

WEEKLY ECONOMIC COMMENTARY

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President Trump issued an executive order recently that advocated a “Buy American” policy. The fundamental assumption behind this directive is that buying only goods produced in the United States will create a multitude of jobs and enhance the country’s prosperity. But while this may sound logical on the surface, the program misunderstands key features of the integrated global economy and the root causes of worker displacement. The imposition of “Buy American” laws will lead to larger government deficits, a distortion of trade flows and higher prices for consumers.

The primary aim of the “Buy American” part of the executive order is to maximize “the use of goods, products and materials produced in the United States.” A number of free trade agreements and the World Trade Organization (WTO) limit the favoring of domestic providers in government contracting, but U.S. officials have been instructed to investigate the latitude available for them to turn inward. A report is due to the President in the fall.

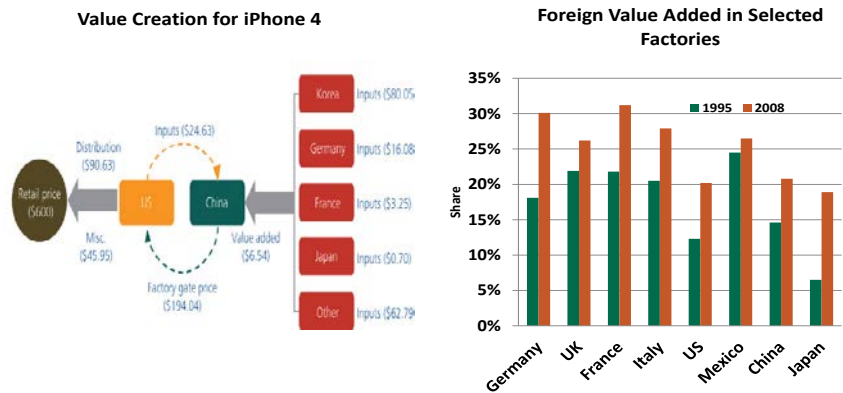
One of the challenges in implanting rules of this kind is determining what qualifies as a domestic product. It is rare indeed to find something that is created exclusively from local content; more commonly, goods are the end result of global value chains (GVCs). GVCs are networks of production stages that span national borders. A GVC involves combining intermediate goods and services into products that are used at a subsequent stage of production.

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Sources: DUPress. Com, Journal of Regional Sciences, 2014

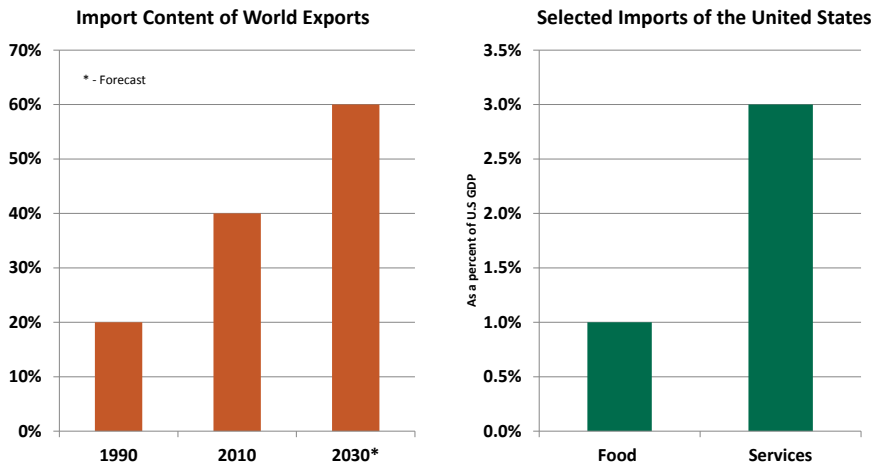
A typical GVC consists of several steps, from conception to assembly to branding and marketing. Organizing production in this manner captures efficiencies from across the world.

The iPhone is a classic example. It is designed in the United States, but uses parts supplied by different countries. It is assembled in China by a Taiwanese firm, and the final product is sold worldwide. As another example, the Ford Taurus is assembled in Chicago, but only 65% of its parts originate in the United States. Should these two well-known products be considered American?

According to the WTO, almost 40% of all U.S. exports are the product of GVCs. [Research](#) analyzing selected factories across eight large economies shows that GVCs have expanded significantly.

