Economic outlook—Thoughts on what to expect in 2018

Dr. Ira Kalish
Chief Global Economist, Deloitte
USA

Strong job market

• Full employment
• Employment rising faster than needed to absorb new entrants into the labor force
• Wage growth starts to accelerate

Average hourly earnings % change

Source: MACROBOND

Unemployment Rate

Source: US Federal Reserve
USA

Consumer spending might become constrained

- Spending fueled by job growth, improved cash flow, access to credit
- Income decelerates
- Consumers retain strong spending growth through borrowing, reduced savings.
- Subprime lenders start to boost loan loss reserves
USA
Trade is driving growth

• Overseas growth is accelerating, boosting demand for US exports

• The value of the dollar has fallen in the past year, boosting export competitiveness

• Protectionist actions represent a threat to strong exports
Inflation, expectations, and consequences

- Core inflation has decelerated, but expectations of inflation have increased
- Wages are starting to accelerate
- The Fed has started to raise rates
- Bond yields rose after tax cut

Expectation of five year inflation
USA
The Fed and its impact

- Fed’s job is to target both inflation and employment. We are at full employment and inflation is starting to rise
- The tax cut will stimulate an economy already at full employment
- Expect the Fed to continue tightening

Federal Funds Rate

Yield on ten year Treasury bond

Source: MACROBOND
USA
Administration fiscal policy

Tax reform:

- Cuts corporate rate, boosts after tax profits
- Temporary 100 percent expensing of investment will temporarily boost investment
- Territoriality will reduce cash held overseas, boost outbound investment
- Lower household rates will boost consumer spending temporarily
- Increase in budget deficit, especially if cuts are made permanent
- Possible problems in housing market
- Big impact on some state and local governments

Budget Deficit as Share of GDP

Source: MACROBOND
### USA

#### Administration trade policy

<table>
<thead>
<tr>
<th>Policy</th>
<th>Impact</th>
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<tbody>
<tr>
<td><strong>Withdraw from TPP</strong></td>
<td>• Retain tariffs on 18,000 traded goods</td>
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<td>• Hurt Japan’s ability to implement structural reforms</td>
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<td>• Reduce leverage with China</td>
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<td>• Enhance China’s geopolitical footprint</td>
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<td><strong>Withdraw from NAFTA</strong></td>
<td>• Revert to WTO tariffs between Mexican and US</td>
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<td></td>
<td>• US-Canada trade reverts to old free trade deal</td>
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<td></td>
<td>• North American supply chains to be restructured</td>
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<td>• Uncertainty about whether US Congress must agree</td>
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<td><strong>Impose tariffs on China</strong></td>
<td>• Raise prices on US imports from China</td>
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<td>• Divert trade to other countries</td>
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<td></td>
<td>• China retaliates, hurting US exports</td>
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<td></td>
<td>• Trade volume declines, economic growth decelerates</td>
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</table>
USA

What have financial markets done?

- Equity prices rose strongly in the past year
  - Improving global economy
  - Very low interest rates
  - Herd mentality creates a bubble
  - Fed tightening might break the bubble

- Bond yields have started to rise
  - Could rise further if investors expect higher inflation
  - Could be suppressed if Fed action implies that inflation will be muted
  - Stable bond yields and rising short term rates could create inverted yield curve
USA
What about the next downturn?

• Recoveries don’t die of old age, but this one is quite old

• Recessions come about due to:
  • Fed policy tightening
  • Sharp rise in commodity prices
  • Popping of asset price bubble
  • Stress in financial markets

• What current events might eventually lead to recession?
  • Fed tightening
  • Stress in financial markets
  • End of asset price bubble
Let’s talk about growth
Working age population is decelerating

Population aged 15 to 64, % Change

Source: Macrobond
Prime age (25-54) labor force participation

- Women [m.a. 50 obs]
- Men [m.a. 50 obs]
Least educated have seen a sharp drop in participation

Sources: US Bureau of Labour Statistics; Council of Economic Advisers
Decline in female participation is unique to the US

- US female participation now lower than in Japan
- One explanation is the nature of family leave and child care policies

Men and women offer different reasons for not working

Reasons why working age men and women are not working

Productivity growth has been slow, not just in the US

Productivity growth in the last three recoveries
Percent, annual average

Source: OECD/Haver Analytics

- Germany
- Japan
- Korea
- United Kingdom
- United States

What can make economies grow faster?

• **What about tax policy?**
  • Probably not—although a better tax code is a good idea
  • Tax policy will not influence labor force size
  • Tax reform is meant to boost investment, which would help productivity
  • Yet many countries have low tax rates and slow productivity growth
  • Companies have low borrowing costs, lots of cash, and profits are strong

• **Other factors can boost productivity growth:**
  • Government R&D
  • Deregulation
  • Investment in human capital
  • Freer trade and capital flows

• **Some policies can hurt economic growth**
  • Protectionism
  • Immigration restrictions
Why are businesses investing so modestly?

- Excess capacity, deflation, political uncertainty, shock of new technologies

**Business investment in OECD countries**

[Graph showing business investment recovery compared to the pre-recession peak.]

*Source: Oxford Economics*
## The rest of the world

### Growth in major economies

<table>
<thead>
<tr>
<th>Country/region</th>
<th>Outlook</th>
<th>Risks</th>
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</thead>
<tbody>
<tr>
<td>Eurozone</td>
<td>• Growth accelerating</td>
<td>• High unemployment reduces political support for structural reform</td>
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<td></td>
<td>• Inflation low</td>
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<tr>
<td></td>
<td>• Monetary policy easy</td>
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<tr>
<td>UK</td>
<td>• Growth decelerating</td>
<td>• Brexit could lead to reduced inbound investment</td>
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<tr>
<td></td>
<td>• Inflation high</td>
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<tr>
<td></td>
<td>• Policy uncertainty</td>
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<tr>
<td>China</td>
<td>• Growth stabilizing</td>
<td>• Too much debt could lead to financial difficulties</td>
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<tr>
<td></td>
<td>• Inflation rising</td>
<td>• Lack of significant reforms</td>
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<td></td>
<td>• Property investment strong</td>
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<tr>
<td>Japan</td>
<td>• Improved growth</td>
<td>• Very poor demographics</td>
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<tr>
<td></td>
<td>• Very low inflation</td>
<td>• Deflationary psychology</td>
</tr>
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Where are there opportunities for growth?

- Countries with:
  - Favorable demographics
  - Open markets
  - Strong institutions
  - Productive investment
  - Innovation and entrepreneurship