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The 2019 Economic Downturn

By Philip K. Verleger, Jr.

Trump's pushing of too many aggressive policies simultaneously is a mistake.

The Trump Administration has been pursuing three key strategies over the last year that have large incompatibilities given conditions in global monetary markets, especially the end of quantitative easing. The combined effects of these policies may inadvertently create an economic crisis in the coming year.

The first policy relates to immigration. Given Congress' inability to pass immigration legislation, now-former U.S. Attorney General Jeff Sessions and U.S. Secretary of Homeland Security Kirstjen Nielsen have taken and continue to take aggressive steps to limit the undocumented immigrants coming into the United States and crack down on those already here. Consequently, the United States faces a shortage of manual labor, especially in the agriculture and construction industries.

The second policy involves trade. U.S. Secretary of Commerce Wilbur Ross, U.S. Trade Representative Robert Lighthizer, and White House trade adviser Peter Navarro have persuaded President Trump to implement tariffs on imports from China, other Asian countries, Canada, and Europe. Quotas may be next.

Finally, U.S. Secretary of State Mike Pompeo, U.S. Treasury Secretary Steven Mnuchin, and National Security Advisor John Bolton favor strictly enforcing the coming re-imposition of sanctions on Iran, with the goal of shutting down all oil exports from the country.

Each of these policies has supporters. U.S. immigration policy has been broken for years. Many low-wage workers believe the influx of undocumented immigrants, primarily from Latin American countries, has prevented them from realizing higher wages. The data support their view.

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The problem is the financial chaos these conflicting policies may create given global economic circumstances.

The inflation-adjusted median "usual weekly earnings" have increased meagerly from $345 per week to $351 per week from 2008 to 2018, a rate of 0.2 percent per year. The lack of rising incomes for full-time workers was one contributor to the Republican victory in 2016, and the much tougher immigration policy was one consequence of that win.

President Trump's "America First" trade policy is the second key factor creating economic risk for the United States and the world. The Trump Administration's actions have focused on reversing the outsourcing of U.S. manufacturing to other countries to bring back those "good manufacturing jobs."

Finally, the State Department, Treasury Department, and the president's national security advisor are working to squeeze Iran from the oil market. The Obama sanctions will be re-imposed on the country but enforced more strictly. As Bloomberg reporters Heesu Lee and Debjit Chakraborty wrote October 3, "Oil buyers who viewed Obama-era policies as precedent for U.S. sanctions on Iran are getting a rude shock."

Lee and Chakraborty explain, for example, that Asian oil importers have been "blindsided." These importers believed they would only need to reduce shipments from Iran as they did during the Obama administration. This is not the case. As the authors note, "Now, one after another, buyers are complying to avoid being cut off from the American financial system when restrictions on Iranian supplies take effect in November."

Lee and Chakraborty assert that the miscalculation is the root cause of oil "surging to over $85 per barrel and forecasts for $100 oil." Prices have risen because Asian buyers have had to reduce or stop their oil imports from Iran. As the authors note in a footnote to a graph, "South Korea has already halted purchases from Iran; Japan has said September cargoes will be its last; India doesn't plan to buy any in November." They add that government officials in India and South Korea are complaining that negotiations with the United States have become much more difficult since Trump took office.

The U.S. officials pushing this "zero imports" policy may have made an innocent mistake, relying on projections from the U.S. Energy Information Administration, an agency that regularly gets forecasts incorrect. There even seemed to be a contingency plan if they were wrong about the sanctions' impact on the oil market. Initially, the United States appeared to be open to releasing oil from the Strategic Petroleum Reserve if sanctions caused excessive market tightness. In late September, Platts' Brian Scheid and Meghan Gordon reported the following statement from a government official, one that implied the possibility of an SPR release: "'We will ensure prior to the re-imposition of our sanctions that we have a well-supplied oil market,' Brian Hook, head of the State Department's Iran action group, said."

Hook was wrong. Within a day, U.S. Secretary of Energy Rick Perry told reporters a release was not being considered, Platts reported. Instead, the United States is leaving it to other producers such as Saudi Arabia and Russia to increase production to replace Iran's lost output.

I note that this is the same policy the Allies tried against Iraq in 1990. Following that country's invasion of Kuwait, the British led an ultimately successful effort to prevent all Iraqi and Kuwaiti oil from reaching the market. Strategic stocks were not released then because, again, other countries were expected to boost output. Few did, however, and prices doubled or tripled.

