Interview with Ryan Sweet, Economist at Moody's Analytics

US Economy Slowing Down in 2020, But Recession Is Unlikely

By *Japan SPOTLIGHT*

In talking about the global economy in 2020, our central interest is how the US economy will fare. There are some who argue that the US economy could fall into recession in 2020 due to the increasing negative effects of the US-China trade war. Will this prove true?

Ryan Sweet, director of real-time economics at Moody's Analytics, is among the most accurate high-frequency forecasters of the US economy, according to Market Watch and Bloomberg. *Japan SPOTLIGHT* held the following interview with him.

(Interviewed on Nov. 7, 2019)

Self-Introduction

JS: Could you provide a self-introduction and tell us about your role at Moody's Analytics.

Sweet: I am director of real-time economics at Moody's Analytics. I have been with Moody's for almost 15 years and am part of the US macroeconomics team. My primary responsibility is forecasting US economic data and providing daily analysis on the economy and financial market conditions on our Economic View platform. Economic View is the vehicle for us to communicate our views on incoming data, and forecast changes to clients very quickly. In the last couple of years, it has been very important because things have been changing pretty quickly.

I also head up our monetary policy research, so I pay close attention to central banks across the globe, but my primary area of expertise when it comes to monetary policy is the Federal Reserve.

Ryan Sweet

Overall Assessment of the US Economy in 2020

JS: How do you assess the current US economy? Many people mention the possibility of a recession in 2020, but would you agree?

Sweet: I don't agree. I think the economy has clearly slowed since the beginning of 2019, and there are a few things behind that. Firstly, there has been fading fiscal stimulus. In 2018, the economy was on a sugar high because of the fiscal stimulus backed by the administration of President Donald Trump, which included corporate tax cuts, personal income tax cuts, and increased government spending. This boosted the economy temporarily which is traditionally what happens with periods of fiscal stimulus; it puts the economy on a bit of an adrenaline rush, which is fading in 2019 and that is why the economy slowed back to 2% GDP growth for the entire year.

Another reason the economy slowed is that the escalation of the trade war between the United States and China did a lot more damage than people anticipated. The stock market was very sensitive to every tweet, and developments on the trade front. All the rhetoric coming from both sides clearly affected manufacturing in the US, which went into a recession in 2019, and agriculture was hit hard. So the two industries that were supposed to benefit from the trade war were hurt the most. The economy slowed down, we came down to roughly 2% growth in 2019, raising concerns about a recession.

I don't expect a recession in 2020 because the traditional causes of recessions in the US in the last 100 years, including an overheating economy, policy error by the Fed, popping of an asset bubble or spike in oil prices; none of these are threatening now. There are none of the usual imbalances in the economy that could cause a recession. That doesn't mean that we couldn't have a recession, but I think something would have to go wrong, such as further escalation in the trade war, which seems unlikely given that 2020 is the election year in the US. I don't think the Trump administration is going to escalate the trade war, but it is equally unlikely that the US or China will roll back these tariffs. I think the key really for 2020 to avoiding a recession is the consumer, and that gets back to the job market. As long as the labor market remains in reasonably good shape, most of the fundamentals for consumers

suggest that the economy will be able to get through 2020 without a recession.

Policy Uncertainty

JS: My concern is about rising uncertainty in the economy today. It is not only limited to the trade war between the US and China, but other uncertainties are rising because of some geopolitical risks and also maybe policy uncertainty which could be triggered by the Trump administration. This uncertainty could have a negative impact upon private investment. Would you concur with this view?

Sweet: Firstly, I would point out that policy uncertainty in the US has remained elevated throughout this expansion, so this is nothing really new. The new aspect of this now is that there is a tremendous amount of uncertainty around trade policy and businesses around the US are wondering if these tariffs are temporary or not. We might have a new norm whereby we have an administration that uses tariffs to achieve trade policy objectives. The Trump administration does have some good objectives, such as addressing China's stealing of intellectual property, but tariffs aren't the right way to go about it. Most economists don't like tariffs. So from the uncertainty perspective, I don't think it is going to decline anytime soon, even if we get a Phase 1 trade deal, because that trade deal addressed some of the short-term frictions between the US and China on the trade front, such as getting China to import more agricultural products.