Furthermore, about 60% of world trade involves intermediate goods and services that are then incorporated at different stages of production. In 1990, the import content of world exports was 20%, which grew to 40% in 2010 and is predicted to be around 60% in 2030. Almost 31% of exports from China, Canada and Mexico include U.S. inputs, and almost 34% of U.S. exports contain inputs from these countries. These numbers indicate that the United States is a part of numerous GVCs that result in output that can be claimed by a variety of countries.

Global value chains are critical for productivity and growth.



Sources: CEPR, Haver Analytics

There are relatively few products that are produced entirely in the United States. Food and services are two examples, but they constitute only a small percentage of U.S. gross domestic product (GDP).

Laws confining the purchase of goods and services to the national boundary contradict the basic tenet of a competitive free market economy that enables every firm, individual, or public agency to purchase goods and services offering the best combination of price and quality. More importantly, the free market arrangement enhances productivity.

The new executive order promises to affect the manner in which federal agencies purchase goods and services. The U.S. government spends nearly half a trillion dollars on contracted work each year. Firms place bids for construction, technology support and other services the government does not perform on its own.

Excluding sensitive defense-related work, both American and foreign firms are currently eligible to bid on these opportunities. Under the new order, only domestic firms will be eligible to win these contracts, potentially costing the taxpayer if revenues are channeled to firms/individuals that may not be the optimum choice.

The “Buy American” policy is a non-tariff trade restriction much like local content requirements (LCRs) designed to protect local industries and jobs. If America presses forward with this agenda, other countries can retaliate with LCRs that can range from requirements to purchase a certain percentage of domestic goods, use only local infrastructure to produce services and impose conditions on the way business is done. The U.S. could well be a net loser in this battle of barriers.

The Global Trade Alert group has identified that 343 LCRs have been implemented since the 2008 financial crisis. Research notes that LCRs largely have a net negative impact on trade flows and investment. The bottom line is that these protectionist measures are economically sub-optimal policies to shield jobs.

Furthermore, there is evidence that technology, not global sourcing, has contributed more to job losses in the United States over recent decades. The Buy American program will not diminish the march of automation.

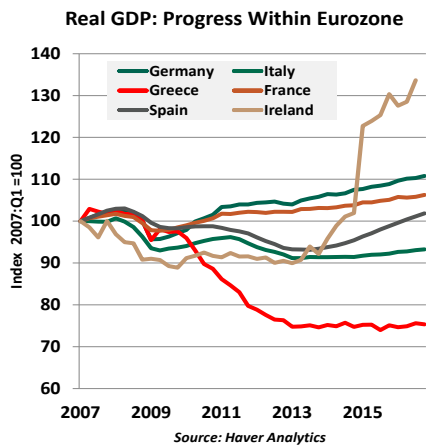
“Buy American” has a certain ring to it, and will no doubt win over some of the electorate. But policymakers need to recognize this simple slogan obscures the more complicated realities of global sourcing, a system from which the United States benefits greatly. What might sound best on Twitter may not be the soundest approach.

Not Out of the Woods

Europe, and the world’s financial markets, breathed a sigh of relief at the conclusion of the French election season. The firebreak against populism in Western Europe seems well-established now, and the leading candidates in the German election this fall are both supporters of European cooperation. The European Union (EU) is no longer in immediate existential danger.

But it would be a mistake to assume that the political stress of the past few months was all a bad dream. Many of the forces that gave rise to populist thoughts are still present in Europe: growing income inequality, high levels of underemployment, anxiety about immigration and dissatisfaction with Brussels. Lingering concerns in these areas could weaken or delay the kind of structural reform that Europe desperately needs.

Protectionist trade measures will not result in new jobs.



Populism is still a powerful force in Italy, which will seek to elect a new prime minister sometime in the next twelve months or so. Italy’s economy (Europe’s third-largest) has been struggling, its banks are weak and it has been directly affected by migration from the Middle East. A victory for the Five Star populist movement would still be a long shot, but not entirely impossible.

The challenges facing the European collective will be on constant and prominent display as the Brexit negotiations heat up. The sparring has already been vigorous; Brussels has taken an increasingly hard line on exit fees, while London continues to suggest that Britain can do better by striking a series of bilateral trade agreements instead of contracting with the EU. Some of this is posturing, but European commerce will surely be changing, and not for the better.

Growth prospects in Europe have improved, and political risk has diminished. But those who see recent polling as clearing the way for a stronger EU may be over-reading things.

