Taxes, Tariffs and Threats: A Look at the Still Booming U.S. Economy | OAS Episode 38 | July 19, 2018

Welcome to “Our American States,” a podcast of meaningful conversations that tell the story of America’s state legislatures, the people in them, the politics that compel them, and the important work of democracy. For the National Conference of State Legislatures, I’m your host, Gene Rose.

For many states the fiscal year ends on June 30th. We decided this would be a good time to get an overview of the national economy from an expert who has established a connection with state legislatures. Our guest on this episode of “Our American States” is Christopher Thornberg, who speaks often to state legislative groups and someone who keeps check on the national economy.

It’s a very interesting conversation that we have with Christopher today. We’ll get his take on how the federal tax bill is affecting the economy, the effect of tariffs, the jobs market, and find out why he doesn’t think the Consumer Confidence Survey is a good indicator of the economy. He also discusses the effect of the aging U.S. population and lets us in on the topic he plans to talk about when he speaks at the National Conference of State Legislatures’ Legislative Summit in Los Angeles in just a couple of weeks from this broadcast. Let’s go to the interview.

We’re talking now with Christopher Thornberg who is the founding partner of the respected research firm, Beacon Economics. Christopher, appreciate you taking time to talk with us today.

Chris:  Great to be here.

Gene:  The fiscal year for most states ended on June 30th this year. I know you haven’t had a lot of time to crunch the data, but is there anything that you’re seeing for the economy that affects the nation’s states?

Chris:  Well, if you look at the numbers, we do have a relatively decent reading on second quarter growth and it will come in pretty close to 4 percent, so more than making up for a little bit of
slow first quarter. You would argue that this last fiscal year really went out with a bang, so to speak, an economy that’s really picking up some speed.

Gene: Are we seeing any effects, either positively or negatively, on how the tax bill that Congress approved last year is affecting states?

Chris: Yeah, I think we are. If you take a look at the numbers that you’re seeing out there today, some of this is being generated by a big surge in business investment. Some of the surge in business investment has to do with increased overall industrial activity in the nation, but also a hunk of it, of course, comes from some of these new rules on rapid depreciation that are really pushing forward, if you will, a lot of business investment.

It has given us this little short-term boost, but of course that short-term boost comes with some mid-term challenges. Remember, this was a fiscal stimulus package, that is to say, the tax cuts were not matched by a decrease in spending. In fact, the federal government saw fit to increase spending even as they cut taxes. That is going to add a significant amount to the budget deficit over the course of the next couple of years. And while this may feel pretty good in the short run, states may find themselves being squeezed by higher interest rates when government borrowing really starts to kick in over the course of the next 24 months.

Gene: Chris, there’s a growing attention being paid to the administration’s actions on tariffs. What’s the potential impact for state governments here?

Chris: That’s a good question. The answer unfortunately is we just don’t know yet, in many ways because where these tariffs actually shake out remains to be seen.

One of the things to keep in mind is right now most of the action on the tariff front is bilateral, that is to say, it’s aimed at China, and that’s important because what it means is while there may be a disruption in the patterns of trade, ultimately China is not a majority trade partner. In fact, overall imports and exports, our trade flows with China run about 15% of overall trade.

Many of the products we either are selling to or buying from China could be sourced through, say, third-party nations, and that would take a lot of the stress off the economy. It’s just kind of a short run issue.

From my perspective the big risk to the economy is not leveraging tariffs on China, but rather what happens if this same sort of approach is used on many other countries. Remember, while China is the central focus, the first move on the trade front was, of course, to slap punitive tariffs on imports of steel and aluminum that, for the most part, come from people that we have always considered to be allies, rather than somebody like China who is clearly a competitor when it comes to either economic and/or political clout on the global stage.

