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Chief Economist's Outlook 2016:
Threat of Diminished Expectations

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8 Key Points in Keating's Analysis:

1. The threat of diminished expectations looms large regarding U.S. economic growth.

2. During periods of recovery and growth (that is, excluding recessions) since 1950, real GDP growth has averaged 4.4 percent. But during this recovery, growth has averaged half of that at 2.2 percent. If the economy had grown during the current recovery at the normal average recovery/growth rate, then the U.S. economy, as measured by real GDP in 2009 dollars, would be $2.3 trillion larger in 2015.

3. A key problem has been a lack of private-sector business investment. Specifically, private fixed investment hit a high in the first quarter of 2006, and it took the U.S. economy nine years, until the first quarter of 2015, to get back to that level of investment.

4. Recent industrial production numbers point to a recession in the industrial sector of the U.S. economy.

5. Through the first ten months of 2015, both exports and imports were down from the same period last year. Previous annual declines in exports and imports occurred during recessions.

6. The number of unincorporated self-employed, a key measure of startups and entrepreneurship, dropped in November, and was down from the intra-year high registered at 9.97 million in May; and far removed from the pre-recession high of 10.86 million registered in December 2006.

7. If the economy was back to its pre-recession employment-population ratio, then the U.S. would have 9 million more jobs than we do. Rather than adding only 2.8 million jobs since November 2007, the U.S. economy would have added nearly 12 million jobs.

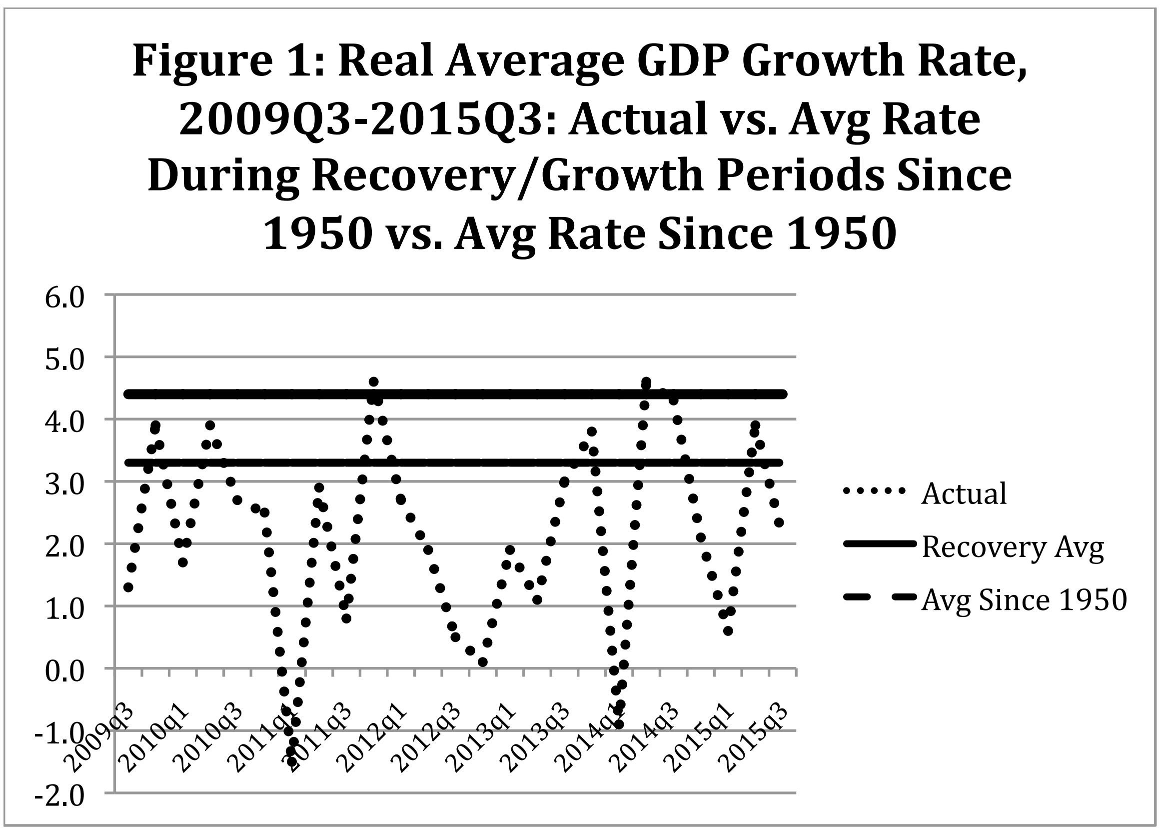
8. Our economic woes have been about federal policies raising the costs of and diminishing incentives for private-sector risk taking. Without substantive tax, regulatory, trade, monetary and government spending policy changes, the U.S. economy will continue to under-perform. And with serious questions about the U.S. industrial sector and trade, there are notable downside risks for 2016. This is not about diminished expectations. If the U.S. gets policy right, the economy can grow robustly.