POSSIBLE CONSEQUENCES

Each of the of three policy thrusts has scores of defenders. And each, even the tariffs, can be justified based on the past actions of other countries. The problem, though, is the financial chaos these conflicting policies may create given global economic circumstances. In particular, the policies have been and are being put into play just as the global economic problems caused by ten years of quantitative easing in the United States and Europe are becoming apparent.

Minimum wage for Amazon, its competitors, and various states

Amazon	$15
Target	$12
Walmart	$11
Washington	$11.50
California	$11
Massachusetts	$11
Oregon	$10.75
Vermont	$10.50
New York	$10.40
Colorado	$10.20
Illinois	$8.25
Texas	$7.25
United States	$7.25

Sources: *Wall Street Journal,* U.S. Department of Labor

The difficulties start with the dollar-denominated debt of emerging market countries. Such debt for these nations and the companies within them has now surpassed $3 trillion, more than tripling since the Asian crisis of 1997.

Recently, the Bank for International Settlements highlighted the threat of greater dollar-denominated debt in emerging market countries:

> *In all major emerging market regions, the growth of U.S. dollar-denominated credit has outpaced that in other foreign currencies. The high share of dollar borrowing foreshadows risks that could materialize in the case of a persistent dollar appreciation. A stronger dollar increases tail risks for global investors holding a diversified portfolio of emerging market economy assets, which can lead to widespread reductions in EME exposures—especially of dollar bonds. This mechanism is likely to have contributed to the recent bout of turbulence in EMEs.*

The Bank for International Settlements also noted that sentiment turned "sharply against EME assets in the third quarter." Tightening by the U.S. Federal Reserve (and the end of accommodative monetary policies) was a key explanation for the turnabout. The tight U.S. labor market and increased global trade tensions were also cited as causes. The consequence of the investor shift was a decline in capital flows into emerging market countries and even outflows in some cases. The BIS authors offered an alarming assessment:

> *The Phillips Curve could return with a vengeance.*

> *The shifts in FX and bond markets during the year also underscored EMEs' persistent sensitivity to the strength of the U.S. dollar. Large depreciations contributed to credit risk concerns, and hence to wider spreads on U.S. dollar-denominated bonds. At the same time, they exacerbated dollar-based investors' losses on local currency instruments. Thus, rises in local currency yields also ensued, and were significantly larger than in previous episodes of market distress.*

The BIS analysis highlights the difficulties threatening emerging market nations, particularly as the U.S. economy surges ahead.

> *Prices have risen because Asian buyers have had to reduce or stop their oil imports from Iran.*

This is where the aggressive U.S. policy against illegal immigration becomes significant, especially given the Federal Reserve's focus on inflation. The U.S. unemployment rate as of October 2018 has dropped to an almost record low of 3.7 percent. Unemployment this low was last seen in 1969, when Richard Nixon was president. Aggressive enforcement of immigration laws has likely played a part in the decline. The current administration has rightly trumpeted the decrease.

In the past, such a decline would have been associated with wage pressures. However, the increased concentration in U.S. industry—monopolization—has held wage increases in check until quite recently. On October 2, 2018, Amazon changed the calculation when it announced it would boost its minimum wage to $15 per hour. The impact of this in a tight labor market will be serious.

Employers of minimum-wage workers in Texas, for example, can pay workers the federal minimum of $7.25 per hour. Many fast-food franchises probably pay precisely that amount. Now, Amazon's preemptive step may force them to double their wages to keep workers. Other employers will need to do the same to keep their best employees. This will be a good—and overdue—reward for those who have been underpaid for so many years.

A year from now, those who borrow money will regret Amazon CEO Jeff Bezos' action—and should also rue U.S. immigration policies that limit the availability of foreign workers—because by then the year-over-year increase in wages may have climbed to 30 percent or 40 percent. Inflation will have increased as well. Borrowers will pay higher interest rates because other employers will have to match Amazon's wage.

Under these circumstances, the relevance of the Phillips Curve—the historically inverse relationship between the wage increase rate and unemployment—could return with a vengeance. Economists have puzzled at the absence of the usual relationship between unemployment and inflation for several years. Should the Phillips Curve relationship be reestablished, the interest rate rise over the next year could be far more rapid than expected.

