

Interview with Eric D. Lundell, President & CEO of ITTA, Inc.

Issues of the US Economy Under the Trump Administration

By Japan SPOTLIGHT

How is the US economy under the administration of President Donald Trump proceeding? What will be the issues and challenges over both the short and long term that the US economy will face? Though it may be a little premature to give a complete and detailed assessment of the Trump administration's economic policies, it is still interesting to have an overview of the implications of its first year for the US economy.

We interviewed Eric Lundell of International Technology and Trade Associates, Inc. (ITTA) in the United States, who has provided analysis of the economy and politics in the US for Japanese businesses and government for a number of years.

(Interviewed on Nov. 16, 2017)

Current Status of the US Economy

JS: I would like to ask about your assessment of the US economy. I've heard a lot of positive comments about the US economy, that it is stable and robust. Does this concur with your view?

Lundell: There have indeed been several positive reports recently about the current state of the US economy. From one measure, the US is in its "third-longest expansion" since 1850. This point was specifically made by the IMF during its 2017 Article IV Consultation with the US this summer. Overall, the US has experienced positive economic growth for an extended period of time, inflation is subdued, and some people would argue that the economy is near full employment. From those macroeconomic perspectives, the US economy is doing well overall. On Nov. 1, the US Federal Reserve reported following its October Open Market Committee meeting that economic activity has been rising at a solid rate, the labor market has continued to strengthen, and market-based measures of inflation compensation remain low.

JS: The latest quarterly estimate for Japanese GDP is 1.7% on an annual basis, and that is robust for Japanese standards. For American standards though, how much growth would constitute "robust and stable"?



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Lundell: Economic growth since the great recession has indeed been historically lower than prior to that period. The IMF predicted 2.2% growth this year. The US National Association for Business Economics (NABE) also predicts 2.2% this year and 2.4% next year. (Interestingly, the US Department of Commerce just released statistics for the third quarter this year at 3.3%, following 3.1% for the second quarter of the year.) Overall, the US is definitely in a low-growth period — and one of the major economic discussions in Washington right now is how to accelerate that growth rate. In terms of what growth rate is "enough", that is a matter of perspective defined by your political priorities and socioeconomic goals.

JS: What is your outlook regarding inflation? According to some economists, there is a sign of an increase in prices to some extent. The interest rate may be raised by the new governor of the Federal Reserve Board which could perhaps lead to concerns about the possibility of stagflation, as inflation is coming up and the interest rate is rising which will put deflationary pressure on the economy. What do you think about this somewhat pessimistic outlook?

Lundell: We have indeed seen some upward pressure on inflation. This is to be expected given the low interest rates and economic growth that the US is experiencing. It is important to note that the normal cycles of expansion and contraction are going to continue; no

mature economy is going to be in a constant state of expansion. However, going through the normal economic cycle is different from concerns about a long-term challenge to an economy such as persistent stagflation.

Again, it is to be expected that inflationary pressures would be upward in the US. We did also see that gasoline prices rose in the aftermath of recent hurricanes. However, overall, inflation for items other than food and energy remains soft. As such, concern about inflation is still relatively low but is being watched very closely. I think this is reflected in recent Fed statements, as well as recent data reported by our Bureau of Labor Statistics.

Possible US Monetary Policy Under New FRB Chairman

JS: I have heard that the new Federal Reserve Board Chairman Jerome Powell is a conservative lawyer and not an economist, so he is very prudent over increasing interest rates. Perhaps from the monetary policy perspective, do you think there shouldn't be anything drastic done to the economy?

Lundell: What the US needs is for the Fed to implement gradual rate increases in response to inflationary signals that will strike a balance between maximum employment and price stability.

From one perspective, given that Powell does not have an economic background, he may be more interested in listening to the opinions of the entire board rather than simply pushing through his own agenda. At the same time, in the recent past there have been concerns about deflation. Some in the analytical community would even prefer the Fed to let inflation moderately exceed its desired target and then work to decrease inflation after that. I think this was even intimated by the IMF in their consultation on the US economy this summer, when they stated that over the next 12–18 months personal consumer expenditure (PCE) inflation is expected to slowly rise above 2%, before returning to the Fed's medium-term target of 2%.

JS: No matter how much the Fed increases the interest rate, I think the direction of monetary policy is to raise the interest rate, so that will perhaps bring about a strong dollar. This strong dollar might increase the trade deficit and that is a bit inconsistent with what the "America First" trade policy is trying to achieve. How do you feel about this observation?