INTRODUCTION

As 2015 sets and 2016 dawns, the threat of diminished expectations continues to grow.

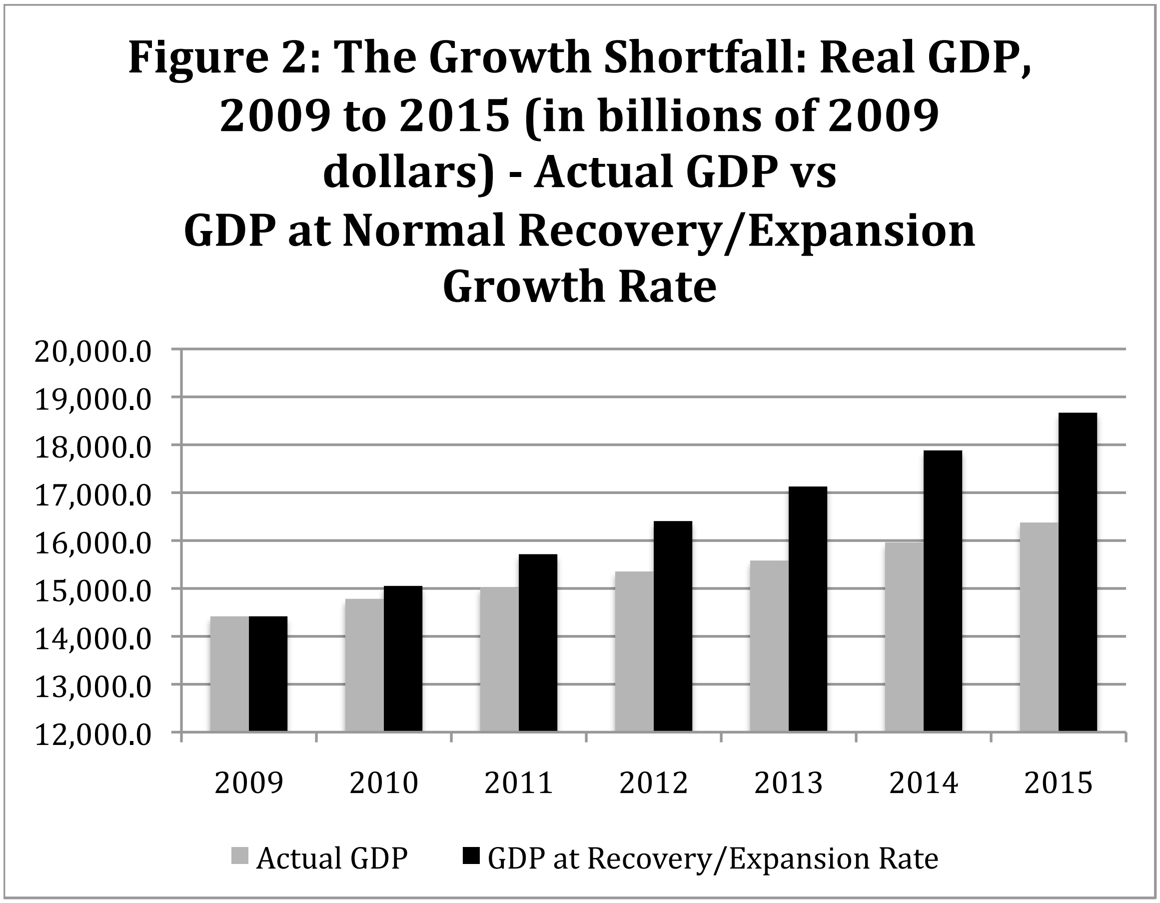
The U.S. economy has performed woefully for more than eight years now, including the Great Recession followed by one of the worst recoveries on record. As this poor economic performance persists, one hears more talk about this being the new normal, or even a poor or sluggish economy being spun as a "strong economy."