U.S. trade policy will likely increase inflation. Secretary Ross, Trade Representative Lighthizer, and trade adviser Navarro have pushed a combative trade policy for more than a year. As a result, the United States has imposed tariffs on almost all Chinese exports to the United States and on imports of steel and aluminum. In addition, the North American Free Trade Agreement has been renegotiated with a key element requiring a greater percentage of automobiles to be made in North America to qualify for tariff-free treatment. All these measures are seen as raising prices.

The price increases will boost long-term inflation rates, which will feed back into the Phillips Curve calculation, boosting wages and further adding to inflation, according to a study by Olivier Blanchard of the Peterson Institute for International Economics. Loretta J. Mester, president and CEO of the Cleveland Federal Reserve, warned last May:

> *In the past, when labor markets have moved too far beyond maximum employment, with the unemployment rate moving substantially below estimates of its longer-run level for some time, the economy overheated, inflation rose, and the economy ended up in a recession. Achieving a soft landing is difficult…*

Some readers will recall that inflation rates began to rise in 1969 and 1970 when unemployment rates last fell to the low levels recorded today. Prices of goods began to increase rapidly. Less than two years later, President Nixon imposed wage and price controls. Despite this, prices kept rising for almost ten years, when the Federal Reserve tightened monetary policy.

Fifty years later, central bankers have a much better understanding of the economic situation. They will not wait ten years. They will not even wait six months. The tight labor supply, trade protectionism, and Amazon's wage raise have laid a foundation for significantly higher interest rates.

Such adjustments have not been factored into economic forecasts yet. Past evidence shows, however, that forecasts lag events. In the case of interest rate changes, the lag is important. Projections for the federal funds rate from the end of 2018 through 2021 as calculated by forty-eight economists surveyed by the *Wall Street Journal* in September found that, on average, these economists see the rate rising modestly from the 2.25 percent set at the beginning of October to 2.3 percent at the end of the year and 2.6 percent at the end of 2019. A few intrepid souls see it moving to 4.5 percent by the end of 2021.

The U.S. officials pushing this “zero imports” policy may have made an innocent mistake.

However, economists have historically been no better at forecasting interest rates than they have been at projecting oil prices. Forecasts published by the *Wall Street Journal* in January 2008 predicted rates close to 4 percent by the end of that year. By June 2008, the economists surveyed had lowered their predictions to the 2–3 percent range. Actual rates fell to zero by 2009, a development the forecasters did not see coming. This experience serves as a warning for the next six to twelve months. Interest rates could surge if inflation picks up. A year from now, rates could be 5 percent or 6 percent.

The higher interest rates in the United States that will come with greater inflation will make the problems of emerging market nations more difficult. The interest rate hikes will raise the cost of servicing the more than $3 trillion of dollar-denominated debt outstanding. At the same time, the rate increase should lead to the dollar strengthening against the emerging market nations' currencies.

The currencies in such countries could face further difficulties if capital flight increases, as it tends to do during crises like the one that seems to be developing. The problems of Argentina and Turkey and now Indonesia and Brazil will be made worse.

The U.S. State Department's aggressive effort to diminish Iran's oil exports is the final element in the U.S. attack on the global economy. The surge in oil prices linked to the renewed sanctions on Iran threatens the economies of many emerging market nations. In early October, the *Financial Times'* Emma Dunkley noted the impact, for example, on India:

> *India in particular faces a triple threat in the form of a massive current account deficit funded in large part by foreign capital, a falling rupee, and its position as the world's fourth-largest oil importer.*

From the first of the year, the Indian rupee has lost 14 percent against the dollar. Thus, while the cost of oil has increased 28 percent in dollar terms, the increase is 42 percent when measured in the Indian currency.

The higher oil prices in India, Indonesia, and other emerging market nations create a serious economic burden as well as a worrisome problem with the public. Earlier this year, Brazil confronted a nationwide trucker

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strike when diesel prices rose. The government had to provide subsidies to lower diesel prices and end the walkout. Other countries are moving in a similar fashion to prevent public outrage and work stoppages. In an effort to ease pressure on consumers, for instance, India has announced a gasoline and diesel fuel tax cut of 2.5 rupees per liter, according to a Reuters report in early October. At current exchange rates, this amounts to a $5.40 per barrel reduction.

