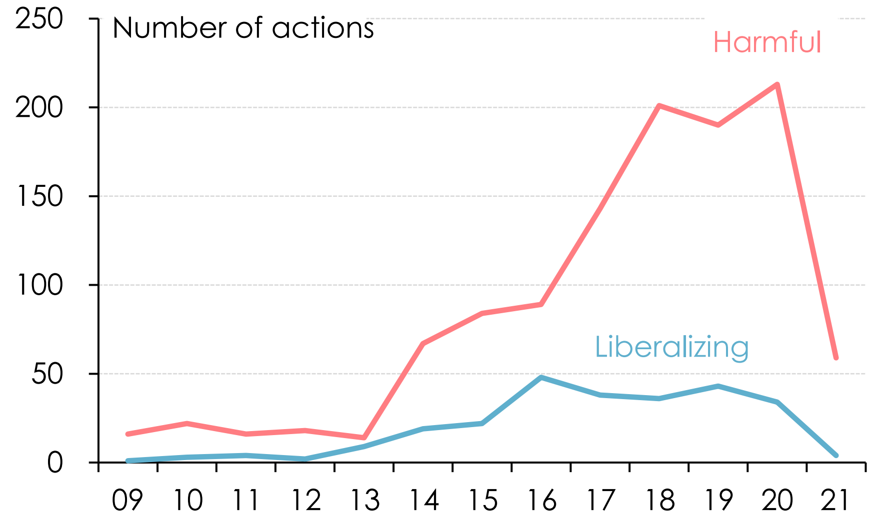
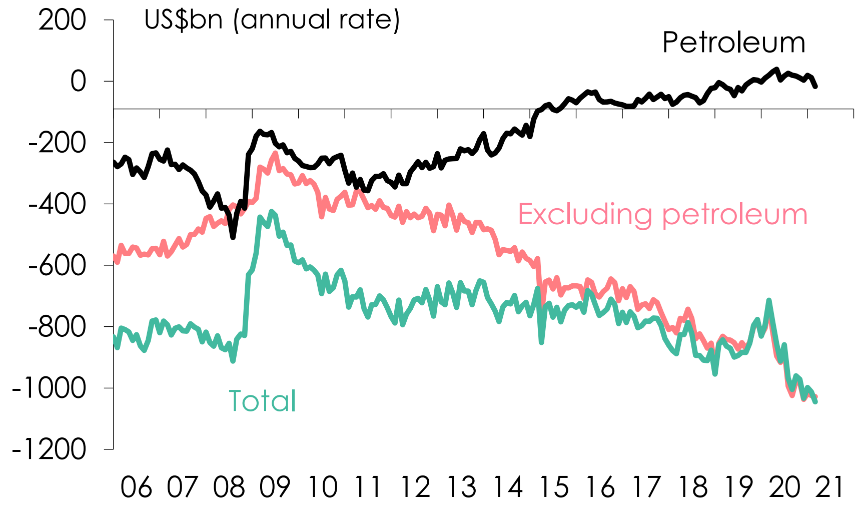
The Trump Administration's trade policies 'redistributed' the US trade deficit (away from China) but <u>didn't</u> reduce it