Consider that real GDP growth, compared to the post-World War II average (that is, since 1950), has badly under-performed for the past eight years. In fact, the growth shortfall has been going on since 2001. During the post-WWII period, real annual GDP growth has averaged 3.3 percent. However, real GDP growth has averaged only 1.8 percent from 2001 to this year, 1.2 percent since the start of the recession, and 2.2 percent since this recovery began in mid-2009. Through the first three quarters of 2015, real growth averaged 2.2 percent.



It also must be kept in mind that during periods of recovery and growth (that is, excluding recessions) since 1950, real GDP growth has averaged 4.4 percent. Compare that to the average growth rate of 2.2 percent, as already noted, during this recovery. That is, real GDP growth during this recovery has been half of what it should be. That leaves, as illustrated in Figure 2, a stunning estimated real growth gap of $2.3 trillion in 2015. If the economy had grown during the current recovery at the normal average recovery/growth rate, then the U.S. economy, as measured by real GDP in 2009 dollars, would be $2.3 trillion larger in 2015.

Accepting such poor growth as the new normal or classifying it as "strong" amounts to surrender without understanding the cause for this under-performance, and to denying that anything can be done. In reality, none of this is inevitable, since the underlying problems are poor policy decisions that have increased costs and uncertainties for the private sector, and undermined incentives for investment and entrepreneurship.

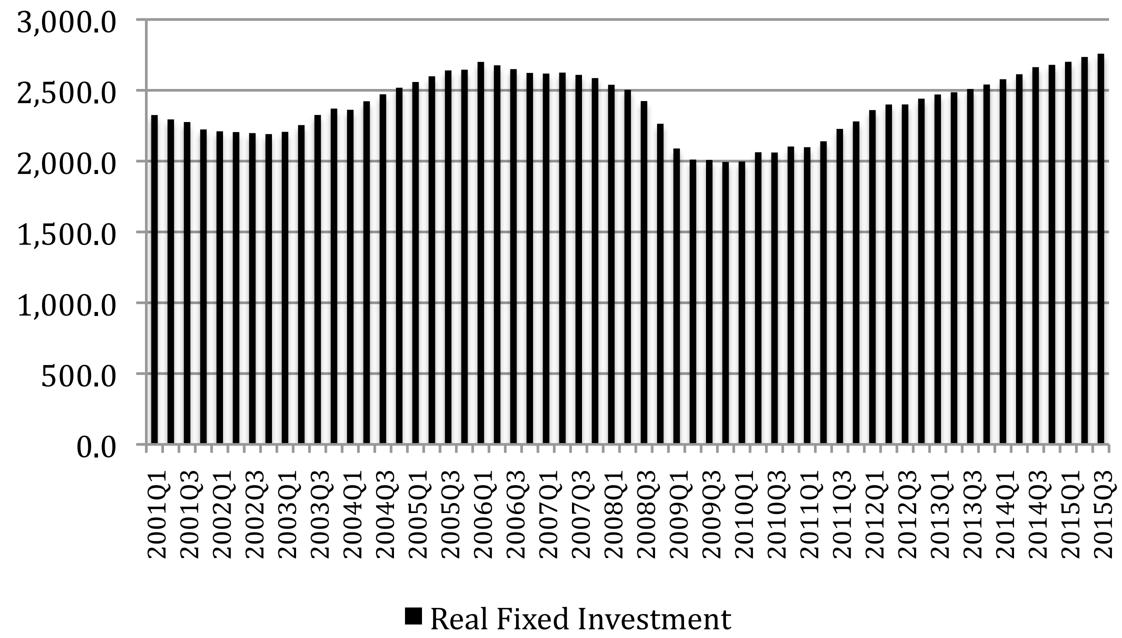


KEY BROAD POINTS ON THE ECONOMY

PRIVATE INVESTMENT

A key problem for economic growth has been the lack of private-sector business investment. When considering the performance of economic, income, productivity and employment growth, it all comes back to investment. Unfortunately, as illustrated in Figure 3, private fixed investment hit a high in the first quarter of 2006, and it took the U.S. economy nine years, until the first quarter of 2015, to get back to that level of investment. Indeed, given the near-decade stretch for investment to recover its previous high, the case can be made that has been a near-depression in investment. And of course, poor private investment creates problems now and into the future for the U.S. economy.