So we do have, I think, this issue which is: Am I terribly worried about the situation with China alone? I’m a little worried. I think that can shave off some of the growth. But I think my bigger fear is that this thing continues to spiral out of control where we start launching, if you will, punitive tariff actions at pretty much every country in the world. It strikes me that a lot of the rhetoric about Europe is just as bad as it is about China, and it remains to be seen if this kind of aggressive behavior is translated to that continent as well.
If this thing starts to escalate, that’s when the risks really start to pick up and yes, it could at some point in time in the next few years cause some sort of downturn in the U.S. economy.

Gene: But right now we are still in an upturn in the economy, Chris?

Chris: Absolutely – again, as noted, second quarter growth is going to be close to 4 percent, a ton of momentum. You have particularly in the business side of the economy a lot of new business spending pushing things forward. Consumers have been relatively steady. So the numbers are good. Even trade has been broadly positive for the U.S. economy over the course of the last year or so.

So we have a lot of momentum, but it seems as if somehow or other, this momentum could be offset by the trade policies of this administration.

Gene: And what about interest rates and other things that affect people and their purchasing here in America?

Chris: Yeah, well that’s the other probably big risk, which is the Federal Reserve. Now typically I wouldn’t say that. I have been quite impressed with the Federal Reserve’s policymaking over the course of the last decade or so. I think it was probably the most important organization that helped us work our way out of the Great Recession a decade ago, and they made some very logical moves, which is more than you can say about some of the fiscal policies that were put in place by Congress back then.

But nowadays I’m less confident in the Fed. We are now on the back end of seven rate hikes; they’re pushing that federal funds rate perilously close to 2%. The reason that’s of interest to everybody, of course, is this is not being reflected in long-run rates. Quite the opposite – long-run rates still remain relatively low. The net impact of that is the yield curve has been flattening pretty sharply.

One of the things we know about the yield curve is an inverted yield curve is not a good sign for the economy. The last seven times we saw an inverted yield curve we had a recession within 12 to 24 months.

Now correlation isn’t causation and a lot of economists still debate whether or not the Federal Reserve flipping the yield curve would indeed cause a recession. But clearly they’re putting some sort of stress and strain on the financial markets. And the real question is: Why? If the answer is because inflation is here, well, no it’s not actually. Quite the opposite – there is very little sign of any major inflationary pressure in the U.S. economy beyond this kind of short-run blip we’re in the midst of right now.

If you look at money supply growth or bank lending growth, everything has been slowing down. This is not what I would call a true inflationary surge. So if the Federal Reserve is fighting this nonexistent threat to the point where you can actually have a true threat on the health of the current economy, well again, that’s not a very good sign for where our economy is heading right now.
Gene: And what about jobs, Chris, employment – is that looking good?

Chris: Well, employment is probably obviously one of the strongest indicators we have right now. It is interesting to me that we continue to talk about this idea that the labor markets in the United States have substantial problems. They don’t. In fact, if anything the biggest problem we have in U.S. labor markets is a lack of workers. The job openings rate is now higher than the unemployment rate. That is to say there are more openings for people than there are people looking for a job in our economy today.

And that is not just true for say, some of the hot, coastal economies. In fact, across the United States right now, many, many places from the Midwest to the Northeast to the Southeast to the West Coast, employers are finding it hard to fill positions because there just aren't people.

Now, this of course is leading to a couple of positive developments. One is there is an increased rate of pay for workers. I realize that a lot of folks continue to believe this myth that wages haven’t been rising, but you know, the number we get on a monthly basis under the BLS is a little bit tricky and there are better numbers out there and those better numbers do suggest that wages have been rising at a good, steady clip for the last three years, which of course, in turn, explains why consumer spending has been so strong.

That’s positive. And the other positive part of it is with a lack of workers, you’re going to see businesses have to invest more and more in sort of labor-saving capital investments. These are good in large part because they will increase labor productivity and ultimately lead to even more wage hikes in the future, and of course, in the short term, it certainly gives a boost to the industrial side of the U.S. economy.

But, of course, even with all those things in place, the fundamental constraint on the number of potential people working in the United States will continue to keep overall growth below 3% in the long run. Last year the Congressional Budget Office put out a very interesting report. They were very clear. They said: if you want the economy to grow faster, that is to say, you want to get us out of this stage of this 2 to 3 percent growth and get us in the 3 percent plus growth, well, by far and away the two best ways of doing that are to increase immigration into the United States and equivalently increase the retirement age to keep Boomers in the workforce longer.

