



Strategic Analysis

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ECONOMIC CHALLENGES OF THE NEW US ADMINISTRATION

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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 50 basis point decrease in interest rates. Moreover, the next government needs to formulate and implement an effective trade policy, while also facing a fiscal policy that—due to perennial and tired debates about the debt ceiling—has led to inadequate expenditure for urgent needs in housing, health care, education, research and development, training, and programs relating to the transition toward greening the economy. Labor force participation is currently at 63 percent and the wage share is at 53 percent of gross national income—both still below the pre-COVID period despite the robust increase in employment and decline in job claims in September 2024. We will return later to a detailed analysis of the prevailing labor landscape. Post-tax profits, by contrast, have grown to 12 percent of GDP, especially among the large technology firms capturing the AI boom (The Economist 2024). President Biden's fiscal policy initiatives implemented in 2022 and continuing to date have made a noticeable contribution to GDP growth. However, the economy is still operating below potential output. The economic challenges facing the US economy, together with the necessary active intervention to calm the global instability worsened by the continuing Russia-Ukraine and the Middle East wars, will require strong leadership from the new president in 2025 and beyond.

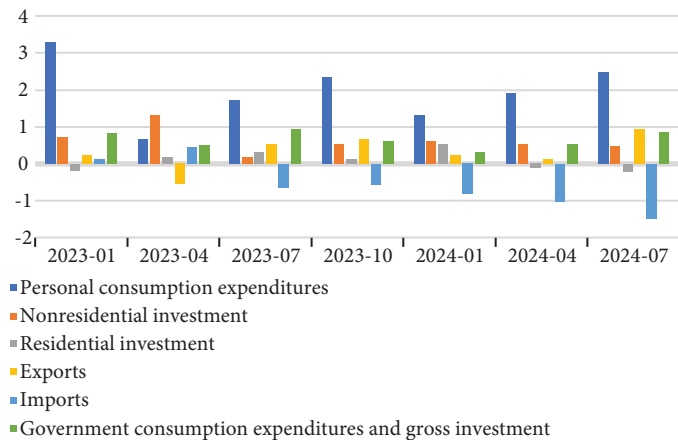
The latest advanced estimate of a 2.8 percent third quarter annualized GDP growth rate is lower than the second quarter (3 percent), but higher than the first quarter (1.4 percent), and many estimates show that the 2024 year will end with a growth rate at around 2.8 percent. It is not at all certain, 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 expenditures, and, to a lesser extent, nonresidential fixed investment. 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 contributed 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 the 0.8 percent 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 of maintaining high interest rates and the lack of clarity from the Fed’s announcements, which have kept mortgage rates high despite the latest decrease in the federal funds rate.

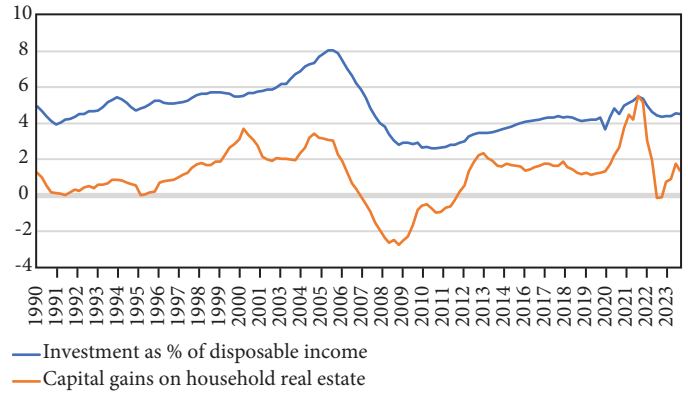
Data from the BEA shows that residential investment, after declining during the COVID-19 period, has stabilized at 4 percent of disposable income, while new mortgages, following almost the same trend, are now at 2 percent of disposable income—both illustrated in Figure 3. Outstanding household debt in long-term mortgages, although high at 60 percent of disposable income, is still much lower than its peak

Figure 1 US Contributions to Real GDP Growth (percent)



