



Strategic Analysis

November 2024

Economic Challenges of the New U.S. Administration

Dimitri B. Papadimitriou, Nikolaos Rodousakis, Giuliano T. Yajima and Gennaro Zezza

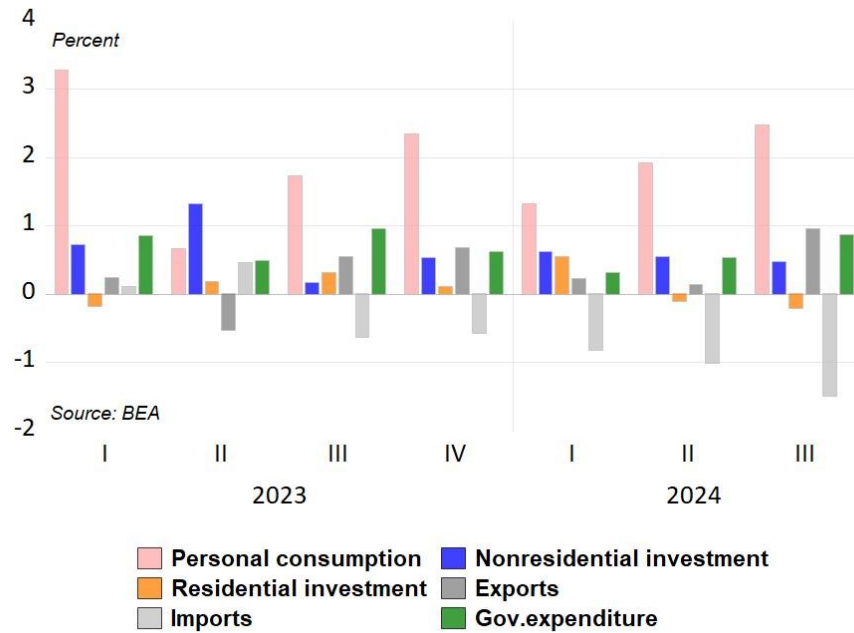
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Introduction -- How is the American economy doing?

Many challenges lie ahead for the US economy after the Presidential election. First and foremost, is the persistence of the Federal Reserve's tight monetary policy affecting household and business borrowing irrespective of the recent decrease by 50 basis points in interest rates. Moreover, fiscal policy –biased from the perennial and tired debate about the debt ceiling—with inadequate expenditure for urgent needs in housing, health care, education, research and development, training and programs relating to the transition of greening the economy—and formulating and implementing an effective trade policy. Labor force participation is currently at 63 percent and wage share of the Gross National Income at 53 percent both still below the pre-Covid period despite the September robust increase in employment and decline in job claims. We will return to a detailed analysis of the prevailing labor landscape later. Post-tax profits, on the other hand, have grown to 12 percent of GDP especially among the technology large firms capturing the AI boom (Economist 2024). President Biden's fiscal policy initiatives implemented in 2022 and continuing to date have contributed noticeably to GDP growth, but the economy is still operating below potential output. The economic challenges facing the U.S. economy together with the necessary active intervention to calm the global instability worsened by the continuing Russia-Ukraine and the Middle-East multi-country wars will require the strong leadership of the new President in 2025 and beyond.

The latest advanced estimate 3rd Quarter annualized GDP growth rate of 2.8 percent is lower than the second quarter of 3 percent, but higher than the first quarter's 1.4 percent and many estimates

Figure 1. U.S. Contributions to Real GDP Growth



show that the 2024 year will end in the 2.8 percent range. It is not at all certain, however, that this healthy rate will continue beyond this year. Private expenditure continued increasing and was the key driver of this growth followed by increases in inventories, government expenditure and nonresidential fixed investment to a lesser extent. The contractionary effect of increased imports continued unabated despite the high tariffs on many goods from China and Europe while exports are growing anemically increasing the trade and current account deficits. In the latest BEA report personal consumption has been contributing the most to real GDP growth in 2024 (Figure 1), with a staggering 2.5 percent, dwarfing the contribution from government expenditure and exports standing at 0.9 percent. Moreover, the substantial rise in demand over the course of 2024 has resulted in a very significant rise in imports negatively impacting real GDP growth; imports increased by 1.5 percent in the third quarter, up from 0.8% of the first quarter of 2024.