Of course, on the immigration front, we seem to moving in the opposite direction and there’s almost no conversation about changing retirement ages. So the net result of that is these labor shortages are here, they’re here to stay for a while until this current expansion comes to an end, and that will have a material influence on how fast our economy can grow.

Gene: Are there other warning signs in the back of your mind, Chris, things to be looking out for?

Chris: Yeah, a little bit here and there. I mean, another thing we’re seeing is another decline in the savings rates for consumers. Savings rates have dropped to 3 percent again, which is too low, dangerously too low. Now it’s not as scary as it was back in 2005 and ’06, the last time it was down past that 3 percent marker, because we don’t have that buildup of debt. But when consumers start to get ahead of themselves, you, of course, always risk a sharp pullback, and
remember, consumer spending is two-thirds of the economy. If consumers suddenly decide to pack up and go home, that can have, yet again, another recession cause on our economy.

Now, with that being said, one of the things I want to get across here is that at this point in time, we still don’t see any recession for the next two years. There’s no reason to believe there’s any threat to the health of this expansion sufficient enough to end where we are. That means, of course, almost assuredly this expansion will end up being the longest on record. How much longer? I don’t really know because we have to wait for these potential negatives to build up.

But while I don’t see a recession in the next 24 months or so, on the other hand, I will say that the stressors starting to build in the U.S. economy are the kinds of things that do make me, for the first time, start to worry about just how long this expansion can last. You know, two years ago you’d ask me this and the answer was: this could go on almost endlessly given the health of the economy.

But now between a flattening yield curve, between falling savings rates, between this current trade dynamic we’re seeing in the U.S. economy, all of course fouled up by a sharp increase in government borrowing over the course of the next couple of years, you start to see a U.S. economy that’s becoming at best wobbly and, of course, at worst truly at risk of yet another downturn.

Gene: And are there certain sectors of the economy that seem to be doing better or worse, Chris? I’m thinking particularly of the energy industry.

Chris: (chuckles) Well, it’s interesting you bring that up. I mean, obviously energy is making a big comeback. Oil and gas production have been some of the shining stars of the U.S. economy. And surely that’s good for those commodity states such as, say, Texas or Oklahoma, although it’s worth noting that prices, while they have come back a little bit, aren’t likely to stay high. After all, there’s quite a bit of a glut in the global market for these sorts of petrochemicals.

Another part of the U.S. economy that continues to do well is actually construction. Construction has been bouncing back nicely. In fact, construction is an industry where one of the biggest problems again is a lack of workers, more so shall we say than a lack of potential jobs. A lot of projects out there, particularly in places like California, where construction projects just can’t get off the ground because they don’t have the crews to actually go out there and start putting nails into pieces of wood, so to speak. So construction is doing well.

Now, industrial production has been up as well, and that suggests that manufacturing is doing better as well. But, of course, there we have to really start to worry, if you will, about the impact of these trade sanctions.

Gene: So what’s your assessment of consumer spending and consumer confidence in this current economy?

Chris: Well, you know, consumer confidence is an interesting statistic. It still gets a lot of attention in the press although I can tell you first-hand from an empirical standpoint, consumer confidence plays no role in our forecast. It just doesn’t have any predictive ability anymore.
From my perspective, I sit back and I look at the numbers and I think consumer spending is going to continue steadily to move forward largely because of the fact that incomes, as noted, have been rising at a nice, steady basis. That is certainly carrying on into, if you will, overall increased consumer spending.

The biggest issue out there for consumers really is the fact that they’re almost spending too much right now as, of course, exhibited by that decline in consumer savings rates I was just referring to a few minutes ago. That’s a big issue. We do have to keep an eye on that savings rate. Americans should be saving more, now more than ever, but unfortunately we seem to be going in the wrong direction on that particular front.