But it doesn't address the elephant in the room, which is intellectual property. I have done some work looking at the economic costs on policy uncertainty and it does have a clear impact on hiring, business investment in equipment and structures. I think that the heightened uncertainty that businesses have had to deal with over the past two years has weighed on the economy and has contributed to a slowing of the job market. It is not the only reason that the economy is slowing down – we are coming off the fiscal stimulus, and also fundamentals for business investment have weakened.

All the weakness in business investment is not just attributable to policy uncertainty; corporate profit margins in the US were compressing in 2019, and you had some stagnant growth which impacts business decisions on investing in equipment and software. There is also a lot of anxiety about a possible recession, and that led businesses to hunker down a little bit.

I do think that policy uncertainty will remain a drag on the economy in 2020 and possibly 2021. Not just because of trade; we have the presidential elections, which could be contentious, there are impeachment hearings going on – there are a lot of factors creating uncertainty. Outside the US you have Brexit. They keep kicking the can down the road but eventually they are going to have to make a decision. You also have geopolitical uncertainty in the Middle East, which could lead to an increase in oil prices.

Fiscal Policy or Monetary Policy

JS: Maybe it will not be a recession, but more of a slowing down of the economy that will be observed in 2020. In that case, do you think the US government would need to stimulate the economy with some fiscal policy or monetary policy?

Sweet: Let me start with the Fed. The Fed has already cut interest rates in the US by 75 basis points, which it described as a mid-cycle adjustment. It was trying to offset some of the impact of the trade tensions on the US economy, not just the direct effects but also the spillover effects from the escalation of the trade war. So the Fed has cut interest rates three times, so I think they will likely be on hold throughout 2020 unless there is clear evidence that the economy is weakening even further or inflation is decelerating. I think the Fed can feel comfortable right now where policy is – they view it as being appropriately calibrated – but it will be the first line of defense if the economy suddenly does weaken. During an election year, there is not going to be a lot of political will to stimulate the economy unless it is clearly falling into a recession. If we get any fiscal stimulus, it will be something that has bipartisan support such as infrastructure spending. Such spending wouldn't start to stimulate the economy till 2021 or even 2022. Trump's administration has talked about tax cuts 2.0 but I just don't see any fiscal stimulus getting through Congress during the presidential election year.

JS: In the current situation where interest rates are already very low, do you think that fiscal policy would be more effective in stimulating the economy rather than monetary policy?

Sweet: I think the key will be for monetary policy and fiscal policy to be on the same page. Throughout most of this expansion, fiscal policy and monetary policy were not in sync, so while monetary policy tried to speed up the economy, fiscal policy was trying to slow it down. For example, during the administration of President Barack Obama they did some fiscal austerity, which was premature and a big mistake during the economic expansion. So fiscal policy turned too restrictive too soon. Where the Fed was trying to slow the economy down and make sure that no glaring imbalances developed, the Trump administration was trying to speed it up through fiscal stimulus. So I think that going forward it would be in the economy's best interest if monetary and fiscal policy were on the same page in trying to stimulate the economy if a recession does occur in 2020 or 2021. I'm not as concerned about how much ammunition the Fed has, because I think it will reduce the interest rate to zero if a recession occurs. They may do additional quantitative easing, aggressive forward guidance, and then maybe pull some rabbits out of the hat, using yield curve control like what has been going on in Japan. But that is an option that will give them a tremendous amount of stimulus.

For fiscal policy, I am a little bit more concerned because there is this growing sense among fiscal policy makers that the US is running out of fiscal space. In other words, how much more borrowing can the US government do. We are running large deficits but I don't think we are out of fiscal space yet. What is really important is what the trigger for recession is and appropriately responding with all hands on deck when that recession occurs because traditional monetary policy won't pack as big a punch as it has in the past.