Figure 3: Real Fixed Investment (in billions of 2009 dollars): 2001Q1 to 2015Q3



INDUSTRIAL PRODUCTION

Recent industrial production numbers point to the industrial sector of the U.S. economy being in recession.

Industrial production (that is, the actual output of manufacturing, mining and utilities) fell in November by 0.6 percent, after a drop of 0.4 percent in October and a 0.1 percent decline in September. Industrial production was down in eight of this year's 11 months, with one flat month. Compared to a year earlier, industrial production in November was down by 1.2 percent. As for manufacturing output, it was flat in November, after it rose by 0.4 percent in October. In the first 11 months of 2015, manufacturing output was down in five months, and flat in two. Compared to a year earlier, manufacturing output was up a mere 0.9 percent. In addition, compared to a year earlier, mining output in November was down a stunning 8.2 percent, and utility output was off by 7.6 percent.

These numbers make clear that there is an industrial sector recession in the U.S, and it must be pointed out that in the past, each period of extended declines in industrial production have led to or signaled a general recession.

TRADE

Trade data during 2015 has been very troubling. In October, both exports and imports declined versus the previous month. And in fact, both exports and imports have been on a general decline since October of 2014:

• Monthly exports registered $184.1 billion in October 2015 compared to $197.8 billion in October 2014.

• Imports came in at $227.95 billion in October 2015 versus $240.5 billion in October 2014.

Given the decline in both exports and imports, this cannot merely be explained away by a strong dollar discouraging exports and promoting imports. In the end, trade trends are driven by economic growth among trading partners.

Over the past two decades, U.S. imports declined in two years – the recession years of 2001 and 2009, and exports fell in three years – the recession year of 2001 and its sluggish 2002 aftermath, and the recession year of 2009. Through the first ten months of 2015, both exports and imports were down from the same period last year.

ENTREPRENEURSHIP

Along with private investment, entrepreneurship is central to U.S. economic growth. And like the investment numbers, a disturbing decline in recent years, and months, raises serious problems in the near term and over the longer haul.

The number of self-employed, as reported by the U.S. Bureau of Labor Statistics, is a key measure of startups and entrepreneurship. After a big bump up in October, the number of unincorporated self-employed dropped in November. The November level stood at 9.423 million. That was down from the intra-year high registered at 9.97 million in May; down from 9.543 million in November of last year; and far removed from the pre-recession high of 10.86 million registered in December 2006.

Meanwhile, incorporated self-employed (with data not seasonally adjusted) came in at 5.692 million in November 2015, which was up compared to 5.585 in November of last year; and 5.037 million in November 2010. However, this latest month’s numbers were down versus 5.872 million in November 2008 and 5.835 million in November 2007.

JOBS

The latest data from November pointed to a second consecutive month of respectable employment numbers. The establishment survey (or payroll numbers) showed a gain of 211,000 in employment in November. But that was down notably from October’s gain. And over the past four months, we've only seen strong growth in one month: 153,000 in August, 145,000 in September, 298,000 in October, and 211,000 in November. During a solid recovery, payrolls should be expanding at better than 250,000 per month.

Meanwhile, according to the household survey, for the second straight month, the unemployment rate remained at 5.0 percent. That, of course, is touted as being half the recent high rate of 10.0 percent hit in October 2009. Unfortunately, the unemployment rate has become far less useful as an economic measure given its detachment from trends in the labor force and employment.

In November, both the labor force and the employment level increased for the second straight month. Nonetheless, the labor force participation rate and the employment-population ratio numbers linger around longtime lows – the labor force participation rate at levels seen last in the late 1970s and the employment-population ratio in the early 1980s.

To understand just how poor this recovery has been on the jobs front, consider that the November 62.5 percent labor force participation rate compared to a rate of 66.0 percent before this last recession, and the employment-population ratio of 59.3 percent in November compared to a pre-recession level of 62.9 percent.

Therefore, if the economy was back to its pre-recession employment-population ratio, then total employment would stand at 158.3 million, compared to the actual November level of 149.4 million. That is, we would have 9 million more jobs. And rather than adding only 2.8 million jobs since November 2007, the U.S. economy would have added nearly 12 million jobs.