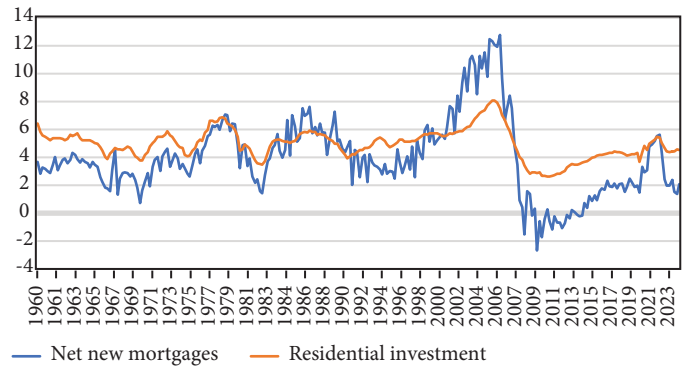
Source: BEA

Figure 2 US Households: Residential Investment and Capital Gains (percent)



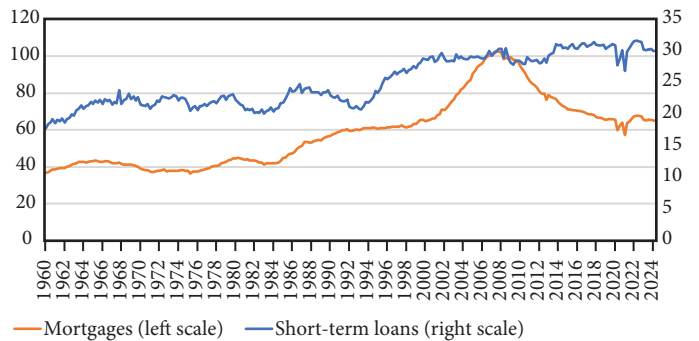
Source: BEA IMA

Figure 3 US Households: Residential Investment and Mortgages (percent of disposable income)



Source: BEA

Figure 4 US Households: Debt Outstanding (percent of disposable income)



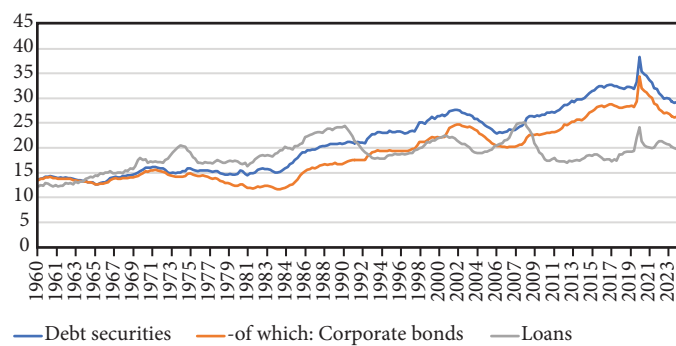
Source: BEA

before the Global Financial Crisis of 2007–09, while short-term debt—after declining during COVID-19—returned to its upward trend, currently sitting at 30 percent of disposable income as shown in Figure 4. Turning to the balance sheets of nonfinancial corporations, we observe from the BEA in Figure 5 that corporate-issued securities and total debt outstanding interrupted their overall rising trend in 2020 and declined to date, despite the increased GDP growth, while corporate loans show an unstable trend.

In various speeches, governors of the Federal Reserve have painted a bright picture of the US economy, 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 rising real- and financial-asset values, the response of households from early indications shows that they are borrowing again against these rising values (Dezember 2024), reminiscent of the pre–Great Recession crisis of 2007–09. Inflation has slowed, primarily due to the normalization of supply chains and falling energy prices, although the costs of food and shelter have remained elevated.

