Global economic challenges for Donald Trump

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- Quadrennial panels offer "Advice for the new Administration"
    - I feel the need this year to acknowledge that advice from us "experts" and "elites" is unwanted by Mr. Trump and his supporters.
        - Just to show that we understand.
    - That said, the Trump Administration will encounter international events and constraints that it did not figure on in the campaign,
    - a common pattern, though much more extreme this time.

- Of course international trade, the US trade deficit, and the Chinese exchange rate were big issues in the campaign
    - Let's start with his promise immediately to name China a manipulator of its currency.
        - Mr. Trump might have to confront the reality that if China moved to a freely market-determined exchange rate as he and other US politicians have been asking, the RMB would get weaker, not stronger.
            - For more than two years, the PBoC has been intervening to fight RMB depreciation, not to encourage it.
                - It has sold dollars and bought RMB, not the other way around.
                  [graph]
            - Similarly, Chinese authorities have recently tightened controls on capital outflows, not inflows.
        - A weaker RMB would of course help China's net exports to the US, not reduce them.

- The US trade balance
    - [Little-known fact:] The US trade deficit as a share of GDP has been narrowing for the last 10 years [graph]
    - Mr. Trump's policies are likely to set the trade deficit back on a deteriorating path
        - even if he doesn't stop China from intervening in the foreign exchange market.
        - But does go ahead with what seem to be his fiscal plans.
    - I refer to plans for massive tax cuts and big increases in spending (including military and infrastructure investment).
        - It is hard to predict what the carryover will be from statements in the campaign to actual policies.
        - But Congress is likely to support this sort of fiscal expansion.
        - Repeats of what Ronald Reagan and George W. Bush did.
    - The budget deficit will reduce national savings which would worsen the current account deficit.
        - An example of the "twin deficits" that we saw under Reagan and Bush.

- Through what causal channel would the trade balance worsen?
    - First, the fiscal expansion will put upward pressure on interest rates, especially since we are already essentially at full employment.
        - Of course the Fed had already been expected to raise interest rates Dec.14.
        - Recent developments augur more interest rate hikes in 2017 and 2018.
        - The new Administration will probably oppose the increases
            - Notwithstanding that during the campaign the candidate attacked the Fed for keeping interest rates too low.
            - Hopefully the Fed's independence will hold, as it did under Volcker.
    - It will also put upward pressure on the dollar.

        - Because higher interest rates attract a capital inflow,
            - as in the classic Mundell-Fleming model :
            - BD ↑ => NS↓ => i rate ↑ => $ ↑ => TD↑
        - Mr. Trump is doing more to depreciate other currencies against the $ than currency manipulation does.
    - Indeed the increases in US interest rates and the value of the dollar have already gotten underway, ever since the election. [graph]

- "How does the importance of free trade fit in and can the US continue its leadership in promoting trade?
    - In the long run, a reversal of US-led globalization will do damage both to our economy and to our geopolitical position.
    - Would a sharp increase in import tariffs, even if inconsistent with our international obligations improve the trade balance?
        - Possibly, in the short term.
        - But the fall in imports is likely to be offset by a fall in exports.
            - If Mexicans' income falls, their imports from us will fall.
            - If our inputs of labor intensive auto parts from Mexico fall, our exports of finished autos are likely to fall.
            - If Mexico retaliates against our tariffs by raising its own, as it is entitled to do, our exports to it will fall.
    - The net effect on the trade balance depends on the macroeconomic factors already considered: a fiscal expansion is likely to worsen the trade balance.