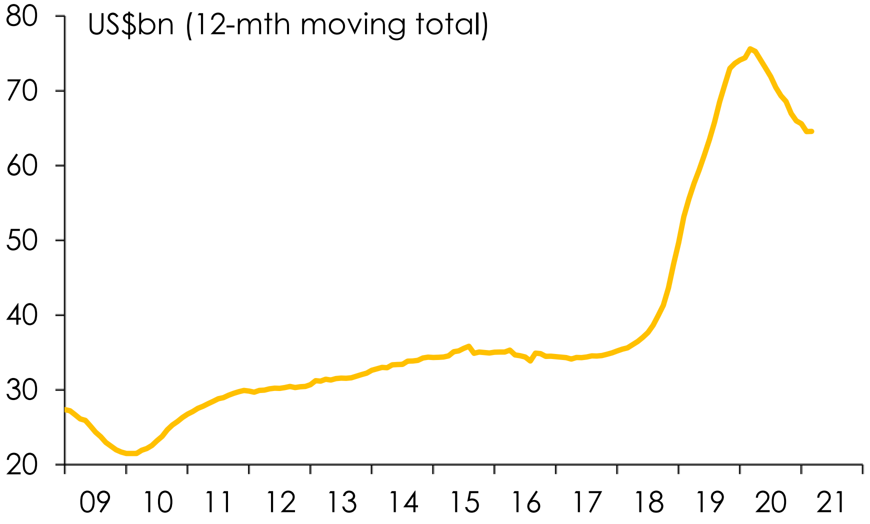
US trade policy actions



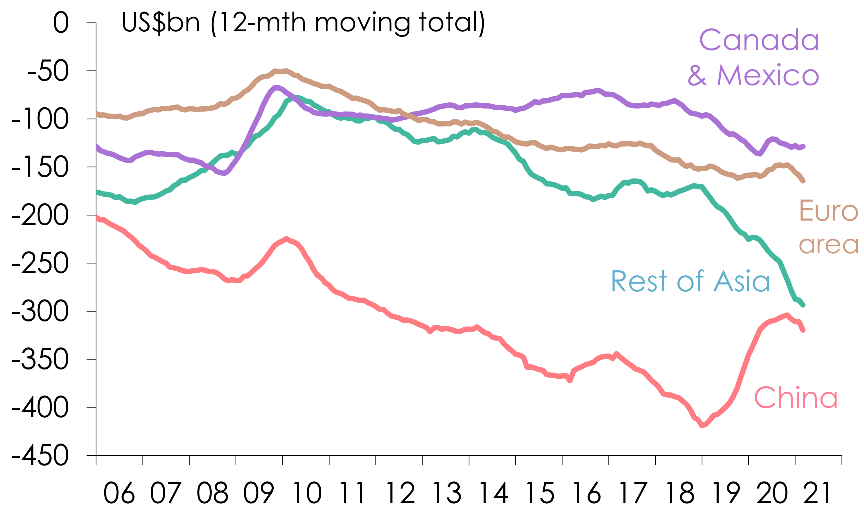
US merchandise trade balance



US customs duty revenue



US bilateral trade balances



- **A Brookings Institution analysis of the impact of the Trump Administration's trade policies suggests that the average American household paid anywhere between "several hundred" and "a thousand dollars or more" per annum in higher prices due to tariffs**
- **The overall US trade deficit continued to widen under the Trump Administration – despite the balance on petroleum products trade moving into surplus**
- **A US$110bn decline in the bilateral deficit with China was more than offset by wider deficits with the rest of Asia, Mexico, Canada and Europe**
- **The US incurred a record (goods & services) trade deficit of US$71bn in February (up from US$68 bn in January and a monthly average of $57bn in 2020)**

Sources: Geoffrey Gertz, *Did Trump's tariffs benefit American workers and national security?*, The Brookings Institution (10th September 2020); Centre for Economic Policy Research, *Global Trade Alert* Global Dynamics (data up to 16th April); US Treasury Department; US Census Bureau

