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Dace Blaskovitz: Welcome back to Money and Politics in Delaware. Robert Fry. Economist's Delawarean and okay, you ready for another primer?

Robert Fry: I'm ready.

Dace Blaskovitz: Very good. When people hear negative interest rates, again, I'm putting you in front of a hypothetical eighth grade class, what are we talking about?

Robert Fry: Well that means you lend money to the government and when they pay you back, they pay you less than what you gave them. It's kind of strange because people would think, "Well, if I'm getting negative interests, shouldn't I just take the money and stick it in my mattress or under my mattress," which regular people can do. Yeah, you and I probably would not be affected by negative interest rates, but if you're a pension fund or an insurance company and you have a lot more money than you can stick in a mattress or a safe or you're required to hold treasury securities for regulatory reasons, you can't avoid it. And so right now in Europe, in Japan it's true. Straights are negative for treasury securities, even longer-term treasuries.

Dace Blaskovitz: Now Robert on your side, if I'm in the audience, I'm going, "That sounds crazy okay," but your insight is they're doubling down on their own pain. Explain that.

Robert Fry: Yeah. There's a paper out by two economists at Princeton, a professor named Marcus Brunnermeier and a graduate student named Yann Koby and it's called The Reversal Interest Rate and they argue that once the interest rate gets below a certain level, that cutting interest rates further doesn't stimulate the economy. It actually slows the economy. It's contractionary and they derive this reversal interest rate through bank profitability and the incentives of banks to make loans.

Robert Fry: I think he can get there in other ways. Generally the way lower interest rates stimulate growth is by stimulating housing. If you've worked in a big company for 30 years, you realize that corporate investment is not very sensitive to interest rates. Cutting interest rates isn't going to get a big company to build a plant or buy more equipment. It used to be that car sales were very interest sensitive. Now the auto companies use that auto finance company interest rate to kind of smooth sales over the cycle.

Robert Fry: So, those auto finance company rates don't necessarily vary with market rates. So you don't get the same effect on vehicle sales. So basically, what you get down to is if you're a central bank and you want to cut interest rates, you're stimulating housing and you're stimulating the purchase of furnishings and furniture and things that go into houses. So that's how monetary policy works.

Robert Fry: Well, what happens if the housing market isn't working very well and that's exactly what's happening now. We've got very low mortgage rates, but housing starts haven't picked up. Part of it's because young people would rather live in an apartment in the city than a house in the suburbs. Part of it is we aren't getting enough houses built because of supply constraints and that's mostly due to zoning and permitting regulations from local governments. I think local governments are actually largely responsible for the very slow recovery in housing during this expansion.

Robert Fry: So, we're not getting a tremendous boost out of low interest rates to housing. At the same time, you have people, especially risk averse, older people who don't buy stocks and bonds, they put money in the bank in CDs and savings accounts. Interest goes down, their income goes down. This happened to my father. So instead of living off the interest as he expected to, he had to withdraw the principal because there wasn't any interest. And then once the interest is gone, you're basically living off social security or excuse me, once the principal is gone, you're living off the social security. So, by cutting interest income, low interest rates have actually reduced consumer spending.

Robert Fry: And I think we were probably at that point in the U.S. up until the Fed raised interest rates above zero. When we had that long zero interest rate period, I think interest rates were too low and they were actually slowing the economy. Well, that's happening in Spain, in Europe, in Japan. Their interest rates are negative. A lot of people there save in bank accounts and postal savings accounts. They're getting a negative return. They can't live off the interest income. They're drawing down the principal. It's not good for consumer spending, so I think in Europe, in Japan, the interest rates are definitely below the reversal interest rates. So, when they cut interest rates, they're slowing growth rather than stimulating it

Dace Blaskovitz: Talking about let's go growth the other way, I won't say you broke a story, but you shared it in your newsletter originally. Fascinating research out of a... If I remember correct, this is a question a Yale professor that says if you want to be reelected as president, you have to have three quarters of GDP growth prior to the election. Tell the story.

Robert Fry: Ray Fair is a professor of economics at Yale who's been there since I was in graduate school back in the 80s. He's a macroeconomist and econometrician. And he has done some models, forecasting models to forecast the results of presidential elections and one of the primary determinants of how well the incumbent does is how fast economic growth is in the three quarters before the election. And that the third of those three quarters GDP will be reported at the end of October, which is about a week before the election. So very important, last data point before the election. So, this argues that you... That if President Trump wants to be elected, he needs to have growth pick up in the first three quarters of 2020.

Dace Blaskovitz: If I was an economist, I'm going to do your job to keep this thing moving. We got about two and a half minutes. If I was an economist, then I have two very different predictions. I would not wed to one. If there is a trade deal, you get 3% growth return. People forget October 18 if there is no trade deal, then you get recession. You get Elizabeth Warren; stock market gets cut in half in my opinion and you get just misery. So smart guy with two and a half minutes to go, do they do a trade deal. And what's the timeline on it?

Robert Fry: I think they probably do. It's funny you were talking about those two scenarios because I was just here sketching that out and doing, updating my forecast. My forecast is basically for 2% growth going forward, but that's an average of a weighted average of two cases that I find much more likely than 2% growth. Say there's a three quarter that fit, 75% chance we get a trade deal and the fed does the right thing. We get 3% growth and there's a 25% chance we don't get a trade deal. We get further increases in tariffs. The fed doesn't done invert the yield curve. We get a recession and say you get minus one. So, if you take a weighted average of 25% on minus one and a 75% on three, you get two I think. So, my forecast is two, but I think it's more likely that we get three and if we don't get three you will probably get minus one instead of two.

Dace Blaskovitz: Tick tock on a clock. You have exactly one minute, 45 seconds, one minute, no more. Why the manufacturing numbers has your interest. Tell that story on the air in 30 seconds.

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Robert Fry: Trade policy tariffs have a lot bigger micro-economic impact than macro-economic impact. They help some sectors and hurt others. They're hurting the tradable good sectors which are manufacturing, mining and agriculture and maybe helping real estate and services. So that's part of it. Part of it is oil prices are down. When oil prices come down, that's great for consumers. They spend money. That helps services, helps the broadened economy but it leads to much less drilling activity, which means less steel demanded for well casings and for pipelines and those industries in heavy manufacturing are getting hit by the lower oil prices.

Dace Blaskovitz: His name is Robert Fry. Robert Fry Economics.