ECB, Slow and Steady

Emmanuel Macron's victory in France has provided a welcome relief from European politics and brought the focus back to economics. Sentiment around the continental economy has been buoyant over the last few months, raising questions about the extraordinary policy accommodation provided by the European Central Bank (ECB).

Leading indicators of eurozone economic activity have certainly had a great run. Purchasing manager surveys, economic sentiment and consumer confidence indicators have posted multi-year highs in a number of eurozone countries. Hard data has also surprised on the upside. This rapid improvement in data has intensified pressure on ECB President Mario Draghi to justify the current policy stance. From an ill-tempered grilling by the Dutch parliament earlier this week to the hawkish comments by the German Finance Ministry, the clamor for 'policy normalization' is growing.

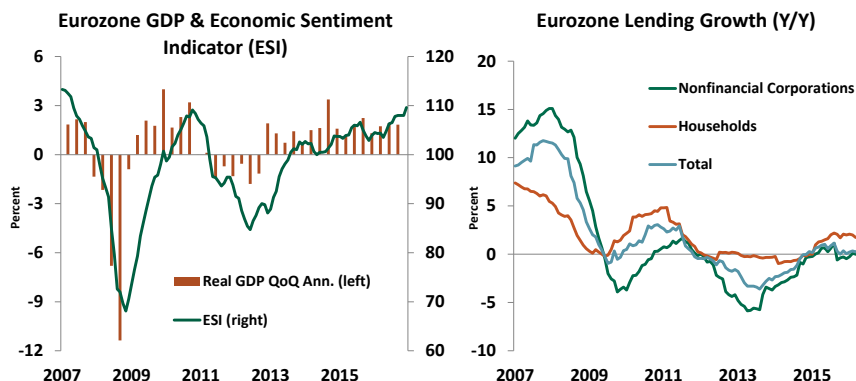
We should assess the ECB's stance in the context of the prerequisites Draghi set out in January for reconsidering monetary strategy: achieving 2% inflation during the medium term in a durable, self-sustained expansion that is broad-based across the euro area.

We think that the European economy is mending slowly, and the underlying fundamentals are weaker than what the robust survey data might indicate. For example, the latest lending survey shows that despite continued easing of credit standards, credit demand has failed to gather much momentum. This is reflected in the glacial pace of recovery in total lending, which is not just lagging nominal GDP growth, but even real GDP growth. Eurozone unemployment has certainly been falling, but remains high at 9.5% and indicates the presence of considerable slack in the economy. Indeed, the ECB has noted that economic risks are tilted to the downside.

Headline inflation has recovered dramatically since the middle 2016, but that has largely been an oil story. ECB staff projections for 2017, 2018 and 2019 are 1.7%, 1.6% and 1.7% respectively. Core inflation has stubbornly stuck around 0.8% since falling below 1% in early 2014. It would need to remain above 1% for at least a few months for price pressures to be considered durable, something that ECB's staff projects to happen by the end of this year. Gradual improvement in economic activity and reduction in labor slack should help with the self-sustainability of price pressures.

Finally, while there is certainly intra-eurozone divergence in inflation, the gap has narrowed materially since last year. Pockets of inflationary and deflationary pressures are unavoidable in a monetary union, and should not prevent the ECB from taking its foot off the accelerator.

Populists have fallen out of favor, but Europe still faces important challenges.



Source: Haver Analytics

Overall, it is a mixed bag when it comes to inflation, and there is no reason for the ECB to hurry its inevitable exit from the ultra-loose policy stance.

When the time comes for change, sequencing will be the key. The first step would be to modify forward guidance to drop the reference to “lower rates” and “downside risks” in the next couple of meetings. This would prepare ground for tapering the pace of asset purchases (rather than a termination of purchases) – the current program expires in December 2017, so tapering would not happen before then. The normalization of the deposit rate would then start somewhere in the middle of 2018. The ECB’s refinancing rate (its benchmark interest rate) would then likely be raised in the middle of 2019.

Having gone to extraordinary lengths to reestablish growth and inflation in the eurozone, the ECB does not want to see those hard-won gains dissipate too quickly. The effectiveness of monetary policy is partly a product of persistence, which shapes expectations. Mario Draghi will certainly face additional pressure to relent in the coming months. But for now, he’d be best advised to stay the course.

The ECB is in no hurry to change its policy stance.

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