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POLICY BRIEF

The Economic Situation, December 2018

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By most of the important measures—the kind that fill tables and text in the annual *Economic Report of the President*—the US economy is on a roll. The first estimate for Q3 2018 GDP growth came in with an annual rate of 3.5 percent—not as good as Q2's 4.2 percent, but a lot better than 2017's 2.8 percent growth for the year.[1] The unemployment rate is reaching record lows; construction activity, while weakening, is still high. Perhaps more importantly, total workplace earnings, including bonuses and fringe benefits, are on the rise. As an overall assessment of personal prosperity, real per capita GDP is also increasing. Put another way, on average, US workers and families are becoming better off.

In fact, some commentators are saying we have a Goldilocks economy where everything is just right. We must remember the rest of the story, though: when the three bears returned, and Goldilocks had to escape. Can we hear some distant growls? There is growing evidence that rising uncertainty regarding trade, interest rates, and other government policies is making managers and owners of businesses hesitate and review the situation before making major new job-creating investments. Keep in mind, it is hesitation in a high-growth economy. What might this say about the prospects for another recession?

This report will address the recession question but will first focus on the hesitating economy. The next section provides some supporting evidence along with a few anecdotes that explain how trade policy uncertainty interrupts plans to hire workers and expand manufacturing plants. Using labor market data, the next section examines the recession question. According to the data, the economy is definitely operating at a high level, and fortunately nothing in the data path presented in the section resembles a recessionary prospect. The section that follows takes a fresh look at how the Trump trade wars are generating a little-discussed facet of growing regulation that involves the granting of favors to trade-regulated firms. After that, a spotlight is placed on Hawaii for this

Table 1. Dr. Bruce Yandle's 2019 Economic Projections

	2019 PROJECTED (PERCENT)	2018 RECENT VALUE (PERCENT)
GDP Growth	3.1	3.5
CPI	3.2	2.9
Unemployment	3.6	3.7
90-Day Bill	3.0	2.1
10-Year Note	3.6	3.2
30-Year Mortgage	5.5	4.9

Note: Estimates are current as of November 21, 2018.
Source: For all of the 2018 recent values except the 90-day bill, see Wells Fargo Securities Economics Group, *Weekly Economic & Financial Commentary*, November 21, 2018, https://www08.wellsfargomedia.com/assets/pdf/commercial/insights/economics/weekly-commentary/weekly-20181121.pdf. For the 90-day bill recent value, see Wells Fargo Securities Economics Group, *Monthly Economic Outlook*, November 7, 2018, https://www08.wellsfargomedia.com/assets/pdf/commercial/insights/economics/monthly-outlook/monthly-20181107.pdf.

quarter's state analysis. The report ends with a visit to Yandle's Reading Table and discusses three books that may be worth reading. Before moving to the next section, I offer projections for the 2019 economy in table 1.

As indicated, I expect little change in GDP growth, a bit higher inflation, slightly tighter employment markets, and higher interest rates. All-in-all, I offer a rather unexciting projection, which, if it comes to pass, may be something to celebrate.

THE HESITATING ECONOMY

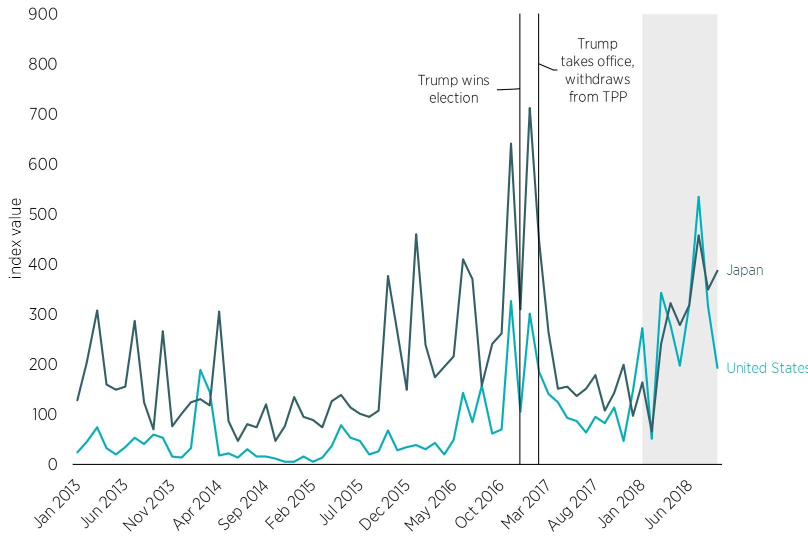
Is the high-growth economy hesitating? Why hesitation, and what's the evidence?[2]