Realistically, particularly for say Gen-Xers and Millennials, they’re going to find that they’re not going to get anywhere near the benefits that their Boomer parents and grandparents did from the federal government just because this super spike we’re going to see in spending on entitlement programs is really going to almost assuredly cause some sort of major change in how those benefits are doled out.

Now that won’t occur for the next decade or so, but of course, Americans need to realize that and start saving ahead. If you don’t start saving now, you’re going to find it much more difficult to get ready for retirement in ten years when suddenly they’re slashing Social Security and Medicare benefits.

Gene: And you’ve mentioned older adults here a couple of times in this conversation and the aging of the country. Are there other impacts to be careful with there?

Chris: Yeah, absolutely. I mean, let’s go back to the conversation about labor shortages in the United States. The tired cliché of so many policymakers out there has been, you know, it’s all about jobs, jobs, jobs. Well, the United States has lots of jobs. What we need to worry about are workers, workers, workers, and the reason we have a problem with workers is because of the Boomer generation.

Of course, they were an enormous generation compared to their parents. As many kids as they were raised in the midst of, at the same time they turned around and had far fewer children than their parents did. The net result of that is our population pyramid has turned into a population column. I hear all the time how Millennials are the biggest generation ever, but I like to point out that they’re only a couple percent bigger than the Baby Boomers.

What that means now that Boomers are starting to retire in mass is, of course, that every time a Boomer does retire, you’re really only bringing one person into the labor force, and that, of course, does have a profound impact on, again, the ability to grow the labor force and thereby grow the economy.

So we have started to hit a wall. Now, it’s not unusual; I mean Japan has been there, Europe has been there; even China has been there. So we’ve seen countries hit this position and we understand the stresses and strains that can impose upon an economy. But, of course, this is not part of the conversation.
A lot of folks often ask me, you know: what is my biggest fear of all in the economy, and the answer really isn’t about the economy at all. The answer is really about our policymakers in Washington, D.C. The hyper partisanship of really both parties has become, to me, incredibly acute. I like to think that 30 years ago, we as a nation could agree on what the problems were, even though we might, shall we say, disagree on the solutions to those problems, where the Republicans would come at it from one direction and the Democrats maybe would come at it from another.

Today this level of political discourse has gotten to the point where we can’t even agree on the problems anymore. Indeed, both parties seem to be running around inventing problems that they can quote/unquote “solve” with their own particular set of political-base friendly policies. And, at the same time, both parties seem to be completely ignoring, if you will, many of the true issues our economy is facing from entitlement programs that are clearly unsustainable and we’re probably less than a decade away from some sort of major crisis on that particular front.

Equivalently, we have a situation where we’re underinvesting in U.S. infrastructure. Again, no one is really talking about that. Another issue is wealth inequality in the United States. Again, very little is being dealt with on that particular front.

So, as opposed to confronting the real problems that face us, we, instead, of course have simply devolved into this crazy political world we’re in. Ignoring where the boat is heading is probably the best way of guaranteeing a major crash.

Gene:  Chris, you will be appearing at the NCSL Legislative Summit in Los Angeles. Is this going to be part of the message that you try to deliver to state legislators and staff?

Chris:  (laughs) It will be, as a matter of fact. In fact, I’m going to call it the “great disconnect” where we are worried about the wrong things and we’re ignoring the right things to worry about. So I obviously look forward to being there. It’s going to be a great group as always. And I’m excited to give people a little bit of the upshot of all these words I just threw at you.

Gene:  We’ve been talking with Christopher Thornberg, the founding partner of the research firm, Beacon Economics. Chris, we really appreciate your time today.

Chris:  A pleasure to be here.

Music and Gene VO:

And that concludes this edition of “Our American States.” If you enjoy this program, we ask that you take a moment to give us a rating on your favorite podcast app and even leave a brief review. Those small actions help to raise the podcast profile and make it easier for your colleagues across the nation to find us.

For the National Conference of State legislators, this is Gene Rose. Thanks for listening.