Economy Growing Amidst Washington Chaos

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We came into the year optimistic about pro-growth economic policies being initiated by the incoming Trump Administration. Those policies included substantial tax cuts, a major investment in infrastructure and regulatory relief. There has been real progress on the regulatory front, but nothing has really happened with respect to tax relief and infrastructure spending. Instead we have witnessed chaos with respect to immigration, healthcare and trade policies and a loss of confidence in the Administration over its handling of the neo-Nazi demonstration in Charlottesville, Virginia and the North Korea nuclear issue. Along the way there has been a revolving door with respect to the staffing of the White House. You need a scorecard to keep track of who is in and who is out.

Nevertheless, notwithstanding the chaos in Washington D.C., the economy continues to plow ahead with modest growth in real GDP and rather strong gains in employment. (See Figure 1 and 2) The employment gain has been even more impressive because it is occurring against a backdrop of a year-over-year decline in retail employment caused by the ongoing restructuring of that

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**Figure 1**
Real GDP Growth, 2007Q1 - 2019Q4F

*(Percent Change, SAAR)*

<table>
<thead>
<tr>
<th>Year</th>
<th>2007</th>
<th>2009</th>
<th>2011</th>
<th>2013</th>
<th>2015</th>
<th>2017</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change</td>
<td>-10%</td>
<td>-8%</td>
<td>-6%</td>
<td>-4%</td>
<td>-2%</td>
<td>0%</td>
<td>2%</td>
</tr>
</tbody>
</table>

*Sources: U.S. Department of Commerce and UCLA Anderson Forecast*

**Figure 2**
Payroll Employment, 2007Q1 - 2019Q4F

*(Millions)*

<table>
<thead>
<tr>
<th>Year</th>
<th>2007</th>
<th>2009</th>
<th>2011</th>
<th>2013</th>
<th>2015</th>
<th>2017</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Millions</td>
<td>125</td>
<td>130</td>
<td>135</td>
<td>140</td>
<td>145</td>
<td>150</td>
<td>155</td>
</tr>
</tbody>
</table>

*Sources: Bureau of Labor Statistics and UCLA Anderson Forecast*
industry as online competition takes its toll. (See Figure 3) We would also note that the only other times we have witnessed year-over-year declines in retail employment has been during recessions.

Specifically, we forecast that growth will continue with real GDP increasing by 2.1%, 2.8% and 2.1% in 2017, 2018 and 2019, respectively. The impact of tropical storms Harvey and Irma will modestly lower growth in the current quarter and possibly the fourth quarter from what it would have been and increase it in early 2018. Although not intended, the post-hurricane rebuilding, which could amount to $200- $300 billion of governmental and insurance funding, will act as if Congress passed a formal infrastructure package. Indeed, the dollars will flow far more rapidly compared to Hurricane Katrina in 2005 because FEMA is accepting applications via smart phones. But make no mistake, wealth was destroyed and that destruction is not measured in GDP. We would note that our 2018 optimism is based on the belief that Congress will ultimately enact tax cuts and a formal infrastructure package later this year, more on that below. In this environment the unemployment rate will remain at or below the current 4.4% for the forecast horizon. (See Figure 4)
Fiscal and Regulatory Policy

Despite the chaos we cited above, we believe that Congress will pass both a tax and an infrastructure bill this year. Why? Nothing focuses the minds of Republican legislators than the thought of losing their majority. Thus, the leadership on tax policy will come from Congress, not the White House. As a result, we are assuming for modeling purposes that Congress will pass a $1.6 trillion tax over 10 years, split evenly between corporations and individuals. Congress will set a 25% corporate tax rate while eliminating several business deductions and allow for the repatriation of overseas profit at a 10% tax rate. We would note that the tax reductions outlined here are well below the $5 trillion we were looking for last December. Moreover, should President Trump’s recent dalliance with Democratic leaders Schumer and Pelosi become a longer-term relationship, then the cuts would tilt more towards middle and lower income constituencies than a more traditional Republican plan.

Of course, to use an old economist joke, we are assuming more than a few can openers. Nevertheless, President Trump and the Congress came together on postponing the debt ceiling issue and on an initial Harvey relief package. Although the debt ceiling agreement expires in December, the temporary lifting of the ceiling will enable the Treasury to engage in extraordinary measures that will postpone a vote until the spring. Thus, the risk of a government shutdown has been pushed back into next year. However, if we are wrong on the tax cuts, growth in 2018 will be slower than what we are now projecting.

On the regulatory front, the Trump Administration has started to roll back environmental, energy, financial and labor regulations. Whether this is good policy or not, it has begun to lift the regulatory burden on businesses and to be very frank, had there been a Clinton Administration, businesses would have faced a continuation of the regulatory onslaught that was characteristic of the Obama Administration.

Sources of Modest Strength

Aside from defense, the sources of growth over the next two years will come from consumption, housing (in 2018) and equipment spending. Real consumption spending is forecast to grow at just under a 3% clip next year and remain strong into 2019. (See Figure 7) Growth here is being underpinned by continued job growth, rising wages and tax cuts. In addition, the automobile industry
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In the houses they are already living in, making it harder for millennials to enter the market.

In response to improved global growth, a rebound in oil drilling activity and the prospect of lower corporate taxation, real equipment spending is forecast at a 4%+ pace though 2019. This will be a decided improvement over the 3.4% decline occurred in 2016. (See Figure 9) Further, as labor markets continue to tighten, the incentive to substitute capital for labor will increase.

Gradual Tightening of Monetary Policy

We have forecast rising inflation over the past several years. Although we were right in terms of direction, we have certainly been wrong with respect to the magnitude of the increase. In part, the sluggishness in average compensation growth has been due to the fact that higher-paid retiring baby boomers are being replaced by lower paid millennials. Nevertheless, both the monetary and Keynesian Phillips Curve (wage growth being negatively correlated with the unemployment rate) explanations have been found wanting. But with the unemployment rate as low as it is, we believe that compensation increases will soon surpass 4% and the consumer price index will be increasing at a rate of at or above 2% over the next two and half years. (See Figures 10 and 11) Simply put, all of the kindling is in place to ignite a round of wage increases that will in turn elevate service sector inflation. It has just taken longer than we thought.
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with a pause in March, and then running through 2019. By then, the federal funds rate would reach 3%, up from the current 1.125%. (See Figure 12) Similarly, the yield on 10-Year U.S. Treasury bonds is forecast to be on a path to 4%, up from 2.1% in early September. Because we have been forecasting a 4% 10-Year U.S. Treasury rate for a long time to no avail, this forecast is yet again another triumph of hope over experience. Nevertheless, we are hard pressed to visualize say a 3% rate, in an environment of 4% unemployment, growing GDP, inflation over 2% and a rising federal deficit.

Conclusion

The economy has grown despite chaos in Washington and will continue to grow at a moderate 2+% rate while operating at full employment. In response to a 2018 tax cut, growth will pick up to about 3% before falling back to 2.5% and lower in 2019. Growth would be underpinned by higher defense outlays and moderate gains in consumption, housing and equipment spending. Unemployment will remain at or below the recent 4.4% over the forecast horizon. Inflation will increase modestly running at a 2+ percent rate. The combination of full employment and somewhat higher inflation will prompt the Fed to continue its modest tightening path by raising interest rates roughly 25 basis points a quarter into 2019. Should we be wrong on the tax cuts, growth would be slower. Of course there is always the risk that dysfunction in Washington will spill over to the real economy.