Lundell: This is why we have a Federal Reserve that is supposed to be independent from politics. The situation that you outline has always been the case. Congress has mandated the Fed to set

monetary policy to promote maximum employment, stable prices, and moderate long-term interest rates. In contrast, all administrations to different degrees have been concerned about trade deficits. The Trump administration, with its "America First" rhetoric, has definitely brought a higher level of concern to that issue, and the exchange rate definitely plays a major factor in that. However, there are also other issues that play into trade deficits and trade politics; and the independence of the Federal Reserve has always been an issue that our executive branch has had to deal with.

Income Inequality — A Big Challenge for the US Economy

JS: Another risk which I have in my mind is income inequality. That does seem to be causing a lot of political confusion today not just in the US but all over the world. You mentioned that employment growth should be robust and so would that perhaps contribute to mitigation of income inequality in the US?

Lundell: I would strongly agree that growing income inequality is one of the greatest economic, political and social challenges for our country. I would argue that this issue is even more important than a low growth rate. The employment rate obviously has some part to play in that, but lowering unemployment alone is insufficient to address this issue. Robust growth alone is also insufficient. How to address growing income inequality is one of the major political discussions in our country right now, ranging from a more Republican/conservative focus on deregulation and tax cuts to stimulate overall growth to a more Democratic/left-wing focus on the use of tax policy for income redistribution.

JS: I would like to ask you about wages and in particular real wages. Under the assumption that the inflation rate is slightly picking up, do you think that wages would also pick up?

Lundell: Well, that is the hope. Again, that has been one of the weak points in the US economy, that wage growth has continued to be below expectations. From a more conservative or Republican view, the hope is, that as we return to full employment and work towards higher growth rates, wage growth will eventually pick up as well in a tighter market. But again, I think this is one of the greatest challenges for the US; we have seen periods of economic growth without corresponding wage growth, which has led to considerable political tensions in the country.

JS: We have the same situation in Japan. Some

economists expect that the role of labor unions is to raise wages. Is there the same argument in the US?

Lundell: The labor union situation in our two countries is very different as I understand it, in that the US has a long history of industrial labor unions, compared to Japan's company-oriented labor union system. As such, our two countries may have a very different experience with both the positive and negative impacts of organized labor. If so, I think it is very difficult to compare the proper role of organized labor moving forward in our two countries. There are cases in our country where labor unions played a very positive role in the industry and then, in some cases, led to stagnation; the auto sector is often cited in this way. On the other hand, the decline of organized labor is often referenced by Democrats as one of the reasons for the problems we are experiencing with income inequality. One challenge for organized labor in the US is adapting to a post-industrial economic environment in which labor is increasingly mobile.

Long-Term Considerations — Economic and Geopolitical Risks

JS: As for the long-term outlook of the US economy, what are the other risks it is facing? Many economists think that geopolitical risks could affect the economy, for example.

Lundell: When you think about long-term geopolitical risks to an economy, almost anything can be a “risk” — ranging from politics in the Middle East to politics in China, etc. So, the difficulty when thinking about geopolitical long-term risks is that they can come from so many places. From the perspective of economically-based long-term risks, our situation in the long term is going to depend greatly on what we do in the near term. I would highlight at least five key points.

In the near term for the US, we have the tax debate. Secondly, we have the government budget debate. These two debates are closely tied together and are very “hot” issues at this very moment in Washington. Thirdly, there is the question of the Fed's monetary policy and its ability to maintain balance between economic growth and employment versus inflation, as we discussed previously. Fourthly, there is the nascent infrastructure debate in the US, which has been delayed till 2018 because of the ongoing tax and government budget debates. Fifthly, there is the healthcare debate in our country, which has been very difficult for the Trump administration and Republican Congress to address in this first year of the administration. This political policy issue is going to have major economic implications for the US. Other issues include labor productivity and labor force participation. Overall, these near-term

questions will define our key long-term issue of wealth polarization in our country. Another longer-term issue that the US is dealing with since the great recession is that the rate of new business formation has not fully recovered. This has always been one of the sources of dynamism in our economy. The weak recovery of new business formation is one of the reasons that you hear so much discussion about small business in the US, whether in the tax policy or deregulation debates.

JS: On the question of geopolitical risks, I am curious about your view on North Korea, as the ITTA is a great expert on security issues.

Lundell: Previously, I mentioned that political developments in places such as the Middle East and China all have economic impacts on the US. Such risks are often quantified in terms of import dependence, trade flow levels, and other measurable factors. However, moving to the question of North Korea, we really are moving to another scale. At the extreme, as you know well, there is greater concern about a nuclear exchange. This goes far beyond any consideration of how regional instability in the Middle East may affect energy prices, to something that the modern global economy has never dealt with before. The one thing we could say about a military conflict with North Korea is that the impact on the modern global economy would be unprecedented.