Residential investment decreased and sales of existing homes in September fell to 2010 levels together with capital gains as illustrated in Figure 2 while housing permits and starts decreased, but completion rates surged. This is consistent with the tight monetary policy in maintaining interest rates high and the lack of clarity from the Fed’s announcements that has kept mortgage rates high despite the latest decrease in the federal funds rate.

Figure 2. U.S. Households. Residential investment and capital gains

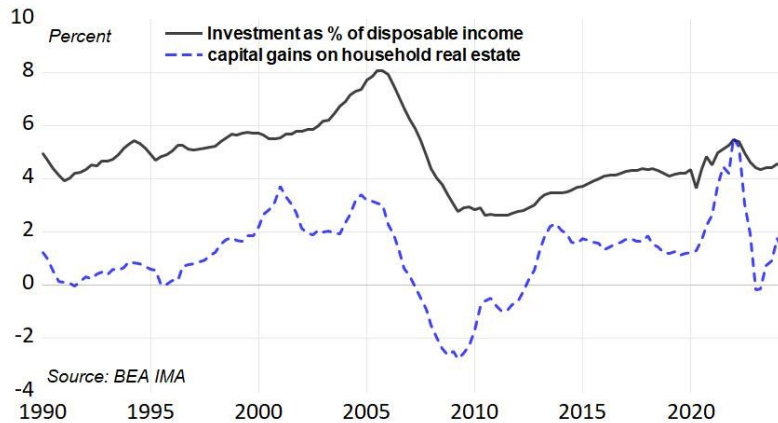
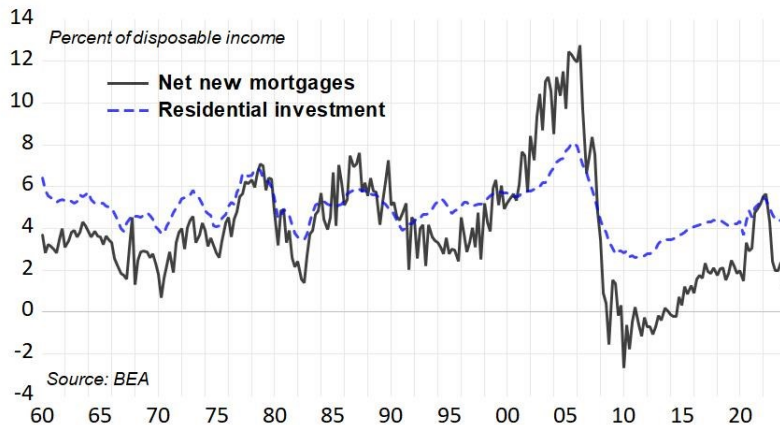


Figure 3. U.S. Households: Residential investment and mortgages



Data from the BEA shows that residential investment after declining during the Covid-19 period has stabilized at 4 percent of disposable income while similarly new mortgages following almost the same trend are now at 2 percent of disposable income –both illustrated in Figure 3. Household outstanding debt in long-term mortgages although high at 60 percent of disposable income is still much lower than its peak in the pre-Global Financial Crisis of 2007-09 while short-term debt after declining in the Covid-19 period returned to its upward trend and is at 30 percent of disposable income as shown in Figure 4. Turning to the balance sheets of non-financial corporations, we observe from data of the BEA in Figure 5, that corporate issued securities and total debt outstanding interrupted their overall rising trend in 2020 and began declining to date despite the increased GDP growth while corporate loans show an unstable trend.