South Korea is also considering such a move. Argus Media reported that Korea might eliminate its 3 percent tariff on crude and liquefied natural gas imports effective January 1, noting that the tax cuts would be made to "increase industrial competitiveness and help customers cope with rising prices."

Other countries will likely follow this example. Fuel tax cuts will have little impact on their economic situation, though, as the oil price rise and decreasing currency values have increased the burden of servicing large amounts of dollar-denominated debt.

Of course, the proponents of the Iran sanctions believe oil prices do not need to rise. In early October, Platts noted that an unnamed State Department official had accused OPEC of withholding 1.42 million barrels per day of spare capacity. The official's statement came in response to rising prices, which have clearly been brought to the attention of those pressing India and other nations to stop buying Iranian crude while threatening to cut them off from the U.S. banking system if they do not.

The Platts report also observed that the official "declined to comment as to whether the administration was considering delaying or phasing in sanctions on Iranian crude exports as prices continue to climb." In classic

bureaucracy-speak, the person said, "We are monitoring this situation closely but we will not get ahead of any decisions regarding this issue."

Meanwhile, President Trump has increased pressure on Saudi Arabia, tweeting that the Saudi king would not last three weeks without U.S. protection. Trump continues to call on the Saudis to boost production, apparently trying to hold them to their promise to replace Iranian crude exports.

Bloomberg published an interview on October 5 with Saudi Crown Prince Mohammed bin Salman in which he stated flatly that Saudi Arabia had kept its word. The interviewers asked if the United States had requested the Saudis to replace Iranian crude. The prince's response is clear:

> *MBS: Yes, actually the request that America made to Saudi Arabia and other OPEC countries is to be sure that if there is any loss of supply from Iran, that we will supply that. And that happened. Because recently, Iran reduced their exports by 700,000 barrels a day, if I'm not mistaken. And Saudi Arabia and OPEC and non-OPEC countries, they've produced 1.5 million barrels a day. So we export as much as 2 barrels for any barrel that disappeared from Iran recently. So we did our job and more.*

The crown prince asserted that higher prices have resulted from production problems in other countries, especially in Venezuela. Oil production in Venezuela is now 500,000 barrels per day below the country's OPEC quota and falling further.

As this issue goes to press, there has been no sign that repercussions from the murder of Saudi journalist Jamal Khashoggi inside the Saudi Consulate in Istanbul, allegedly on the orders of Prince Mohammed, will affect the price or supply of Saudi oil.

The key point is that no other member of OPEC or the extended oil-producing group is replacing the lost production from Venezuela. It is not clear whether they could. The consequence is higher prices that could be avoided if the United States released oil from its strategic stocks or other countries boosted their output.

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In the absence of sanctions, though, prices could be lower. Thus, in my view, the U.S. sanctions policy—especially the belligerent tactics of Bolton, Mnuchin, and Pompeo—is to blame for the higher crude oil prices and for the economic hardships they cause. The decrease in U.S. housing construction activity will add further to U.S. economic misery. A September 30 *New York Times* report discussed the slowdown in the U.S. housing market. The author, Ben Casselman, explained that many Americans are being priced out of buying houses today because higher construction costs have raised the price of finished new homes well above what they can afford.

Casselman cited several factors that explain this development. Labor costs have increased (in part due to limits on immigration). Land prices have risen as well. Furthermore, zoning restrictions and permit costs have added to new home prices. Finally, tariffs on Canadian lumber imports have upped the cost of building materials.

These problems have been worsened by climbing interest rates. Over the next year, additional rate hikes will further limit the availability of new homes and the ability of Americans to buy them.

Looking at the big picture, U.S. policies limiting immigration, raising tariffs, and sanctioning Iran—combined with the need to raise interest rates in response to rising prices—have laid the foundation for an economic downturn in 2019. The onset of a currency contagion—or a serious recession—cannot be ruled out.

A serious economic crisis seems unavoidable. It will be accompanied by a sharp drop in global oil demand. Today, one wonders whether $20 per barrel oil could happen in 2020. If it did, Donald Trump may have made the world's adaptation to the IMO 2020 rule easy (see "The IMO Iceberg" in the Spring 2018 issue of *TIE*).

The global economic collapse will occur because the United States is pushing too many aggressive economic policies simultaneously. Problems would be less likely if the trade program or the sanctions had been put off for a year or two. However, the current administration apparently has an unfortunate desire to do everything at once. ◆