JS: Some experts say there might be a 15% risk of a war between the US and North Korea. Would you concur with this assessment?

Lundell: Placing a numerical probability on multi-actor events is always an interesting exercise. In general, I think very intelligent people can come up with very credible analyses to justify a range of numbers. Overall, I would agree that the probability of a nuclear exchange in the foreseeable future remains low. However, it's one thing to put numerical predictions on who may win an election or the probability of a bill passing the US Congress. In contrast, in this case, we have multiple actors to consider — two of whom, Donald Trump and Kim Jong Un, specifically seek — as a matter of their foreign policy tactics — to create uncertainty among other stakeholders. This is very different from how we look at other types of political modeling and forecasting, which are largely based on a “rational actor” model.

The Future of US Tax Reform

JS: Let's move on to the question of economic policies. Regarding general trends in fiscal policy, the US government is now trying to implement tax cuts

while increasing expenditure on infrastructure. That would mean there will be more strain on the budget. Do you think this is sustainable for the US economy?

Lundell: One of Trump's campaign messages was the need to increase infrastructure investment in the US. However, this has become a secondary issue compared to healthcare reform, tax reform, and reform of the federal budget. Given the current focus on tax cuts, there has been a lot of discussion in the US about what would constitute a Trump administration infrastructure program in future years. It may not be a traditional infrastructure program in the sense of federal government spending, but rather policies and programs to further develop private-public partnerships for infrastructure

As you implied, simultaneously reducing government debt, implementing tax cuts, and developing a large infrastructure package are indeed somewhat incongruous goals. This is one of the key tensions within the Trump administration and the Republican Party as they try to pursue all of their various objectives. This is also why the infrastructure package has taken a second-tier level of importance during the first year of the Trump administration.

Regarding the outlook for the fiscal deficit, a prudent approach would be to adopt a policy that would gradually bring greater fiscal discipline and reduce the fiscal deficit, rather than dramatic moves in either direction. During the Obama administration, the Republican focus was indeed on deficit reduction. However, during the first year of the Trump administration, Republican focus has moved more towards tax cuts to stimulate the economy rather than narrowing the fiscal deficit. This is indeed one of the tensions in the Republican Party, where some factions are still focused on fiscal discipline but are finding themselves in the minority wing of the party at this time.

JS: We have been hearing that US corporate tax cuts are likely to be implemented and that the tax rate will be lowered from 35% to 20%. Do you think this corporate tax cut is absolutely necessary in order to strengthen US industry's competitiveness?

Lundell: No one measure is "absolutely necessary". Obviously, reduction of the US corporate tax rate to 20% would have a positive effect on the US corporate sector. On the US tax debate, a key issue is the difference between tax reform and tax cuts. In the US, "tax reform" is a much broader concept and there is a general consensus for some overall objectives of tax reform, which would involve simplifying the US tax code; reducing the web of tax preferences and tax credits that litter our tax code.

To reform our tax code in that manner, to rationalize it, is generally seen as positive. However, while each special interest in the US agrees with that general principle, it still wants to protect its own

specific tax provisions. As such, our Congress is now facing the challenge to maintain a broad tax agenda and not just to default to a more narrow tax cut. There is extensive lobbying in Washington right now on all of these issues. One of the political issues we face is that the current tax proposals provide tax cuts at all income brackets, but are seen as providing larger monetary benefits in terms of dollar value to the top 1% in the US. This is contrary to what we were talking about earlier — the need to address wealth disparity and wealth concentration in the US.

The Democratic Party will be emphasizing this point in its criticism of the Republican tax proposals, that this is yet another effort by the wealthy in the country to solidify and even enhance wealth accumulation. We face the challenge of developing a tax plan that is pro-growth and that does not further exacerbate the challenges we have with wealth disparity.

JS: Could you share your views on the tax reform debate in Congress? I understand it is going to be discussed next year.

Lundell: As mentioned previously, there is actually a very detailed discussion right now. The Republican Congress has been preparing for this tax reform effort for years, and this effort intensified following the election of Trump. Detailed discussions arguably have been led by the House Means and Ways Committee, chaired by Kevin Brady, a Republican from Texas. On Nov. 1, Brady introduced his tax reform bill, the "Tax Cuts and Jobs Act". On Nov. 13, the House Ways and Means Committee approved the bill. On Nov. 16, the House of Representatives managed to pass the Act. Also on Nov. 16, the Senate Finance Committee under Senator Orrin Hatch, a Republican from Utah, advanced its own tax reform legislation. The Senate's version is similar to the House's broad framework (for example, reducing the corporate tax rate from 35% to 20%), but contains a number of differences that will need to be resolved in conference between the two chambers. The pressure on the Republicans is that, although they now control the House and the Senate and The White House, they have yet to complete a major agenda item, because of disagreements within the Republican caucus and between the White House and the Republican Congress. They have yet to finalize any healthcare reform bill, yet to finalize a federal budget, and have yet to finalize any major trade changes such as the ongoing NAFTA negotiations. They are beginning to feel pressure with the upcoming 2018 congressional elections, where the voter will ask, what have you accomplished?