Figure 4. U.S. Households: Debt outstanding

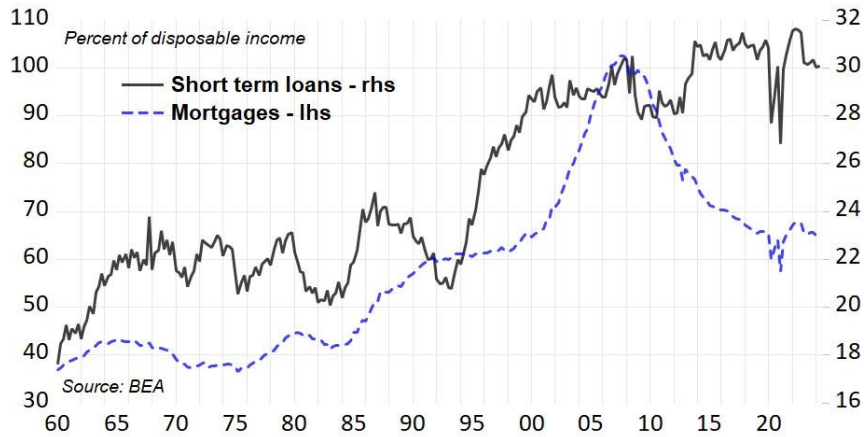
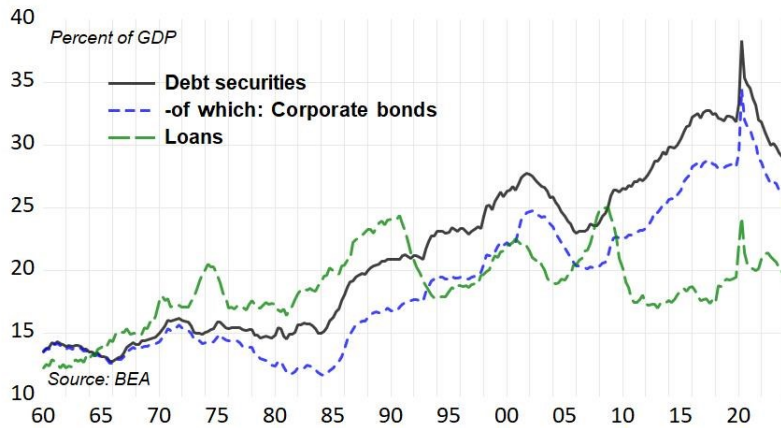
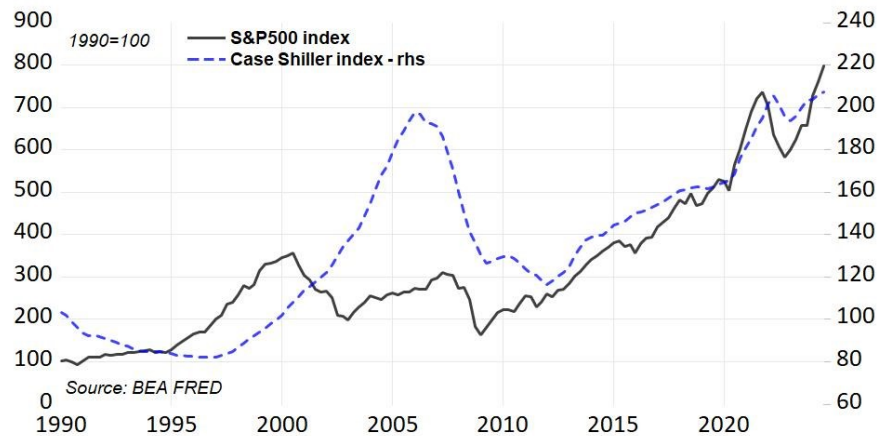


Figure 5. U.S. Non-financial Corporate Business



Governors of the Federal Reserve in various speeches paint the U.S. economic picture brightly insisting on the certainty of a “soft landing” as the Fed moves to gradual decreases of interest rates eliminating the possibility of a recession. The plausibility of the soft landing story has been accepted by the financial markets manifested into new highs and a lot of volatility in the equity (Figure 6) and bond markets. Consistent with real and financial asset rising values, households’ response, from early indications, shows that they are borrowing again against these rising values (WSJ 2024) reminiscent of the pre-Great Recession crisis of 2007-2009. Inflation has slowed, but this is mostly due to supply chains return to normalcy and decreasing energy prices even though foodstuffs and shelter costs have remained high.