Consider this: there are unstable oil prices, generated partly by US restrictions on the shipment of Iranian oil; higher interest rates with the Fed promising more of the same; and growing uncertainty with regard to ratification of the recently negotiated US-Mexico-Canada trade agreement. Then, there are continuing belligerent trade conversations between White House officials and Chinese leadership and on-again, off-again Trump administration commitments to befriend North Korea. These make up major ingredients of the uncertainty soup that private decision makers are trying to understand. Occurrence of any number of these could be enough to cause some firms to hesitate in their plans for expanding operations and markets. All of them together could take the wind out of the economy's high-flying sails. In the following section, I look closely at trade policy, which is the more troublesome part of the economic uncertainty puzzle.

What about the evidence?

In a recent study, University of Chicago economist Steven J. Davis reported an uncertainty index for Japan and the United States he developed based on the occurrence of key words, such as "trade

Figure 1. Trade Policy Uncertainty



Note: TPP = Trans Pacific Partnership. The shaded period represents when President Trump announced tariff hikes; and when trade policy tensions intensified, especially between the United States and China.
Sources: **US Data:** Scott R. Baker, Nicholas Bloom, and Steven J. Davis, "Measuring Economic Policy Uncertainty," *Quarterly Journal of Economics* 131, no. 4 (2016): 1539–1636; **Japan Data:** Elif C. Arbatli, Steven J. Davis, Arata Ito, Naoko Miake, and Ikuo Saito, "Policy Uncertainty in Japan" (NBER Working Paper No. 23411, National Bureau of Economic Research, Cambridge, MA, May 2017). All data were downloaded from policyuncertainty.com.

policy uncertainty," in international newspapers.[3] Davis examined the patterns that resulted and labeled some of them. His chart is reported here.

The chart shows the two indices spiking with President Trump's unexpected election to office and his associated promise to remove the United States from the Trans-Pacific Partnership trade agreement. A second series of spikes is seen with the 2018 start of the current trade wars.

As Davis suggests, charts are nice, but does the pattern tell us anything about decisions to expand businesses? Do executives hesitate when uncertainty rises? To answer this question, Davis cites a recent Federal Reserve Bank of Atlanta survey of 330 business executives that asked, "Have the recently announced tariff hikes or concerns about retaliation caused your firm to re-assess its capital expenditure plans?"[4] About one-fifth of the respondents said, "Yes." A similar Reuters survey of Japanese manufacturing firms discussed by Davis asked about postponed investment plans. Of the 253 responding firms, 24 percent indicated they were postponing or reassessing major investment plans.

Uncertainty regarding trade and established sources of supply causes managers of US manufacturing plants to postpone pending expansion plans and then to devote their time to finding suppliers not subject to tariffs. The requirements of the new US-Mexico-Canada trade agreement, yet to be ratified by Congress, are that automobile manufacturers source at least 70 percent of their steel and aluminum from within the three countries or pay a 2.5 percent tariff on noncomplying products. While a final determination is yet to be made, this may mean that Mercedes-Benz and BMW, which currently import engines from Germany, may have to move engine production to North America. If so, that would lead to an increase in manufacturing activity in the region, but also to higher costs, leading to higher prices and potential assembly plant layoffs.

A reverse example is seen in the case of Kent International, Inc., a South Carolina bicycle producer with an assembly plant employing 167 workers.[5] Before the outbreak of the US-China trade war, Kent's principal owner, Arnold Kamler, had expansion plans in the works. His firm was going to import steel tubes from China and use the tubes to form bicycle frames. Then the tariffs hit. Kamler explains, "When we started getting winds of tariffs and were confident cut tubes would be subject to tariffs, we stopped."[6] Kamler indicated that he traveled to the Philippines and Taiwan to find tariff-free sources for tubing. "We are not bringing jobs back to America with this thing. We are bringing jobs to different countries in Southeast Asia."[7] The Kent, Mercedes-Benz, and BMW stories illustrate how new search costs result from the tariff war, and how the already-scarce time of top managers is diverted to dealing with a new, politically determined cost. Those costs explode when the number of tariff-affected firms increases.