The US government's fiscal situation is on an unsustainable trajectory; in good times we should be trying to reduce the deficit, but when a recession occurs that changes things. With regards to the fiscal situation, in the long run it would be ideal if the government could reduce the deficit, but when recession hits it needs to step in quickly and try to stabilize the economy. We don't want a recession, but if it is inevitable, the goal of policy is to limit the severity and duration of a recession in order to limit the impact on the economy and consumers. My concern is that there could be a perception that the US does not have enough fiscal space. The issue with fiscal space is that it is not directly observable – we can estimate it econometrically but it is imprecise science and the concern would be that if a recession occurred in 2020, some policymakers would look around at the deficit and realize that they can't do much, and that would have a pretty detrimental effect on the economy.

JS: Looking at the longer term, you already mentioned the possible effects of monetary and fiscal policy. Generally speaking, most of the OECD nations are facing strict budget constraint with very few options for monetary policy. If the economy gets into a recession, would it be far more lengthy and disastrous?

Sweet: It could be. I'm not concerned about the Fed's policy response in the US, but I am concerned if a recession occurs in 2020 or even in 2021 in terms of what the policy response in Japan is going to be, or by the European Central Bank. In Europe, they are going to have to put pressure on countries that have fiscal space to deploy in an effort to limit the severity of any recession there. If we have a recession in the US, the global policy response is going to be very important. It is very unlikely that the next recession will be anything close to the great recession. In terms of our forecast for the US, we have eight different alternative scenarios for our baseline, and we have a next recession scenario, which assumes a slight downturn. Because we don't have any glaring imbalances in the economy today, or in financial markets, it is unlikely that we will have a recession like the one from 2007 to 2009. It will be painful but it won't be the cataclysmic event that we went through in the last recession. The policy response is important – when the next recession ends, the recovery will be slow and gradual, even though it is noticeably less severe than what we had in the last downturn.

Global Economy in 2020

JS: What do you think about the global economy? We have been talking about the US economy mostly, but at least in 2020 you would not predict a recession in the US economy. Does that mean you would not predict one in the global economy?

Sweet: Some countries will experience a recession; already a number of countries are flirting with a recession. Germany is close to falling into a recession due to manufacturing struggling and weak exports. If Germany goes down it will affect many parts of Europe. How Brexit plays out will determine whether or not the UK economy can avoid a recession in 2020. If there is a no-deal Brexit, then a recession in the United Kingdom will be very likely, and that could easily spread into Europe. Even though the global economy is clearly slow in 2019, it will be slower and weaker in 2020, but it is unusual that countries all fall into recession at the same time. We can have periods where we have a growth recession, where the economy grows quickly enough to prevent unemployment from rising and inflation is decelerating. China is getting close to that – its economy has slowed substantially and GDP growth is about 6.5%. If it falls into the low 5% range, it wouldn't be surprising if unemployment started to rise and inflation started to accelerate. Recessions are defined by two consecutive declines in GDP, which a lot of countries call a "technical recession", and it is very unlikely to occur in China.

In the US, you don't have to have two consecutive declines in GDP; it can just be a period of prolonged economic weakness. In our forecast, we have GDP growth down to 1.5% or 1.6% next year; it will feel uncomfortable, but I don't think we are going to experience a recession unless something goes wrong on the trade front, or with Brexit, or there is a flare-up in geopolitical tensions in the Middle East. In 2020, most of the global economy could have a very uncomfortable year, with bouts of recession fears. To get through it, some countries are going to need more luck than others.

JS: The Chinese economy is now slowing down. The US economy will also most likely slow down. Maybe it is a part of the outcome of the US-China trade war. In the long run, could this trade war have a serious impact on the global economy?

Sweet: I would agree with you – a lot of economists will focus on the implications for GDP growth in 2020 and 2021 – but it is unclear what the ultimate objective of these trade tensions are. If the Trump administration is trying to address intellectual property and other structural issues with China, then that is one thing; but if it is trying to sever ties, then that could have negative and serious consequences for the global economy. You are already seeing business respond, by looking for low-cost alternatives to import the goods that they need to make their products in the US. If Trump wins a second term and we don't have a trade deal by election day to end

these trade tensions, then there will be a high possibility of a recession in 2021. Trump won't have to worry about re-election and could significantly escalate trade tensions to try to get everything that he wants in this deal.