Figure 6. U.S. Real S&P500 and Case Shiller indices



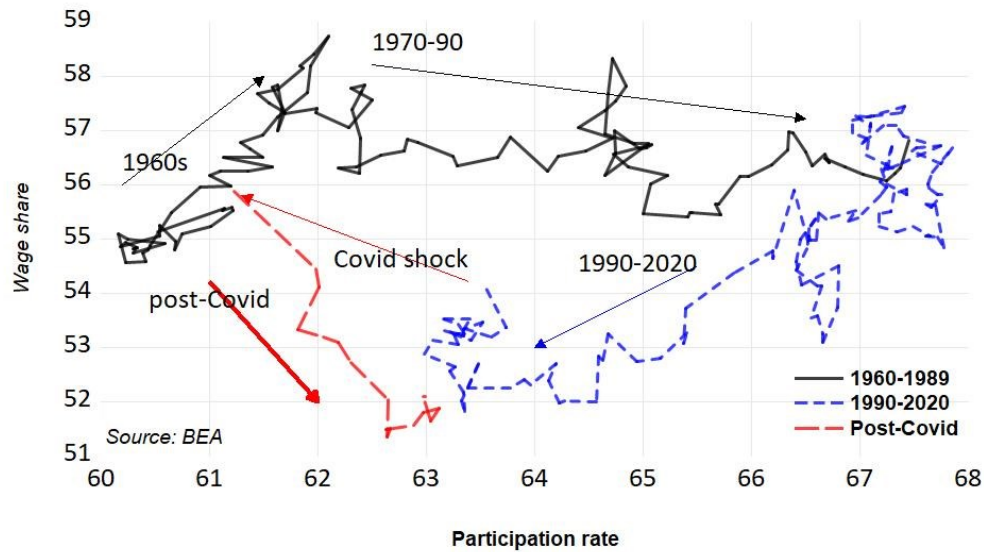
As the US Census reports, retail sales rose in September demonstrating the resilience of consumer spending invigorating the economy. Retail purchases –inflation unadjusted –recorded an increase of 0.4 percent following the 0.1 percent rise in August. The gain in September was 0.7 percent excluding automobile and gasoline stations purchases. This should bode well in GDP growth for the remaining of the year together with the September increasing employment despite the disappointing October employment marking the lowest monthly growth for over twenty years. It should be noted, however, as the BLS reports that long-term jobs are declining especially for the younger ages. Opinions from some commentators suggest the U.S. has now reached full employment at 4.1 percent unemployment rate. It is, however, important to analyze more closely the labor market’s current condition. In Figure 7 we plot the adjusted¹ participation rate and employment rate. Both indicators are well below the peak they reached in the year 2000. A back-of-the-envelope calculation shows that, to reach the peak employment rate the U.S. economy achieved in April of 2000, approximately 12 million jobs should be added!²

These figures suggest that there should be plenty of slack for an increase in employment, matched by a similar decrease in the number of persons out of the labor force, the so called “inactive” labor force.

¹ In the tradition of the Strategic Analysis produced by Wynne Godley we add the estimate of U.S. armed forces to both the numerator and the denominator of the participation rate (the ratio of the labor force to the population in working age) and of the employment rate.

² If this figure seems too high, consider that population in working age has increased since 2000 by 56.8 million (26.8 percent), while employment has increased only by 24.1 million (17.6 percent).

Figure 7. U.S. Labour supply and the wage share

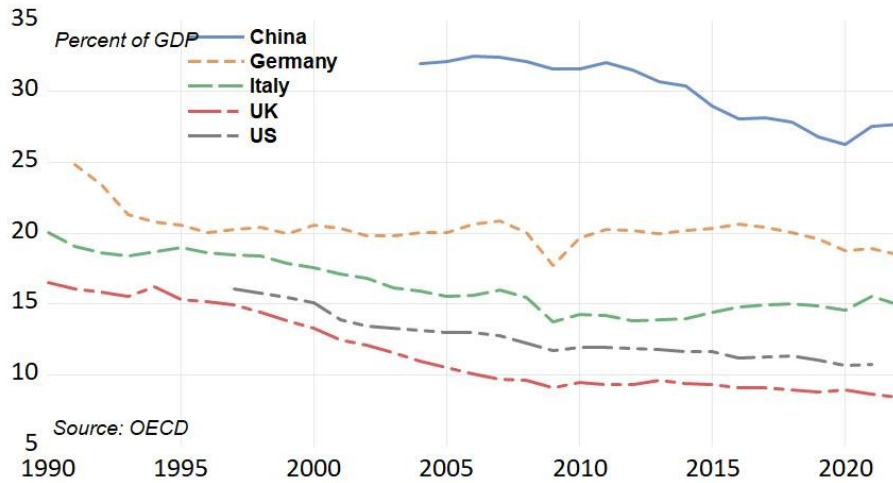


Looking at the labor market data from a long-term perspective gives a somewhat different picture. Inspired by the analysis pioneered by Goodwin for a predator-prey model of the labor market.³ In Figure 7 we report, on the horizontal axis, the participation rate, and on the vertical axis the wage share, measured as the ratio of Compensation of employees in national accounts to gross domestic income. The chart helps understand different phases of labor market relations: in the first two decades after WW2 an increase in the participation rate implied a strengthening of labor and in turn increasing its income share. This process ended in the 1970s, when the rapid increase in the supply of labor from women was no longer implying shifts in income distribution. It is worth noting that the participation rate of males has a declining trend, from 83 percent in 1960 to 68 percent in 2024, while the participation rate of women increased steadily from 37.7 percent in 1960 to 60 percent in 2000, when it stabilized first, and somewhat declined after the Great Recession of 2007-2009. The gender composition of the labor force has certainly had a large impact on the dynamics reported in Figure 7. After 1990 the participation rate started to drop, and this process saw a decline in the wage share which continued to date, with the data showing some erratic movements only in the Covid-19 period in 2020.