As the US Census reports, retail sales rose in September, demonstrating the resilience of consumer spending in 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 gas station purchases. This should bode well for GDP growth for the remainder of the year, together with the September employment increase (despite the disappointing October employment number,

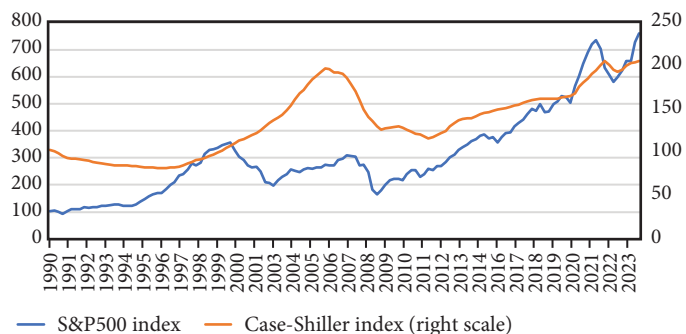
Figure 5 US Nonfinancial Corporate Business (percent of GDP)



Source: BEA

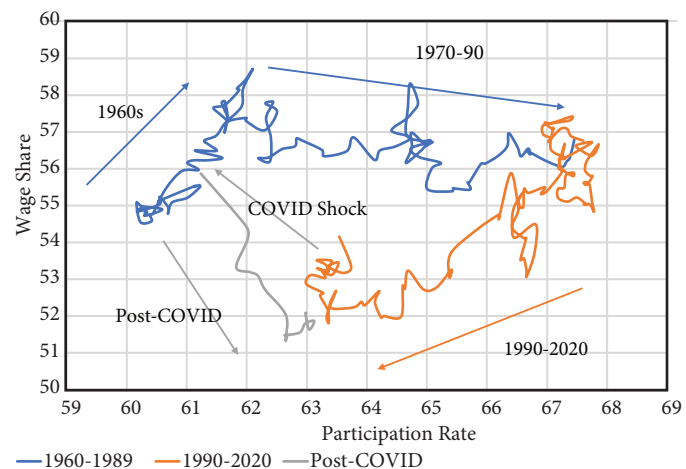
marking the lowest monthly growth for over twenty years). It should be noted, however, that the BLS reports long-term jobs are declining, especially for the younger ages. Opinions from some commentators suggest the US has now reached full employment at a 4.1 percent unemployment rate. It is, however, 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 peaks reached in the year 2000. A back-of-the-envelope calculation shows that, to reach the peak employment rate achieved in April of 2000, approximately 12 million jobs would need to 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.

Figure 6 US Real S&P500 and Case Shiller Indices (1990=100)



Source: BEA FRED

Figure 7 US Labor Supply and the Wage Share



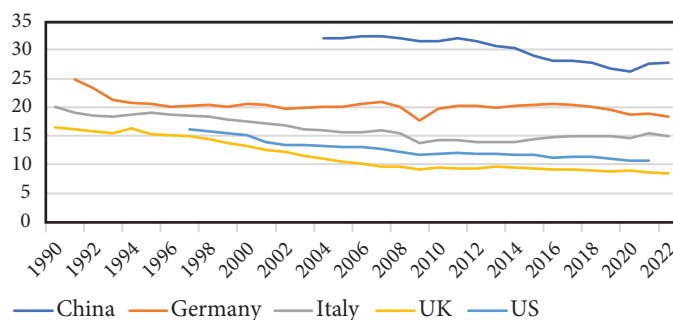
Source: BEA

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 Figure 7 reports the participation rate on the horizontal axis and the wage share on the vertical axis, measured as the ratio of employee compensation in national accounts to gross domestic income. The chart helps understand different phases of labor market relations: in the first two decades after World War II, an increase in the participation rate implied a strengthening of labor and in turn an increase in 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, and then 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, seeing a decline in the wage share which continues 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 US workers in 2024 are not in a good position, compared with other post-WW2 periods.

Is Re-Industrialization Possible?

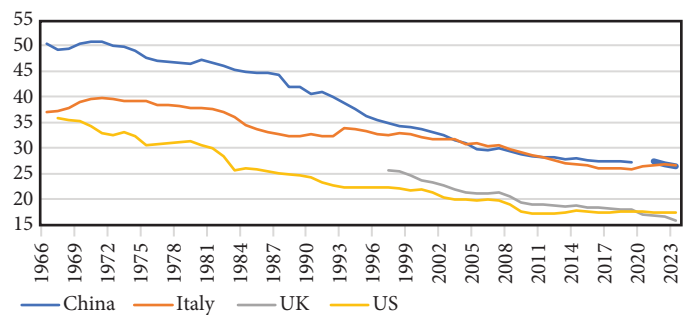
Deindustrialization, as is commonly known, is the drop in the share of manufacturing value-added and employment as percentages of overall GDP and employment. It is a common pattern with significant differences among some OECD countries, as can be observed in Figure 8—and the differences are even more pronounced when it comes to employment

