United States

Time to spend

■ **The US economic slowdown is getting confirmed, with not so encouraging prospects ahead.**

■ **This raises the question of whether it is really the right time to tighten monetary policy again, and of the opportunity to use fiscal policy.**

The US economic slowdown has been confirmed, despite the rebound in Q3 GDP (annualised quarterly rate of 2.9%). Given the sluggish performances of the previous three quarters, this rebound must be kept in perspective. Between Q4 2015 and H1 2016, growth was limited to 1%. To offset this weak performance and return to a trend of 2%, it would have taken Q3 GDP growth of 4.9%. As it turns out, growth fell short of this mark by 2 points, bringing the average for the past four quarters to only 1.5%. Moreover, the components of demand were not very encouraging: Q3 growth was mainly fuelled by temporary factors, notably inventory building (+0.6-point contribution to average quarterly growth) and a surge in agricultural exports. Exports of agricultural products alone contributed 0.9 points to Q3 GDP growth.

Final domestic demand actually slowed to +1.4% in Q3 (from +2.4% in Q2), an undeniably poor performance after +2.6% in 2014 and +3.1% in 2015. So far, the slowdown is mainly due to the business sector, which have cutback spending by 4.1% per quarter since early 2016, after an average increase of 4% in 2014-2015. But household consumption – and residential investment – is also showing signs of weakness, and personal income is following an alarming trend. Real disposable income per capita increased only 1.4% year-on-year in September, the slowest pace since 2013, when two points were added to the payroll tax rate. So far, households have chosen to dip into savings (5.7% of disposable income in September, vs. 6.1% in 2015). If the job market's dynamic momentum is called into question, however, we cannot rule out the risk of an even sharper slowdown in household spending.

Slowing demand generally goes hand in hand with an easing of inflationary pressures. Today, these pressures are non-existent. Energy prices have rebounded slightly, but most of the effect is concentrated on the correction of inflation expectations, while though the upturn in oil prices already seems to have run its course. The private consumption expenditure (PCE) price index, excluding energy and food products, has been perfectly steady since the beginning of the year (1.7% in September). If we use the "market price" index, which excludes free goods and services, core inflation even seems to have peaked. As to wages, the latest figures for the Employment Cost Index point to a slowdown: in the private sector, the index slowing from 2.1% in 2014 and 2015, to 1.9% year-on-year in Q3.

A less accommodating Fed and slower growth

— GDP growth (y/y, %); — Spread between the estimated natural rate and the Fed funds target rate, using the Wu-Xia shadow rate between 2008 and 2015 to take into account the different waves of QE *(inverted r.h.s., %)*

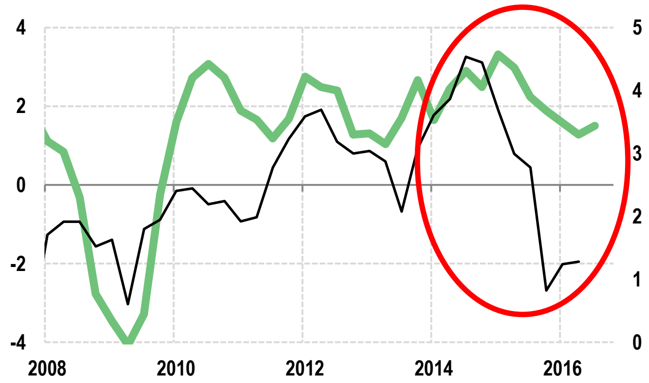

Chart 1 **Sources: FOMC, Laubach-Williams, Wu-Xia, BNPP**

This raises the question of whether the time is really ripe for the Fed to raise key rates. Indeed, the Fed opted not to replay the 2015 scenario in which it virtually pre-committed to a December rate increase. Following September's meeting, it had looked like we were set to see a repeat performance. Over the past six weeks, however, the battle line seems to have shifted yet again with, on the one hand, the members of the Board of Governors and their more cautious, patient approach, and on the other, the presidents of the regional Feds, who seem hard pressed to continue normalising monetary policy. Uncertainty over a December rate increase was mainly fuelled by Eric S. Rosengren's decision not to reiterate his dissenting vote in November, but also by the (slight) deterioration in the economic environment diagnosis, notably for household consumption.

The Fed's monetary policy might already be too restrictive. According to one measure of the degree of tightness that we introduced last week (see chart 1)[1], the Fed's monetary policy has been much less accommodating since fall 2014. As Janet L. Yellen declared during the September post-FOMC meeting press brief: "With the Fed funds rate modestly below the neutral rate, the current stance of monetary policy should be viewed as modestly accommodative". Some think that monetary policy has reached its limits, arguing that the Fed's extreme interventionism in recent years has actually not allowed the closing of the output gap.

It is important to keep in mind that the economy reacts to the policy mix, i.e. to the combination of both monetary and fiscal policy. In terms of fiscal policy, the brakes were hit hard. Austerity measures were initially applied at the State and local government levels in response to the crisis, and in compliance with constitutional laws

[1] "United States: The sin of certainty", Alexandra Estiot, Eco Week BNP Paribas, 28 October 2016.

obliging them to pass balanced budgets. Meanwhile, the federal government launched a stimulus plan. But austerity rapidly spread to Washington, too. Excluding interest payments, the general government deficit[2] narrowed from 8.3% of GDP in 2009 to 0.6% in 2015. In six years, the primary deficit narrowed by 7.7 points of GDP (chart 2), including two years during which austerity was particularly fierce: 2.1 points in 2012 and 3.1 points in 2013. Household consumption was particularly hard hit, and slowed to 1.5% in 2012 and 2013. Although GDP growth was more resilient, at least in 2012, this was mainly due to fixed investment, the vigour of which cannot be totally unrelated to the Fed's stimulus policy. Of the countries that have applied restrictive fiscal policies in recent years[3], the United States ranks 9th for the size of adjustments, with a reduction in the primary structural surplus of 6.4 points (vs. 3.5 points in the eurozone). It was also the only country that managed to avoid slipping back into recession despite austerity. This is another indication that the Fed's proactive policies were effective, and that the policies conducted by Ben Bernanke and Janet Yellen helped ease the austerity shock.