Summing up, the data reported in Figure 7 show that workers in 2024 are not in a good position, compared with other U.S. post-WW2 periods.

³ See Mohun & Veneziani (2016) for a discussion.

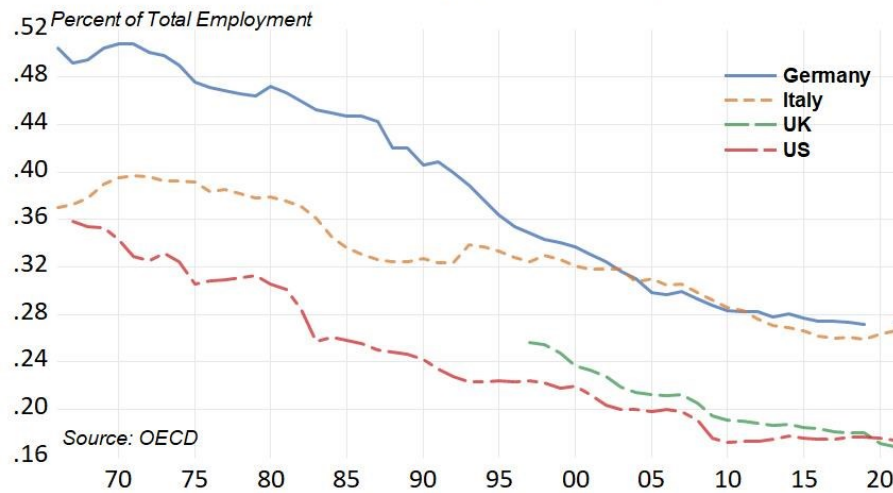
Figure 8. Value added in manufacturing



Is re-industrialization possible?

Deindustrialization, as is commonly known is the drop in the share of manufacturing value-added and employment as percentages of overall GDP and employment. It is a common pattern with significant differences among some OECD countries, as it can be observed in Figure 8 and more pronounced in terms of employment in Figure 9. The notable exception is the share of manufacturing in China and some other Asian countries that has remained relatively high, despite some partial adjustment as these economies are experiencing a shift towards services activities. It should be noted,

Figure 9. Employment in Industry



however, that the larger decline in manufacturing employment in part is due to automatic and robotic processes but still the decline is due to gradual deindustrialization. As demonstrated in Figure 8 the largest decline is the one experienced in the U.S. whose manufacturing employment share dropped from 35% to 17%. It is therefore extraordinarily difficult for the US to begin a process of reindustrialization based on import substitution achieved through the imposition of tariffs. As it will be shown below imports would not be affected and given the structure of the U.S. economy the shift from the tertiary sector to manufacturing would be a Herculean task, if at all possible. On the other hand, in the process of “greening” the economy, President Biden’s initiatives on technological training together with the “green subsidies” would be a good start. In Rodrik’s (2022) view, however, an industrial policy should focus instead on good jobs creation since manufacturing being more and more automated would not absorb any unemployed or underemployed labor. Both Presidential candidates advocate for the revival of the manufacturing sector focusing on different approaches –import substitution or government expenditure paid for from increased taxes. As it will be shown below, our simulations based on assumptions relating to these two approaches give different growth paths for the intermediate period.