Figure 8 Value Added in Manufacturing (percent of GDP)



Source: OECD

Figure 9 Employment in Industry (percent)



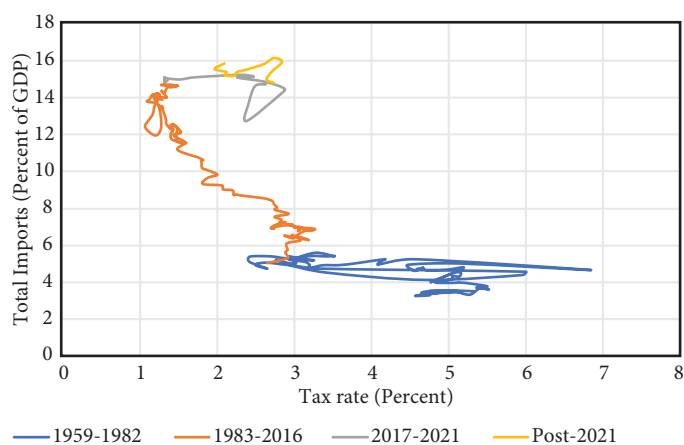
Source: OECD

in particular, as seen in Figure 9. The notable exceptions are the shares of manufacturing in China and some other Asian countries that have remained relatively high, despite some partial adjustment as these economies experience a shift toward service activities. It should be noted that the larger decline in manufacturing employment is due in part 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 US, whose manufacturing employment share dropped from 35 percent to 17 percent. 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 is shown below, imports would not be affected, and given the structure of the US, 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 “green subsidies,” would be a good start. In Rodrik’s (2022) view, however, industrial policy should prioritize job creation, as increasing automation in manufacturing is unlikely to absorb 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 shown below, our simulations, which are based on assumptions related to these two approaches, yield different growth trajectories 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. The simulation exercise for

Figure 10 US Imports and Tariffs



Source: BEA

our baseline delivers different results as compared to the latest update to the Budget and Economic Outlook posted in June 2024. As illustrated in Table 1, our estimates for growth for the 2025–27 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 pointed out above. We make neutral assumptions regarding inflation and exchange rate dynamics for the upcoming quarters.

Alternative Scenarios

At the time of writing, the outcome of the presidential elections on November 5, 2024 is unknown. However, we attempt to evaluate two alternative scenarios based on the key economic policy proposals put forward by the two leading candidates. 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—he 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

TABLE 1 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
Percent of GDP					
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 2

	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
Percent of GDP						
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

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. After 2017, tariffs declined again somewhat, but the correlation with imports was lost, and it is not significantly different from zero for 2017–24.

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 2—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 0.5 percent greater 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 US trading partners will introduce retaliatory tariffs on US exports, which will reduce their volume with respect to the baseline.

For Scenario 2, we assume instead that the government will increase expenditure more substantially in 2025 and 2026, but will mitigate the impact on the 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.

Conclusions

The US 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, investing in education, health care, and affordable housing, addressing the climate crisis through targeted programs, and instituting an effective trade policy to arrest the ever-increasing current account deficit. The challenges abroad include implementing both economic and foreign policy that will contribute toward global stability. In this report, we concentrate on the domestic economic challenges facing the US in the next two to three years.

We review and discuss the existing economic conditions of the US economy, including monetary policy, inflation, and the likely behavior of households and nonfinancial institutions regarding expenditures and residential and nonresidential investment. We express reservations regarding the plausibility

of a serious revival of the manufacturing sector, especially with respect to the attempt at import substitution through the institution of high tariffs. We are, however, 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, 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 and affordable education and health care.

Notes

1. In the tradition of the Strategic Analysis produced by Wynne Godley, we add the estimate of US 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).
3. See Mohun and Veneziani (2016) for a discussion.
4. More precisely, the denominator is given by the dollar value of imports of goods and services, minus custom duties.

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Data Sources

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- 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)