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The US Economy Under President Trump

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- We are now at the three month mark in the Trump presidency. Everything about him is so radically different from past presidents, that **one might have expected radical changes** in the economy after he took office.

- **So far, the path of the US economy is a** continuation of the same path it was on in 2015 and 2016:
  - completing the recovery from the 2007-09 recession,
    - notably adding another three months of job gains to what had already been a record 75 continuous months,
    - bringing unemployment down to 4 ½ %, = 'full employment."
    - Growth around 2% which seems to be the rate of growth of potential output in the 21st century (will probably be less in Q1).
    - Inflation up to 2%, the target.
  - Proximity to full employment and potential output implies that further expansion would show up more in the form of rising inflation, interest rates, and – to the extent that the US exceeds growth among other countries – rising dollar and trade deficit.
  - The Fed is expected to raise interest rates two more times this year, for a total of four.
  - Interest rates received a further push in Nov. after the surprise election outcome
    - because of expected Trump plans for fiscal stimulus.
    - Immediate rise in long-term interest rates and the dollar.[i]
    - Markets have been expecting a repeat of 1981 when Reagan enacted large tax cuts and rapid growth of military spending, while FRB Chairman Paul Volcker held the line on money growth, so that the fiscal expansion

showed up in higher real interest rates, capital inflows, a record-strong dollar, and record trade deficits. The Mundell-Fleming model remains useful.

- **"What will Trump do?"** His policy positions are highly unpredictable. Much of what he says is contradicted either by what his top appointees say, by what he himself said before (sometimes just minutes before), or by the facts of objective reality -- including sometimes the laws of arithmetic and the laws of man. He has reversed positions on many issues, especially in the last week. [ii] He has indicated that he considers unpredictability to be a virtue in a leader.

- The two big initiatives that he tackled first -- **immigration and health care** – appear so far to have been failures.
  - The long-promised repeal of **Obamacare** failed. The common diagnosis of the failure is a neglect of political homework (even though the Republicans control both houses of congress). That diagnosis is true, so far as it goes; but it doesn't get at the deeper cause. If the Republicans had succeeded in getting the repeal of Obamacare through the Congress, the outcome for them would probably have been even worse politically (but also for the country), because an estimated additional 24 million people would have gone without health insurance. After seven years of trying to abolish Obamacare, the Republicans had no replacement plan that would take the federal government regulation out of health care insurance without also taking 24 million Americans out of health care insurance. The reason is that no such plan is possible. The scandal is that apparently they honestly hadn't thought about this; that applies to the Republicans in Congress almost as much as it applies to Trump.
    - The same sort of debacle would likely have taken place if some Republican less idiosyncratic than Trump had been elected president.
  - The ban on immigrants from a particular list of Muslim countries has been found by the courts to constitute Constitution-violating religious discrimination. That was probably predictable.
  - Of course he has still managed to inflict hardship on the lives of many people seeking to enter the US, and may yet do worse. And similarly he can still find

ways to undermine Obamacare, starting with withholding subsidies [to insurance companies that reduce costs for low-income consumers]. But so far, no.

- The priority which is next in line is **tax reform.**
  - The conventional critics say that White House ineptitude on Obamacare has made tax reform that much harder.
  - But my guess is that true tax reform was doomed to fail anyway because of inherent contradictions [analogous to those involved in the effort to repeal Obamacare].
  - Let us define true tax reform as a reduction in tax rates (probably both corporate and personal), offset by enough broadening of the base (elimination of distortionary deductions and loopholes) so that overall revenue does not fall.
    - Tax reform will fail because the Republicans are not able to identify enough deductions for elimination to close the revenue gap.
    - Even the revenue-generating proposals that economists agree on the most – such as curtailing deductions for interest payments – would have a hard time getting enough votes in the Congress, because of the political interest groups that would be hurt by them.

  - Instead, I am willing to bet that we will get the **cuts in tax rates** without the offsetting measures (eventually-- probably be early 2018)
    - so that tax receipts will fall and the budget deficit will soar.
    - It is always politically easy for politicians to give money away, even those who call themselves fiscal conservatives and campaigned for office on promises of cutting the budget deficit or even promises of paying down the national debt.
    - This sort of tax cut is what Ronald Reagan did when he came to office in 1981 and George W. Bush in 2001. Each time, contrary to promises, the budget deficit rose, and with it the trade deficit.
    - It will be worse this time than in 1981 or 2001 in several respects, particularly with respect to distribution and timing.

- Distributionally, the tax cuts on which Trump campaigned would give a vastly disproportionate share of their benefits to the rich
    - [elimination of estate tax on estates over $10 million, cuts in tax rates on high earners & especially on capital income],
    - even though the Trump revolution was supposedly on behalf of the workers who had been left behind economically.
        - (Treasury Secy. Mnuchin has yet to retract his amazing claim that *none* of the benefits will go to the rich, let alone a disproportionately high share.)