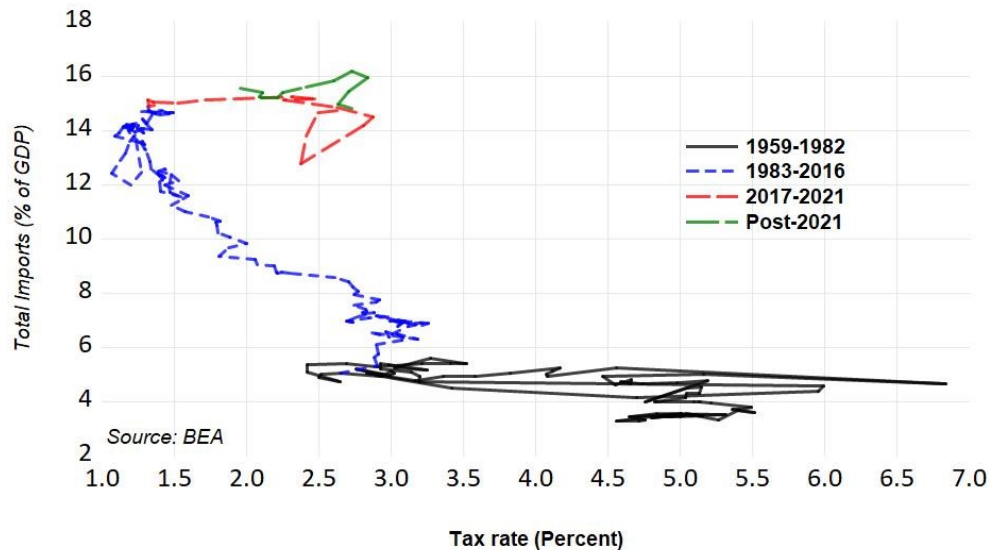
Baseline Scenario

Our point of departure in developing our baseline scenario is to review and adjust the CBO (2024) assumptions related to government revenues and outlays. Our simulation exercise for our baseline delivers different results as they compared to the latest update to the Budget and Economic Outlook posted in June 2024. As illustrated in Table A, our estimates for growth for the 2025-2027 period are substantially different from the conservative estimates provided by the CBO. Our model, which follows the tradition of the New Cambridge Approach (Cripps and Godley, 1976; Godley, 1997) is driven by the dynamic of aggregate demand, whose components have been surprisingly resilient in the last two quarters of 2024 as we pointed out above. We make neutral assumptions regarding inflation and the exchange rate dynamics for the upcoming quarters.

Alternative Scenarios

At the time of writing, we do not know the outcome of the Presidential elections which will take place on November 5, 2024, but we try to evaluate two alternative scenarios on the basis of the announcements on key economic policy points made by the two most important candidates.

Figure 10. U.S. Import and tariffs



In Scenario 1, we assume that a conservative policy aiming at reindustrialization is put in place through a strong increase in import tariffs. President Trump announced that – should he be elected – would introduce import tariffs as high as 200 percent. To evaluate the potential impact of such tariffs we looked at a synthetic indicator, given by the ratio of Custom Duties to the value of imports,⁴ reported on the horizontal axis as “tax rate” in Figure 10, plotted against the ratio of total imports to GDP. A careful inspection of this Figure reveals three rather different periods: before 1983, imports were a relatively small percentage of GDP, although their value increased in the 1970s with the oil shock. In this period, tariffs had a large variance, with a significant negative correlation (-0.7) to the import share.

After 1982, Figure 10 clearly shows an increased trend in the import share, coupled with a decline in tariffs. Next, for the period ending in 2017, the negative correlation between tariffs and the imports share had grown to -0.96.

We look at the next period beginning with the first Trump administration in 2017. This period marked a substantial increase in our variable measuring tariffs, but the Figure shows that such increase had only a minimal impact on imports: the correlation is now only -0.38.

⁴ More precisely, the denominator is given by the dollar value of imports of goods and services less Custom duties.

After 2017 tariffs declined again somewhat, but the correlation with imports was lost, and it is not significantly different from zero for the whole period 2017-2024.

This analysis is relevant, since we have to rely on econometric estimation to evaluate the impact of the proposed increase in tariffs over trade, and our estimates – incorporated in the figures reported in Table B – indeed find that such an economic policy would substantially reduce imports. However, the analysis above suggests that we may be overestimating the efficacy of this policy, since the econometric estimate of the correlation between tariffs and imports will heavily depend on the data of the previous decades.

For Scenario 1, we also assume that the marginal tax rate will be substantially reduced, and our model obviously suggests that this will contribute to an increase in private sector aggregate demand. We assume additional government expenditure of about \$ 40 billion in 2025, and a growth rate of 0.5 percent more in 2026 with respect to the baseline. All these assumptions imply a boost in the level and the growth rate of real GDP in 2025 and 2026. Furthermore, we assumed that U.S. trading partners will introduce retaliatory tariffs on U.S. exports, which will reduce their volume with respect to the baseline.