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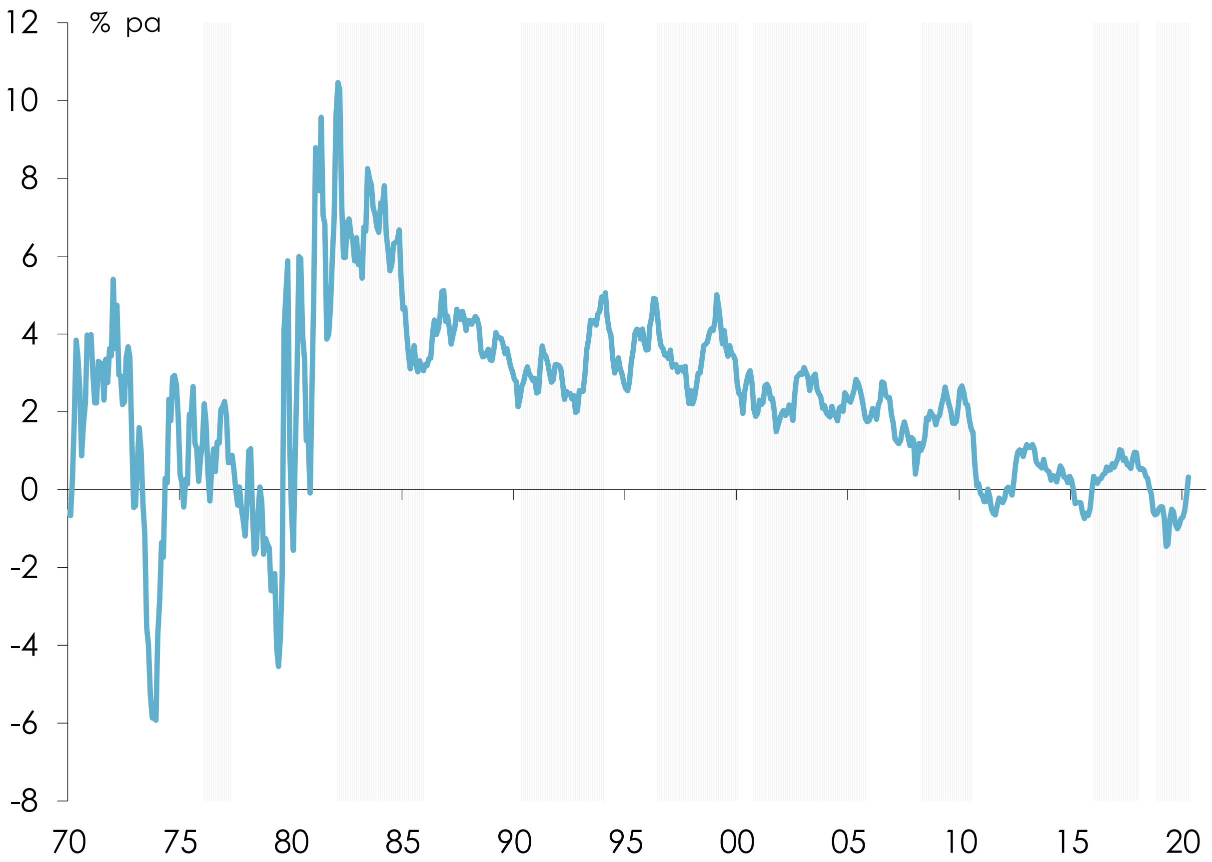
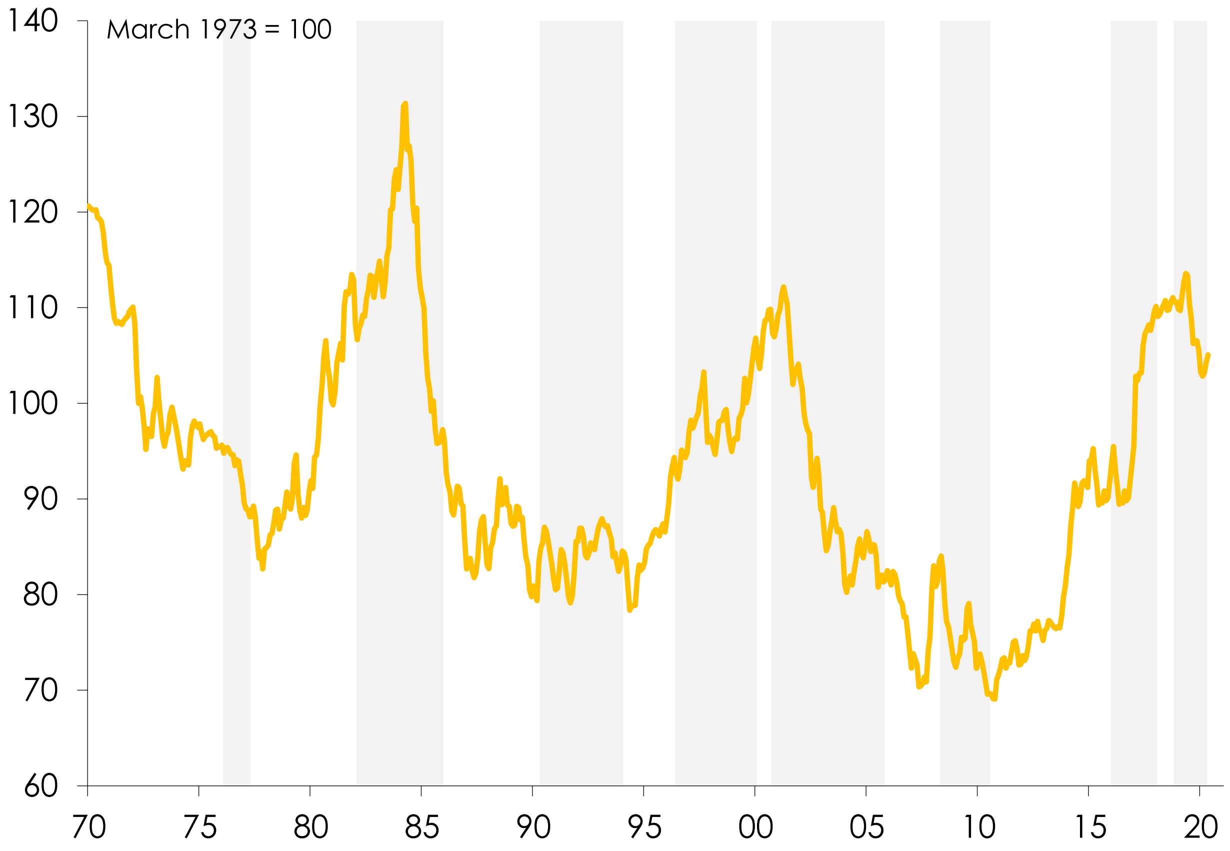
History also suggests that a widening US current account deficit is likely to result in higher real US bond yields and a stronger US dollar