There is another unobserved cost associated with imposing tariffs. As illustrated in the South Carolina bicycle plant story, top management is diverted from the projects it would have been working on to dealing with revisions in plans and perhaps interacting with political leaders as it negotiates the fallout from the tariffs. Since May—when the Trump steel and aluminum tariffs were announced—the US Department of Commerce, which administers the associated regulations, has received more than 35,000 petitions from firms seeking exemptions from steel and aluminum tariffs.[8] What if, on average, preparing the petitions took just 8 hours? That would amount to 280,000 hours or 7,000 weeks of management time, all in an effort to recover a now-blocked production relationship. This does not bode well for productivity improvement. Only a successful petition will allow a firm to recover the position occupied prior to the advent of higher tariffs (that is, to return to square one, after expending substantial resources).

When operators of US manufacturing plants face uncertainty, they also turn to temporary workers when contracting for additional labor instead of making permanent hires. The most recent Bureau of Labor Statistics (BLS) employment data show the rate of growth of manufacturing employment falling and—you guessed it—the rate of growth for temporary contract worker employment rising, each by almost equal amounts.[9]

When labor markets are tight and productivity is rising, employers tend to raise wages in order to attract and keep workers. But when uncertainty enters the picture, the same employers go with bonuses, vacation time, use of company vehicles, and other fringe benefits—things they can turn off and on—rather than raising wages. Recent BLS survey data indicate this is happening.[10]

Does this mean we are seeing the high point of the current long-lived expansion? Maybe. Or does this mean it's time for Washington decision makers to pause in their constant efforts to disrupt major policies and to give the economy a chance to take a deep breath?

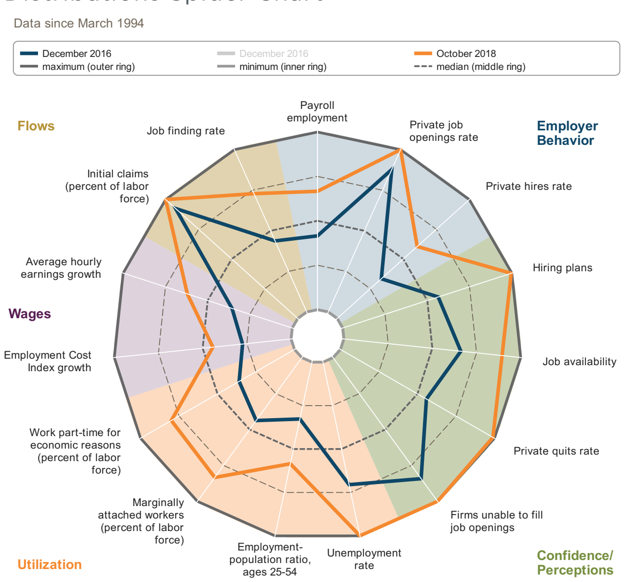
Why risk another recession when it can be avoided?

WHAT DO LABOR MARKETS SAY?

Just how strong is the economy, and is there room in the tight labor markets for some more growth? The labor market distributions spider charts maintained by the Federal Reserve Bank of Atlanta provide an in-depth composite view of patterns formed by 15 labor market variables. Placed into five categories—employer behavior, confidence/perceptions, utilization, wages, and flows—the values attained quarterly by the 15 variables can be compared with their earlier counterparts. To illustrate, I provide the spider chart that shows the pattern formed by comparing October 2018 data with those of December 2016 (see figure 2). Visual inspection of the chart tells us which of the five variable categories has improved most across the 22-month period and accordingly helps us assess the current strength of the overall economy.

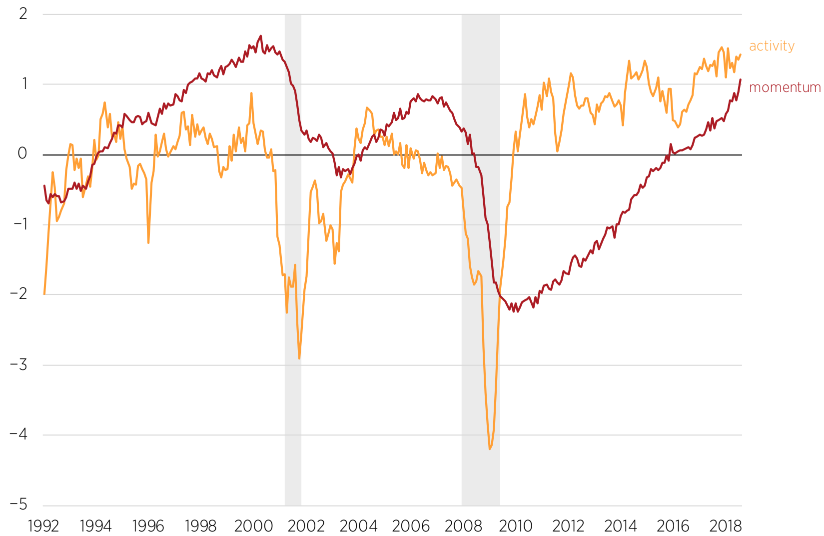
Employer behavior and confidence/perceptions stand out for their relative strength. Buried in the categories are hiring plans, availability of labor, and future planned hiring. The chart patterns suggest the economy's post-2016 expansion is broadly based and that the current pace of growth is expected to continue, but that labor-supply constraints are beginning to be felt. The

