

United States

Monetary policy at a turning point

Although household consumption remained rather buoyant at springtime, foreign trade as well as investment may have weakened. In June, the business survey results were lacklustre, while the Federal Reserve opened the door to cutting interest rates. Already back on the campaign trail, President Trump is unlikely to soften his hard line on tariffs, although he will surely remain as unpredictable as ever. The economy is likely going to need some support.

In all likelihood, the US Federal Reserve (Fed) will cut its key rates by the end of the year. Not because the economy is doing so badly. Until June, consumption and the job market have been solid, unemployment kept very low. Yet the snapshot provided by the Federal Open Market Committee (FOMC) at its latest monetary policy meeting was rather flattering. But headwinds are building up, especially those that are hampering trade, which is becoming increasingly alarming for American producers¹.

■ Monetary easing seems almost certain

The slowdown in world trade has already depressed several business climate indicators, although it has yet to carry over to GDP, which rose at an annualised rate of 3.1% in Q1. The benchmark index of the Institute for Supply Management (ISM) has plunged since last summer. In June, manufacturing ISM slipped to 51.7, which is not far from the discomfort zone at which business volumes begin to stagnate.

The dichotomy between surveys and the national accounts never lasts very long, so that the Fed expects hard data to become less rosy and is gearing its communications accordingly. Key rates are currently fluctuating within a range of 2.25% and 2.50%, and the announced rate cut seems all the more credible given that it is in line with market expectations. Since spring, there has been an inversion of the yield curve for all maturities up to 5 years: in the past, such yield curve inversions have always preceded or accompanied monetary easing (see chart 2).

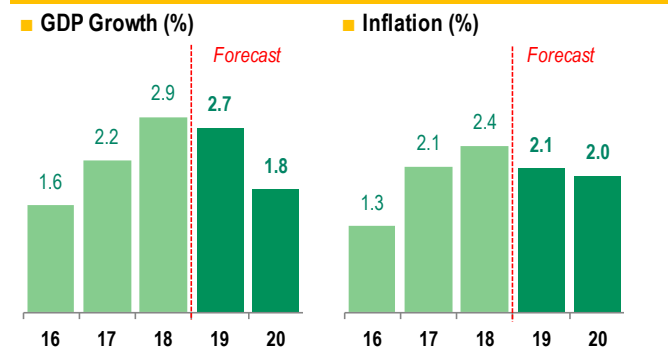
But that is not all. Although it revised its inflation outlook to 1.8% in 2019 and 1.9% in 2020², the FOMC indicated that it did not find wage and price dynamics to be excessive for this point in the cycle, notably with regard to the official target of 2%³. Unit labour costs (wages, bonuses and charges per unit of output) declined in the first quarter (-0.8% for the year in the non-farm sector), which is not very frequent and foreshadows milder inflation.

¹ “[...] our contacts in business and agriculture report heightened concerns over trade developments. These concerns may have contributed to the drop in business confidence in some recent surveys and may be starting to show through to incoming data.” Powell, J. (2019), Press conference following the 19 June FOMC meeting.

² Core personal consumption expenditure price index, excluding energy and food; year-on-year, for Q4 2019 and Q4 2020.

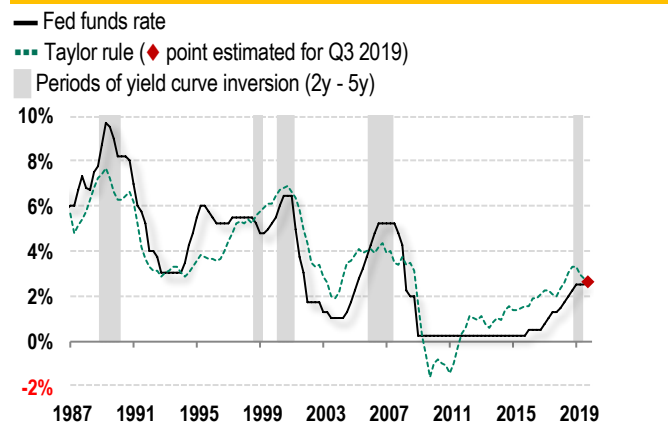
³ “[...] committee participants expressed concerns about the pace of inflation’s return to 2 percent. Wages are rising, [...] but not at a pace that would provide much upward impetus to inflation.” Powell, J., Ibid.

1- Growth and inflation



Source: National accounts, BNP Paribas

2- End of a cycle



Source: Federal Reserve, CBO, Refinitiv.

According to the Taylor rule (see box 3 and chart 2), the inflation gap (the spread between observed and expected price inflation) should swing into negative territory, and the output gap (the spread between actual and potential GDP) should indicate fewer pressures on production capacity. Under these conditions, the Fed would at least mark a pause, and is more likely to opt for a key rate cut. President Trump would be wrong to rejoice even though his wishes are about to come true: by adopting a more accommodating stance, the central bank would not be following his orders as much as providing the necessary support for an increasingly likely US economic slowdown.



