United States

The slowdown continues

The contraction in world trade, exacerbated by President Trump's tariff offensive against China, has begun to spread to the United States. The economic slowdown, which can also be attributed to domestic factors, has prolonged throughout the summer of 2019, and business surveys do not suggest any improvements in the months ahead. Corporate investment will remain downbeat, while household consumption, which has been resilient so far, should begin to falter. In the face of this environment, the Federal Reserve -- which no longer provides forward guidance on upcoming policy moves – is bound to lower its key rates again.

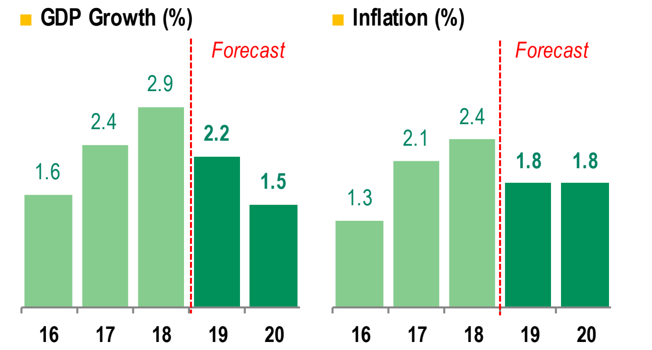
During the summer months, the US economy continued to slow although it seemed to be fairly resistant to the headwinds affecting world trade. The annual GDP growth rate dropped to 2%, one point below the 2018 level, which is still an enviable performance when seen from Europe, where recession is looming in countries like Germany, Italy and the UK. Yet, taking a closer look, the US economic slowdown is more severe than it might seem. The only factors limiting the fall in year-on-year GDP growth were public spending and inventory building in anticipation of new tariffs imposed by President Trump. Foreign trade provided a negative contribution, but the bulk of the slowdown was essentially due to domestic factors. It can be attributed to the decline in private investment, which was first seen in residential construction, and then spread to all sectors with the exception of software. Although consumption and employment are both resilient, they seem to be losing momentum. Lastly, business surveys are depressed and do not signal any improvements in the near future.

Downgraded prospects

The drop in the Institute for Supply Management (ISM) index for the manufacturing industry, as well as the reversal of the capacity utilization rate, suggest a further decline in capital goods spending. The drop could be particularly severe in the very capital-intensive oil and shale gas sectors, where the first signs of over-investment have emerged (chart 2). With production volumes at an all-time high of 8 million barrels per day (b/d), the profitability of new wells can no longer be taken for granted. Producing less than expected after being drilled too close to one another and operated by heavily-indebted industry players, the number of new wells is trending downwards[1].

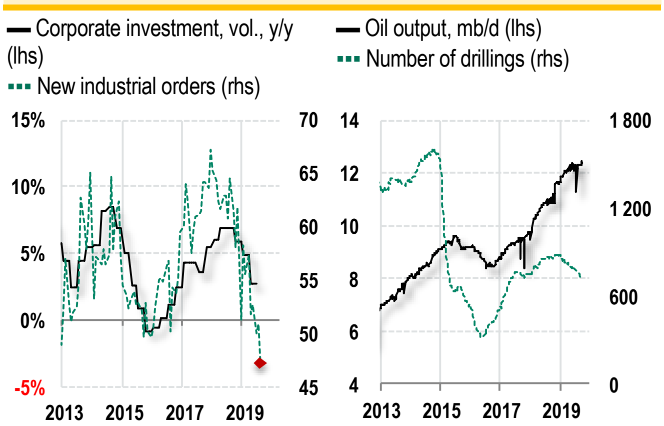
US household consumption – which at USD 14,000 billion a year is five times higher than French GDP – is by far the most powerful driving force of domestic demand. In 2018, the combination of tax cuts, job creations and consumer credit created a rather high-octane fuel, but the mixture has weakened in 2019. Companies are not only re-assessing market outlets and scaling back investment, they are also slowing the pace of hiring. Net job creations have fallen to a monthly average of 161,000 between January and September, the lowest number in nine years. Given the population inflow into the labour market (1.8 million on average in 2018), job creations hardly suffice to bring down the unemployment rate, already standing at all-time low (3.5% in September). Farmers and purchasing managers are no longer the only segments of the population suffering from President Trump's trade war. Even though consumer goods are not affected much, higher import tariffs are having a non-negligible impact on inflation (see box 3). Faced with higher prices for capital goods and inputs manufactured in China, there has yet to be a significant shift in demand towards other countries[2]. US companies are bearing the costs, modulating the efforts granted by suppliers and their reactions to exchange rates. In the end, the

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Downturn in the investment cycle



Source: Institute for Supply Management, US BEA, IEA.