Geopolitical Risks in Economic Forecasts

JS: Geopolitical risks are not limited to the Middle East or North Korea but are also rising in Latin America. These risks might have some serious impact on international trade. I wonder if your team is now attempting to take these risks into account for your econometric models or your forecast models?

Sweet: We have a global macro model, so we forecast more than 100 countries, and we are trying to incorporate geopolitical events into the forecasts. We have created a number of tools to help us monitor events, such as the currency depreciation index, which lets us know any potential currency issues that could pop up, and there are factors such as political unrest that feed into these. Sometimes these things come out of nowhere. Often with politics and geopolitical unrest it is very difficult to forecast. A few years ago, the UK decided to leave the European Union but not many people anticipated that we would still be discussing Brexit in 2020.

JS: Do you think your economic forecasters will need to make more efforts to improve the accuracy of forecasts by taking many political factors into consideration?

Sweet: We are always making changes and enhancing the accuracy of our global macroeconomic models. For short-term forecasts we have other tools such as current quarter models, and a team of economists who monitor the economy in real time. So we are always looking very closely at what is going on globally from a political perspective, from a geopolitical risk perspective, and we are trying to create new tools through our equations and our models to capture these potential shocks. Forecasting accuracy and transparency is very important to us; every year we write a forecast accuracy piece which we provide to our clients so they can see what we got right and wrong, and which part of our model didn't do as well as we anticipated, and then we focus some resources on improving our models. Besides geopolitical issues, we are always looking at trying to improve the linkages between financial markets and the economy, because our models for global forecasts view financial market conditions and then integrate them into the macro economy. The importance of doing that really was raised following the financial crisis. I think that a lot of the economic forecasting models didn't really capture the direct impact and the spillover effects of financial market conditions onto the broader macro economy.

Growth Potential of US Economy

JS: You mentioned that in 2020, the US economy will return to a normal growth rate, which is supposed to be around 2%. Does that mean you estimate the growth potential to be 2% in the medium-to-long term? Also, how do you assess the growth potential of the world economy?

Sweet: Our forecast for GDP growth in the US in 2020 is about 1.5% to 1.6%, and our estimate for potential GDP growth is 2%. Of course that is weaker than what we have seen in the early 2000s, the 1990s, and the 1980s, but there are structural things in the US economy that have lowered the economy's potential. We assume that productivity growth in the US is weak, the labor force growth is much weaker than in past decades, and we have an aging population. So we don't think that over the next 5-10 years you are going to see an improvement in the potential growth rate. However, you have to keep in mind that the millennial generation is larger than the baby boomer population, but they are just spread out over a longer period of time, so we will eventually go from this demographic headwind to a little bit of a tailwind. Consumers have been depressed in the US since the recession, but hopefully they will start to turn around if the economy continues to chug along. I think housing will start to improve in the medium term. Some of these headwinds are depressing potential growth now, but will start to shift. Businesses recently have been investing a lot in intellectual property, and that should help boost productivity growth three or four years down the road. I do think you will see a little bit of improvement in potential GDP growth but that is still over the horizon and will remain at 2% or a little bit lower for a few years. I don't have any estimate for global GDP off the top of my head, but I think it is around 3.5%.

JS: In thinking about growth potential, apart from population growth, innovation is a very important factor. How do you see innovation in the US supporting growth potential?

Sweet: I am not worried about innovation, and I don't think it will be a drag on the economy. My one concern would be the little entrepreneurship rate in the US, as it has been slow to come back from the recession, and risk takers are the ones that will boost innovation down the road. Given the growing share of the tech industry in the US, innovation is not going to be a big issue for productivity growth down the road. Demographics are more of a headwind in the next few years than innovation. JS

Written with the cooperation of Joel Challender, who is a translator, interpreter, researcher and writer specializing in Japanese disaster preparedness.