Real US ten-year bond yields



US dollar against other major currencies



- ❑ **Real US bond yields and the US$ usually (although admittedly not always) rise when the US current account deficit is widening – especially if that is the result of faster economic growth in the US than elsewhere**
- ❑ **The fact that the Fed is not seeking to counter rises in US bond yields with stepped-up bond purchases – in contrast to the ECB and BoJ – increases the likelihood of a stronger US$**

Note: 'Real' US bond yields are nominal yields less the increase in the CPI excluding food and energy over the preceding 12 months; shaded areas denote periods when the US current account deficit was widening (irrespective of how large it was). *Sources:* Refinitiv Datastream; US Federal Reserve (H.10/G5 and H.15).

Some important risks to the US economic outlook (and to the global outlook arising from the US)

- **The Biden Administration won't be able to get all of its measures through Congress**
  - Senate Republicans seem determined to 'oppose everything' (as they did during the Obama Administration), which means that Democrats will need unanimity in the Senate and even then will have to rely on Vice-President Harris' casting vote
  - at least two Democrat Senators – Joe Manchin (West Virginia) and Kyrsten Sinema (Arizona) – are likely to defect from the Democratic caucus on some proposals eg for tax increases, large spending increases, or other 'progressive' measures
- **US political history suggests that the Democrats could lose their Senate majority, and perhaps even their majority in the House, at next year's mid-term elections – which would make 'gridlock' very likely**
  - since the end of World War II, the party of an incumbent first-term President has lost an average of 24 seats in the House, and one in the Senate, at mid-term elections
  - the Democrats only need to lose 6 seats in the House to lose their majority, and 1 seat in the Senate (although 20 Senate places currently held by Republicans are up for election in 2022, cf. 14 held by Democrats)
  - Republicans control a majority of state governorships and legislatures, and already many of them are seeking to 'suppress the vote' in ways that would disadvantage Democrats in 2022 (and 2024)
- **Donald Trump is likely to continue to exert a malign influence over the Republican Party – as a result of which US politics could become even more adversarial and confrontational, especially over 'cultural' issues**
- **US inflation could rise more significantly if the Administration or Congress react to widening US trade and current account deficits by resorting to more protectionist measures**
- **Higher US bond yields and/or a much stronger US$ could prompt financial crises in emerging markets**
  - although Asian economies are better 'insulated' from those risks than they were in 2013 (during the so-called 'taper tantrum' or in 2018 (when the Fed started raising interest rates)
- **Geo-political tensions with China are likely to remain elevated (despite the recent agreement to 'work together' on climate change**
  - Taiwan is likely to remain a flashpoint

Important information

This document has been prepared by Saul Eslake on behalf of Corinna Economic Advisory Pty Ltd, ABN 165 668 058 69, whose registered office is located at Level 11, 114 William Street, Melbourne, Victoria 3000 Australia.

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