The WorldPost Opinion

What worries me about the U.S. economy

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The U.S. economy certainly appears as if it is in an ideal place: unemployment is at its lowest in nearly half a century, and the number of people voluntarily leaving jobs to find new ones, an indicator of their confidence in the economy, is at a 20-year high. Economic growth this year is likely to be around 3 percent, more than what most economists think the economy is capable of in the medium term. Inflation is moderate.

But as the current stock market nosedive reminds us, there are risks that could jolt the economy out of its strong position. They have to do with three related factors: timing, debt and slowing growth in the rest of the world.

First, the Trump administration’s tax cuts were not well-timed. Economic stimulus is best when unemployment is high because the resulting demand growth can be accommodated by putting more people back to work. The administration’s tax reforms earlier this year stimulated an economy that was already close to full employment. When demand exceeds the economy’s supply potential, there is a risk of triggering inflation.

This is not, however, baked in. For one, U.S. consumers can buy foreign-made products. But unfortunately, the administration seems to view high import levels and a large trade deficit as signs of how much other countries are taking advantage of the United States, which could spur yet more actions against trade.

Alternatively, U.S. firms could invest more in labor-saving equipment in order to raise labor productivity. This appeared to be under way, possibly encouraged by the administration’s tax incentives for investment, but investment growth has fallen off in the last quarter. If productivity does not pick up, the Federal Reserve will continue to raise interest rates so that economic growth stabilizes at a sustainable pace and inflation stays moderate.

The Fed has reiterated its determination to do so. However, some worry that if the Fed calibrates interest rates to current buoyant economic conditions, they may be too high when the fiscal stimulus ends next year. High interest rates will naturally slow interest-sensitive sectors like the auto industry, housing and construction but will especially affect entities that have borrowed too much.
Second, financial conditions across the world have been very easy for a long time, leading some entities to overborrow. These are typically not the same entities that borrowed before the financial crisis. For the most part, banks and households in the United States have been more cautious about levering up this time.

Yet there are other areas of excess. For example, covenant-lite loans, which offer less protections to the lender than traditional loans and are often used for highly-levered private equity deals, are at an all-time high. Some of these deals center on firms that have changed hands many times, with each exchange adding yet more debt. Many of these loans are being made by the non-banking financial sector, which is less regulated, but banks are joining in on the action.

With the Fed’s policy interest rate still below measures of generalized inflation, financial conditions are still very accommodating and the financial sector is exuberant. But before the last crisis — with rates rising but financial conditions still easy — lenders made mistakes, such as issuing NINJA housing loans, so-called because they were made to people with no income, no jobs and no assets. They were predicated on repossessing and selling the house if they did not pay. It worked — until the housing market collapsed.

Third, growth in much of the world is slowing, and many emerging markets are not well-positioned to weather slow growth. President Trump’s threats to trade may well have depressed investment sentiment elsewhere, as corporations wait to see how their supply chains will be affected. Moreover, China is a prime destination for many emerging-market exporters, and its economy has been slowing. This was happening even before Trump announced his $200 billion worth of tariffs on Chinese goods.

Emerging markets, by and large, have better macroeconomic policies than in the past, but not all are well-placed to weather slower growth. Rising oil prices, driven in part by impending sanctions on Iranian oil and collapsing Venezuelan production, are forcing oil-consuming countries to borrow more to finance their deficits. When combined with already-high dollar borrowing, rising U.S. interest rates and weakening domestic currencies, it is no surprise that foreign investors are shying away from such emerging markets, making financing more difficult.

None of this means a generalized crisis is imminent. However, strong U.S. growth should not make us oblivious to rising risks in the domestic financial sector and increasing fragilities abroad — the world is too interconnected for any country to be immune.

The Fed’s measured pace of raising rates would be less accommodating of financial sector risk-taking if it could bring other tools to bear. For instance, Eric Rosengren, the president of the Federal Reserve Bank of Boston, has suggested raising counter-cyclical capital requirements on banks; forcing banks to set aside more capital for every risky loan they make will curb exuberant lending.

Instead of helping moderate financial excess, however, the U.S. administration has pushed back on regulators urging banks to limit lending to highly indebted firms, which means banks are now competing with non-banks
The U.S. economy worries me. Here's why.

The Trump administration also needs to recognize that the rest of the world is now more fragile and less able to navigate the stream of disruptive actions launched from Washington. For instance, the uncertainty the United States has created about whether it will cut off Iran’s oil production has raised oil prices significantly. While the consequences from the fragility induced in oil-consuming emerging markets may take time to filter back to the United States, the adverse effects of higher oil prices on U.S. consumers’ disposable income and demand will soon be felt.

At a time when financial fragilities are building, uncertainty about economic policy only adds to economic vulnerability. Put differently, strong U.S. growth is sustainable only if policymakers act as if they believe it is not. Anything else and we are in for a rough ride.

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