Figure 2. Labor Market Distributions Spider Chart



Source: Federal Reserve Bank of Atlanta, "Labor Market Distributions Spider Chart," November 6, 2018, https://www.frbatlanta.org/chcs/labor-market-distributions.aspx?panel=1.

Figure 3. KC Labor Market Conditions Indexes



Note: Shaded periods indicate recessions.
Sources: Federal Reserve Bank of St. Louis, "KC Fed Labor Market Conditions Index, Momentum Indicator," accessed November 4, https://fred.stlouisfed.org/series/FRBKCLMCIM; Federal Reserve Bank of St. Louis, "KC Fed Labor Market Conditions Index, Level of Activity Indicator," accessed November 4, https://fred.stlouisfed.org/series/FRBKCLMCILA.

chart does not support the notion that what we are experiencing in terms of GDP growth is a flash in the pan.

Another view of the economy's current strength is found in two indexes reported by the Federal Reserve Bank of Kansas City. One index seeks to describe the strength of the current economy; the other the momentum observed in the economy's performance. The bank economists use 12 variables for each of the two measures. All of these are labor market variables. Figure 3 reports the two indexes for January 1992 through August 2018. Note that there are two recessions identified during this period. Also note how the two indexes performed as they approach the recessionary periods and how this compares with the current period.

The Kansas City data tell us that we are experiencing a robust growth period, one that is sustained by strong economic momentum; there are no indications from these two indexes that a recession lies waiting. Put another way, the Kansas City chart confirms the picture reported in the Federal Reserve Bank of Atlanta's spider chart.

TRUMP'S NEW FULL ECONOMY REGULATION

Corporate tax cuts and sharp reductions in federal regulation are main GDP growth drivers.[11] Those who wanted less federal regulation have a lot to celebrate—maybe. White House leadership has seemingly put the brakes on runaway regulation. The number of *Federal Register* pages issued annually has fallen significantly, and the number of newly proposed “economically significant” rules (that is, rules with a potential effect on the economy in excess of $100 million) has dropped toward zero. Regulatory cuts have sharply revised the Environmental Protection Agency’s treatment of coal-burning electricity producers and lightened the regulatory load carried by community banks and other financial institutions. But alas, the story doesn’t end there. Trade war regulation that cuts deeply into the economy is the new regulation growth industry. As mentioned previously, firms and sectors are now petitioning Washington by the thousands for permission to avoid tariffs and stay in business.

When President Trump placed tariffs on steel and aluminum imports this past May, due process considerations required the US Department of Commerce to announce the related rules and allow firms, based on special circumstances and economic hardship, to request waivers to escape the tariffs. The due process rules allow American aluminum and steel producers to intervene when petitioners ask for relief and, if they desire, show that they, the domestic producers, can supply the needs of the petitioning firms—but, of course, at a higher price. Thus far, American steel producers Nucor and United States Steel have successfully blocked all 1,600 requests for waivers on steel tariffs. On the other hand, some US aluminum producers requested waivers on aluminum tariffs so they could continue to bring in aluminum produced in their Canadian plants, tariff free.[12]

The tariff rulemaking procedures put in place a regulatory process that now envelops all American business firms that use or produce steel and aluminum products, and that cuts a large swath across the economy. Of course, steel and aluminum are just the beginning. Trump tariff expansion now applies to thousands of imported products from China.[13] Yes, the number of *Federal Register* pages may be falling, and pre-Trump-administration measures of major regulatory activity may be in a state of decline, but make no mistake about what is really going on. The US economy is now beset by growing industry regulation administered by the Department of Commerce

While in the process of becoming less regulated, the US economy was hijacked by growing trade-war-generated regulation. Let’s hope the Trump trade war is short lived.