US Innovation Capacity

JS: I wanted to ask about the supply side policy for the US economy. Do you think US industries overall

will still enjoy high productivity because of robust innovation capacity or is this a little bit eroded and there should be some industrial or trade policy to encourage productivity and innovation?

Lundell: The US is still one of the most innovative economies in the world. At the same time, it also faces challenges in maintaining that dynamism and the impact of the great recession still hangs over the US economy in that regard.

I would highlight that “innovation policy” is discussed differently in the US compared to other countries — where innovation policies are often connected to science and technology policy or industrial policy. In the US, most of our discussions on innovation policy revolve around business policies (whether it be tax policy such as overall tax rates or tax credits for R&D), labor policy, or regulatory policy. In Washington, we have a range of discussions about how to stimulate innovation, with the more Republican-leaning side promoting the ongoing tax reforms — and specifically the reduction of the US corporate tax rate — as the key policy to increase and maintain the dynamism and innovative capacity of the US economy.

Regarding more specific policies, the conservative side (and especially the Trump administration) focus on the topic of deregulation. There is a lot of focus on the Trump administration’s roll-back of existing regulations, which can be a very time-consuming and complicated process. There is, however, a much more immediate impact. The Trump administration’s anti-regulatory agenda provides certainty for the US business sector that there will not be significant new regulations over at least the next three and a half years. With the election of Trump, the US business sector is assured that there will be very little new regulatory burden in any area, whether it be labor, wage, environmental, or financial regulation. So the very day Trump was elected, the US business sector achieved a major victory in terms of regulatory certainty. In the US, we will be having very serious debates about the regulatory agenda of the government and very serious discussions about its impacts on other issues such as the environment. However, the corporate sector almost has a guarantee that there will not be significant new regulatory issues creating new compliance burdens.

JS: The space industry seems to attract a lot of attention today. Besides other industries such as AI, how do you see the prospects for the US space industry?

Lundell: Considerable attention is paid to NASA in this regard. However, it is important to remember that, for the US space industry, the Department of Defense space program is several orders of magnitude larger than the NASA space program. Overall, Trump’s focus on increasing national security budgets will benefit the general

space technology sector. Specific characteristics will change, though — for example, interest in earth observation for environmental purposes will diminish in favor of national security-focused technologies. I would also highlight that the Trump administration has worked to re-institute the National Space Council, working to bring perhaps more clarity to the US government space mission than the Obama administration was able to.

US Trade Policy & Business Interests

JS: The renegotiation of NAFTA has been going on for a while and appears to be at a bottleneck, as the US auto industry seems opposed to renegotiation. How do you see recent developments in terms of the conflicts between the auto industry and US government on the renegotiation of NAFTA?

Lundell: This is indeed a key issue for Japanese manufacturers in North America as well. Overall, trade policy is one of the key areas where President Trump has permanently changed the nature of US politics. Economic analysis shows that, overall, NAFTA has had a small but positive effect on US GDP. In previous decades, that positive impact — even though small — was enough to justify NAFTA, especially within the Republican Party.

However, Trump has emphasized to the Republican Party that free trade agreements have winners and losers within the US. While NAFTA has had a small positive effect at the macroeconomic level for the US, it has also had a major impact on integrating the North American economy comprising Canada, the US and Mexico. This integration has been much more significant than the overall positive macroeconomic impact on the US, and this integration has winners and losers. This was the issue that allowed Trump to win key Democratic states in the presidential election in 2016, such as Michigan, Ohio, Pennsylvania and Wisconsin, where individual counties within those states did not benefit from NAFTA.

The tensions between the US auto lobby and the Trump administration reflect this situation. The auto industry has pursued economic efficiency since the signing of NAFTA. However, Trump is focused on a different issue. Trump is focused on the US political map. This is what scares the auto lobby in Washington — that purely macroeconomic arguments are not necessarily sufficient to sway the Trump administration. That is why you have seen a number of US business lobbies become increasingly concerned about the Trump administration’s approach to the NAFTA negotiations. Over the past month, this concern has been expressed through heightened lobbying by US business interests to their members of Congress.

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Written with the cooperation of Mayu Fukutani who is a freelance translator.