■ **No immediate appeasement with China**

Despite the truce announced at the Osaka G20 summit meeting on 29 June and just after the United States imposed new tariffs on China⁴, it seems vain to expect any easing of US trade tough line. First, appeasement does not fit with the political calendar. Already back on the campaign trail for the 2020 election, President Trump intends to reap as much political gain as possible from his hard-line policy, as economically risky as it might be. More importantly, the nature of US-China trade relations has changed profoundly in recent years and the two rivals are now in open competition to achieve technological supremacy.

Although the United States is still in the lead, notably in semiconductors, its supply chains are integrating a growing share of Chinese components: 85% of the taxed imports are part of the production process of major US corporations (Lovely & Liang⁵). The image of US-China trade in which Chinese textiles and household appliances are traded for American nuclear power and aeronautics equipment, which still prevailed when China joined the World Trade Organisation (WTO) in 2001, is an outdated stereotype that no longer corresponds to reality. In 2018, clothing, footwear, home furniture and travel goods only accounted for 14% of US imports from China, and their weighting has been slashed in half over the past twenty years. They have been replaced by telecommunications (the largest import category) and transport equipment, machinery and other industrial equipment, which now account for 30% of imports and are designed for all purposes, both civil and military.

The cards have been shuffled and re-dealt: the next time US trade negotiators face off with their Chinese counterparts, they are less likely to worry about the trade deficit and more about the challenges of cybersecurity and defence. Besides, when they do meet, “the security people are in the room”⁶.

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⁴ On 10 May 2019, the tariffs applied on some USD 200 billion in US imports from China were increased to 25%, from 10% in September 2018. All in all, USD 250 billion in annual imports from China are now hit by the 25% tariff.

⁵ Lovely M. E., Liang Y. (2018), *Trump taxation primarily hits multinational supply chains, harms US technology competitiveness*, Policy Brief, Peterson Institute for International Economics, Policy Brief, May.

⁶ Cited by *The Economist* (2019) “A new kind of cold war”, May 18th.

⁷ Taylor, J.B. (1993), *Discretion versus Policy Rules in Practice*, Carnegie-Rochester Conference Series on Public Policy, n° 39.

⁸ Adam Shapiro A., Wilson D.J. (2019), *The Evolution of the FOMC’s Explicit Inflation Target*, Federal Reserve Bank of San Francisco Economic Letter, April 15.

3- The Fed funds rate: what does the Taylor rule say?

Established in 1993 by the American economist John Taylor⁷, the Taylor rule links a central bank’s key rates to current and expected inflation trends, as well as to the output gap (the difference between observed and potential GDP). Using the following key:

i_{FF} : Fed funds rate, the US central bank’s key rate

y : Real GDP (log-level)

y^* : Potential real GDP (log-level)

π : Smoothed observed inflation rate

π_a : the central bank’s expected inflation rate

r^* : the real neutral or equilibrium short term rate

the Taylor rule can be written as follows:

$$i_{FF} = r^* + \pi + 0.5 \cdot (\pi - \pi_a) + 0.5 \cdot (y - y^*)$$

Results

Although it has the merit of simplicity, the Taylor rule depends on several exogenous variables that cannot be observed directly, and which are subject to diverse and fluctuating estimates. Another subject of debate is the empirical validity of its coefficients (initially set at 0.5).

Nonetheless, the Taylor rule describes rather accurately the fluctuations in the Fed funds rate over the past 30 years, notably during turning points (see chart 2).

Using the core PCE deflator (core personal consumption expenditure, excluding energy and food), a benchmark frequently used by the Fed (see Shapiro & Wilson, 2019)⁸, inflation came to 1.6% in Q1 2019, which is lower than the Fed’s 2% target and the long-term inflationary trend of 1.7% based on a Hodrick Prescott filter. Whether we use this figure or the 2% target to evaluate inflation expectations, the inflation gap seems to be slightly negative. Above all, the Taylor rule also depends on the hypotheses used for the real neutral rate (r^*) and the output gap.

In the initial Taylor rule, r^* is constant and set at 2%. Yet, it is largely admitted that the neutral rate has shrunk in the aftermath of the Great Recession. r^* would now range between 0.5% and 1.5%, using the FOMC long term projections for the Fed funds rates (we retain 1%). As regarding the output gap in 2019, it is also subject to various estimates: -0.1% (OECD), +1.1% (CBO) or +1.4% (IMF). Depending on various hypothesis, the Taylor rate would finally range from a 2.5% to 3.3% at the start of the year, e.g. no so far from the actual Fed funds rates.

Estimation of the Taylor rule, % (Q1 2019)

π (T1 2019)	1.6		
π_a	1.7		
r^*	1.0		
$y - y^*$ (2019)	CBO	IMF	OECD
	1.1	1.4	-0.1
	3.1	3.3	2.5
i_{FF}			