Today, the fiscal brakes are no longer being tightened, and they have even been eased ever so slightly. At the federal level, there is a slight easing trend: the Congressional Budget Office (CBO) foresees a slight widening of the deficit (to 3.2% of GDP, from 2.5%) over the course of the current fiscal year. At the State and local level, the pro-cyclical nature of finances has also allowed a slight easing trend: after 5 years of cutbacks, State and local government payrolls have begun rising again since the end of summer 2014. Unless growth accelerates, however, it is unlikely that much more support will be provided.

The US economy has also had to face two other headwinds that are in the process of winding down: the drop-off in oil prices and the dollar's appreciation. Like fiscal austerity, these factors have not become growth engines, but are putting less of a drag on the economy. Assuming that the output gap still has not closed yet, and that the economy needs to grow at a faster pace than its long-term potential – which is no longer the case, even using the most pessimistic estimates of the potential growth rate[4] – then some support is still necessary. It is extremely hard to imagine the Fed doing much more, unless one believes that signals are an important part of monetary policy, in which case by skipping the opportunity to raise rates in December, the Fed would be providing a kind of support. That leaves the fiscal option…

Although the world is suffering from a savings glut, the same analysis is less clear in the United States, where the current account balance still is a deficit. Here we must keep in mind the US dollar's status as the international reserve currency, which implies a permanent external account deficit. For the US, the equilibrium level is certainly a deficit: before the crisis, this deficit could be estimated at about 3% of GDP, but it is probably larger today. Since 2012, the external

American-style austerity

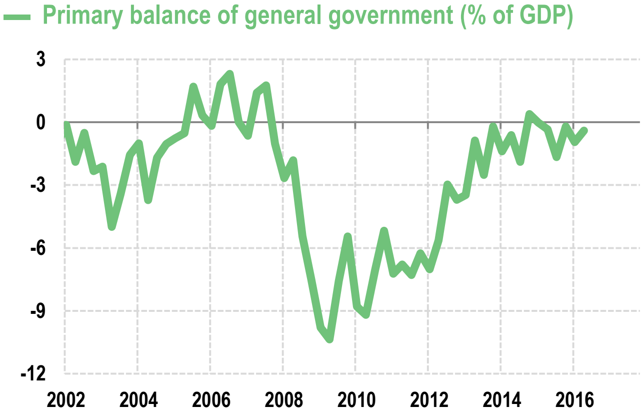

Chart 2 **Source: Federal Reserve**

deficit has been smaller than this threshold, but the reason has less to do with a savings glut than with an investment shortfall. Although investment surged in 2011-2012, it has slowed ever since. The net investment rate, i.e. investment minus capital consumption (as a share of GDP), which measures the increase in capital stock, has contracted since mid-2014. Granted, part of this adjustment can be attributed to the commodity sector: the drop-off in oil prices slashed investment in this industry by two thirds. Excluding this component, corporate investment has been growing again for the past two quarters[5], albeit at a mild pace. As a share of GDP, it is only slightly lower than the Q3 2015 peak of 13%. Residential investment is still far short of its peak (3.5% of GDP, vs. 6.1% in 2005), but it is hard to see this in a negative light: its corollary is household indebtdness, and it does not generate productivity gains.

All in all, the investment shortfall can be blamed on the public sector, and the federal government in particular. Gross fixed capital formation by the Federal government has dwindled to 1.4 points of GDP, from about 5 points of GDP in the aftermath of the Second World War, and recent budget cuts have only accentuated this trend. As a share of GDP, the corporate and government GFCF ratio is currently 15.5%, two points below the average for the second half of the 1990s. Although some might doubt that the public authorities are capable of encouraging companies to increase productive investment – we should never underestimate the power of taxation, but that's a different argument – there can be no doubt that they have the capacity to close the investment gap on their own. Financing constraints are not a valid argument at a time when real interest rates are much lower than the potential growth rate, and above all, when US Treasuries are more attractive than ever in a global savings glut with high demand for secure assets. On top of that, today's spending would pay for themselves as fiscal multipliers on infrastructure expenditure are particularly high, and probably higher when interest rates are close the their effective lower bound. If only the balanced budget dogma could be thrown out and the next president be elected with a friendly Congress… A little hope never hurts.

[2] Table F.105-General Government Financial Accounts of the US.

[3] Our measure is based on the reduction in the primary structural deficit, i.e. the fiscal balance excluding interest payments and adjusted for cyclical effects. IMF data (Fiscal Monitor).

[4] Estimates vary. The potential growth rate is 1.6% according to the CBO and OECD, 1.8% according to FOMC members (median of long-term GDP projections) and 1.9% according to the IMF.

[5] Gross data. For capital depreciation, we do not have a detailed breakdown by type of investment.