[1] The Wall Street Journal (2019), *Shale Boom Is Slowing Just When the World Needs Oil Most*, Sept. 29

[2] French Treasury (2019), *Impact of first US-China trade tensions*, Lettre Trésor-éco n°244, September

impact on prices paid by end consumers is estimated at a few tenths of a point[3]. After holding to a slowing trend recently, core inflation rebounded to 2.4% in August. This has lowered the growth of real disposal income for US households.

Consumer credit is also less buoyant, which is not unusual at this stage of the business cycle: household non-mortgage debt has increased 55% from the 2009 low, coming back to relatively high levels as regard of disposable incomes. Car sales have matched all-time highs, so that the fleet has been largely renewed. Lastly, banks are tightening lending conditions at a time when transformation conditions have deteriorated due to the inversion of the yield curve (Wheelock, 2018)[4].

More key rate cuts

In the months ahead, the Federal Reserve (Fed) will need to steepen the yield curve, which means further monetary policy easing. The Fed funds target rate has already dropped from 2.5% to 2%, and we think it could be lowered further, to 1.75% at end-2019 and 1.25% at end-2020.

Of course, the official position remains cautious and does not signal such a move. Having foregone "forward guidance", Federal Reserve Chairman Jerome Powell has linked any policy changes to upcoming economic publications. He also pointed out that monetary easing phases can sometimes be very short[5]. Yet he did not cite the most pertinent example: the Fed cut its key rates in the fall of 1998 to counter the potentially systemic effects of the quasi-bankruptcy of an entire hedge fund[6], not to accompany a cyclical downturn, as now seems to be the case.

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3- Escalation of the US-China trade war

The facts*. On 6 July 2018, the United States opted to apply a 25% tariff on a first list of products imported from China for a total of USD 36 bn, a decision immediately followed by retaliatory measures (see the tit-for-tat chronicle of events below). A little over a year after the hostilities were launched, some USD 250 bn in annual imports to the US from China (or about half of all purchases) are now taxed at an average tariff of 25%. This essentially comprises intermediate products and industrial capital goods (80%) while the remaining 20% is for end consumer goods. In retaliation, China has applied variable tariffs on all of its imports from the United States (USD 110 bn a year) and suspended soybean purchases.*

Additional risks. *In the heat of August, President Donald Trump said he wanted to increase the tariffs already applied to Chinese imports from 25% to 30%, and to impose tariffs on all Chinese imports that were not already taxed, representing an additional amount of USD 272 bn a year. This threat was supposed to take effect on 1 September 2019, but the date was pushed back to give the United States and China time to restart negotiations and try to reach a compromise, undoubtedly during the second week of October.*

Date	***United States***	***China***
July-Aug. 2018	• ***25%*** *on* ***$50 bn*** *($36 bn +$16 bn) of imports from China (lists 1 & 2)*	• ***5% to 25%*** *on* ***$50 bn*** *of imports from the US (list 1)*
Sept.-Nov. 2018	• ***10%*** *on* ***$200 bn*** *of imports from China (list 3)*	• ***5% to 25%*** *on* ***$60 bn*** *of imports from the US (list 2)*
May 2019	*10% ↗* ***25%*** *on* ***$200 bn*** *of imports from China* • *(list 3)*	• *Suspension of soybean imports*
Sept. 2019	• ***10%*** *on* ***$120 bn*** *of imports from China (list 4A)*	• *Higher tariffs on $60 bn of imports from the US (list 2)*
Oct.-Dec. 2019? Threats	• *25% ↗* ***30%*** *on* ***$250 bn*** *of imports from China (lists 1 to 3)* • *15% on* ***$272 bn*** *of imports previously without tariffs (list 4)*	• *China attempts to ease tensions by postponing certain planned tariff increases and resuming soybean imports.*

Consequences. *Based solely on the measures already taken (and using the 2018 value of trade), the weighted average US tariff rate would rise from 1.7% in 2017 (one of the lowest rates in the OECD) to 7.7% in 2020 (one of the highest rates). China would be hit hardest. Its sales to the US have already declined (by 20% for the year for targeted products, a figure amplified, however, by early shipments in 2018) and US tariffs would cost its economy as much as 1 point of GDP in 2020. Yet there are no winners, and the IMF estimates that the shock has cost the US 0.7 points of GDP.*

Source: French Treasury (op. cit.), IMF, BNP Paribas

[3] Jean S. & Santoni G. (2018), *How Far Will Trump Protectionism Push Up Inflation*?, CEPII Policy Brief n°23, December. The two authors estimate that the sanctions already imposed on China (25% tariffs on USD 250 billion in annual imports) triggered a 0.25%-0.38% increase in inflation.
[4] Wheelock D. (2018), *Can an Inverted Yield Curve Cause a Recession?*, Federal Reserve Bank of Saint Louis Blog, Dec. 27
[5] Powell J., Press conference following the Monetary Policy Committee meeting of 18 September 2019
[6] In this case, Long Term Capital Management (LTCM)