POLICY AND THE ECONOMY

The recent and extended under-performance of the U.S. economy is not about the usual issues often heard in the media and in certain political circles, such as the value of the dollar or a lack of strength among consumers. It's not all about the shaking off of a credit mess that occurred seven years ago.

Economic growth comes from the supply-side of the economy, that is, from risk taking in the forms of entrepreneurship and investment. The problem over the past nine years has been misguided and costly federal policymaking that has raised the costs of and diminished incentives for critical private-sector risk taking. That includes the following:

• *Hyper-regulation.* With the economy knocked down with a recession that started in late 2007, the Obama administration stepped forward with an intrusive regulatory agenda, including ObamaCare, Dodd-Frank, EPA activism, labor regulations, and so on. This regulatory agenda has only served to raise costs and create uncertainty, which in turn has greatly restrained business investment and hiring.

• *Taxes.* During tough economic times, very few economists – whether they be Keynesian, supply-side or Austrian economists – would advise in favor of increasing taxes. Unfortunately, the Obama administration has been hammering away in favor of a wide array of tax increases, with the White House and Congress imposing a variety of tax hikes at the start of 2013, including higher personal income, capital gains and death tax rates.

• *Trade.* When President Obama entered the oval office, the U.S. immediately abandoned its global leadership role in advancing free trade. Of recent times, free trade has reappeared on the U.S. policymaking radar with the Trans-Pacific Partnership deal. Still, various noteworthy Republicans have joined with Democratic colleagues in railing against free trade.

• *Monetary Policy.* The Fed has maneuvered itself into a no-win situation by trying to use monetary policy as a means for attempting to stimulate the economy. Despite the tiny increase announced in mid-December in the federal funds rate (from the range of 0 to 1/4 percent to a range of 1/4 to 1/2 percent), the Fed continues to run historically loose (previously unimaginable) monetary policy, and will do so for the foreseeable future. The hope was that this loose money experiment would boost the economy without any negative ramifications. Some even say that the Fed saved us from another depression. But that's not supported by the reality of the Great Recession followed by one of the worst recoveries on record. The Fed's loose money has been all about added uncertainty for businesses and investors, not about saving us from another depression.

• *Government spending and debt.* Total federal outlays jumped dramatically from 2007 to 2011 – with the biggest jump coming in 2009. However, in both 2012 and 2013, outlays actually declined, and in 2014, growth amounted to only 1.4 percent. However, in 2015, federal outlays jumped by a notable 4.9 percent. After the federal spending mess from 2008 to 2011, some subsequent good news came via relative spending restraint, largely imposed via Congress, from 2012 to 2014. However, spending restraint was gone for fiscal year 2015, significantly due to ObamaCare's expansion of government's role in health care. One of the results of the spending spree of recent years has been a dramatic increase in federal debt, which raises the threat of future tax increases. Looking ahead, the Obama budget projects big spending increases in coming years. Draining more and more resources from the private sector via taxes or debt for increased federal government spending works against economic growth, and it promises to get worse in coming years without serious efforts to rein in government.

OUTLOOK

Looking ahead, without dramatic shifts in tax, regulatory, trade, and government spending policies in a pro-growth direction, and a change in monetary policy to being focused on price stability, few reasons exist to expect anything more than a continued under-performing economic recovery. This assessment is not about diminished expectations. Indeed, it is the antithesis to such assumptions. If the U.S. gets the policy mix right, there is no reason that the economy cannot grow at the historic average of 3.3 percent annually, or even the 4.4 percent average achieved during recovery-expansion periods.

Given the centrality of policy weighing down the economy, however, it's difficult to see strong growth in 2016 since the political mix and policy decisions will not be changing in any substantive way during the year. The December measures to lift the U.S. ban on crude oil exports, and making small business expensing and the R&D tax credit permanent were positives, but much more is needed to shift economic growth into high gear. In fact, the potential for additional regulation during Mr. Obama's last year in office, along with serious questions about the U.S. industrial sector and trade, notable downside risks lurk for the 2016 economy. To be sure, the state of the U.S. economy beyond 2016 will be decided by the ideas offered by presidential and congressional candidates, and by voters at the ballot box in November 2016.

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