For the alternative Scenario 2, we assume instead that the government will increase expenditure more substantially in 2025 and 2026, but will mitigate the impact on government budget through an increase in the marginal tax rate. The Keynesian structure of our model implies that, in both scenarios, if the economy achieves a higher growth rate of GDP through an expansionary fiscal policy, the public debt to GDP ratio will stabilize, or may even decline.

TABLE A - BASELINE					
	2023	2024	2025	2026	2027
GDP	2.9	2.8	2.9	2.8	2.6
Private Expenditure	2.0	3.2	3.5	3.5	3.6
Government expenditure	3.9	2.9	1.3	1.0	0.6
Exports of goods and services	2.8	2.6	3.1	3.5	3.2
- Non-Oil Exports	2.2	2.4	3.2	3.6	3.2
- Oil Exports	9.5	4.9	2.1	3.0	3.0
Imports of goods and services	-1.2	5.0	4.9	5.8	6.3
- Non-Oil Imports	-0.4	11.3	9.7	11.8	12.8
- Oil Imports	2.0	0.1	4.0	3.5	3.6
<i>Percent of GDP</i>					
Government balance	-7.6	-7.4	-7.2	-6.9	-6.7
Current account balance	-3.9	-4.1	-3.9	-3.9	-4.1
Government debt	122.3	123.2	123.8	124.6	125.3

TABLE B	SCENARIO 1			SCENARIO 2		
	2025	2026	2027	2025	2026	2027
GDP	3.3	3.1	2.6	3.3	2.9	2.6
Private Expenditure	3.6	3.8	3.7	3.5	3.6	3.6
Government expenditure	1.9	1.5	0.8	3.6	1.7	0.6
Exports of goods and services	2.4	-0.1	-0.5	3.1	3.5	3.2
- Non-Oil Exports	2.4	-0.3	-0.8	3.2	3.6	3.2
- Oil Exports	2.1	3.0	3.0	2.1	3.0	3.0
Imports of goods and services	3.0	3.1	4.7	4.9	5.9	6.4
- Non-Oil Imports	5.8	6.2	9.6	9.8	12.1	13.0
- Oil Imports	4.0	3.4	3.3	4.0	3.6	3.6
<i>Percent of GDP</i>						
Government balance	-7.2	-7.0	-6.8	-7.2	-7.0	-6.7
Current account balance	-3.8	-3.8	-4.2	-3.9	-3.9	-4.2
Government debt	123.4	124.0	124.8	123.3	124.0	124.8

Conclusions

The U.S. is heading for the election of a new President. Irrespective of the election results, the new Administration will face a number of significant challenges both at home and abroad. On the home front, the challenges include maintaining high employment, and growth, investments in education, health care, affordable housing, programs focusing on the climate crisis and instituting an effective trade policy to arrest the ever increasing current account deficit. The challenges abroad include both economic and foreign policy that will contribute toward global stability. In this report, we concentrate on the domestic economic challenges facing the U.S. in the next two to three years.

We review and discuss the existing economic conditions of the U.S. economy including monetary policy, inflation and the likely behavior of households and non-financial institutions regarding expenditures and residential and nonresidential investment. We express reservations for the

plausibility of a serious revival of the manufacturing sector especially the attempt for import substitution through the institution of high tariffs, but inclined to accept that an industrial policy could be beneficial with regards to training for good jobs and programs directed at environmental protection. Reviewing the latest CBO growth projections and the assumptions on the likely paths of private and government expenditures and revenues and net exports, we simulate a baseline and two alternative growth scenarios. Our baseline scenario is more optimistic than the corresponding CBO scenario. Our own baseline includes data released subsequent to the June 2024 CBO assumptions and growth projections that could account for the differences. The alternative scenarios attempt to replicate as much as possible the economic policies announced from the two Presidential candidates and provide the likely GDP growth paths. As usual the simulations of our model are not forecasts, but projections of orders of magnitude.

Summing up, given the domestic and foreign challenges, the policies implemented by the next occupant of the White House will change the trajectory of the United States. It will, of course, depend on the course to be followed. Clearly, we should not rollback climate regulations, but to the contrary reinforce them and support expanded programs directed toward the greening of our economy, ensuring high employment, affordable education and health care.

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Data Sources

BEA (Bureau of Economic Analysis) various reports

BLS (Bureau of Labor Statistics) various reports

FRED (Federal Reserve Bank of St. Louis) various reports

IMF (International Monetary Fund) various reports

OECD (Organization of Economic Co-operation Development)