Exhibit 1: The fiscal situation is worse than 1981 or 2001
Source: CBO, Treasury, Goldman Sachs Global Investment Research

(% of GDP)	1981	2001	2017
Debt Held By the Public	25.1	31.4	76.6
Projected Revenues, Next 5 Years	22.4	20.4	18.2
Projected Budget Balance, Next 5 Years	2	3.3	-3.4
Proposed Tax Cut	-2.1	-0.8	-1.2 to -2.4
Enacted Tax Cut	-1.9	-0.8	?

- The Reagan and Bush tax cuts came at a time when there was some fiscal space:
    - Debt/ratios were still relatively low and the baby boom generation was still working.
    - But the debt/GDP ratio has already tripled in the meantime [since 1981; see table];
    - And in the meantime the baby-boom generation has begun to retire, so federal retirement programs will be running increasing deficits from here on out [“entitlements” social security & Medicare]. We can ill afford rising “on-budget” deficits at the same time.

- Cyclically, the Reagan and Bush tax cuts were enacted at times of recession so at least their initial effects were countercyclical. The US economy is now essentially at full employment, so the Trump tax cuts are likely to be *pro-cyclical*,
    - unless a recession hits soon [which is what happened Reagan and Bush's first year; Republicans seem particularly unlucky in this respect].
    - The implication is that, because the economy will already be operating close to full capacity, the fiscal boost will show up less as higher output and employment and more as higher inflation, interest rates, and trade deficits.

- Thus one can be relatively confident in forecasting a rising budget deficit and trade deficit (the famous twin deficits), all of them the opposite of what Trump campaigned on. Not to mention a rising national debt.
    - One can also be confident that his promises to restore lost US jobs in manufacturing and even in coal will not be met, even in absolute employment numbers, let alone as a share of the total work force. The long historical trends of declining jobs in these sectors are primarily due to technological progress and productivity growth, not trade agreements and government regulation.

- **Monetary policy**

  On the long list of topics where Trump is reversing himself in his first 100 days, the most predictable is monetary policy. He complained during the campaign that the Fed's interest rates were too low [and other Republicans had been doing it for 8 years, notwithstanding that unemployment was more than twice as high in 2010 as it is today[iii]]. Recently he has said that he likes the Fed's low interest rates of recent years.
    - Nevertheless, the Fed can be expected to continue raising interest rates, at least two more times this year, as noted, and more in 2018.
    - Trump will probably turn against Yellen and Fischer at some point.
        - If things go badly in the economy, he will blame it on the Fed.

- In any case he will start appointing his own Fed governors, probably trying to choose loyalists who he thinks will keep money easy.

- **Spending**
  My guess is that we will see neither the huge increase in infrastructure spending that the stock markets seem to have expected from Trump nor the huge cuts in spending overall that would be required to prevent rising budget deficits. We may get a substantial rise in military spending and some spending on photo-opportunity segments of a wall at some points along the US-Mexican border. But Congress might not be able to come together on spending increases. There could even be a return of old procedural deadlocks, despite the Republican majorities: there is the risk of a government shutdown on April 29 and a debt ceiling stand-off around October.

- **Financial reform**
  The quantity of financial regulation is not as important as the quality. One must get the details right. There is reason to think that President Trump will not get the details right.[iv]

In March, he issued an executive order directing a comprehensive rethinking of the Dodd-Frank financial reform of 2010. One can imagine various ways to improve the current legislation. The most straightforward would be to restore many of the worthwhile features of the original plan that Republicans have undermined or negated over the last seven years.[v]

In theory, one might also attempt the difficult and delicate task of modifying, for example, the Volcker Rule, to improve the efficiency tradeoff between compliance costs for banks & other financial institutions, on the one hand, and the danger of instability in the system, on the other hand. Some in the business community act as if they believe that Trump will get this tradeoff right. I see no grounds whatsoever for thinking so.

The financial system has been strengthened substantially by such features of Dodd-Frank as:

- higher capital requirements for banks,
- the establishment of the Consumer Financial Protection Bureau,

- the designation of Systemically Important Financial Institutions,
- tough stress tests on banks,
- and enhanced transparency for derivatives.

  If these features were undermined or reversed, it would raise the odds of a damaging repeat of the 2007-08 financial crisis down the road.

- **Trade**

The Trump Administration says it is sticking with its core campaign promise to renegotiate NAFTA. It still plans at some point to invoke the procedures for doing so, after which there is to be a 90-day consultation period with Congress before actual negotiations begin. Of course Mr. Trump could any day think it over more carefully and abandon the promise, as he (fortunately) has now done with the pledge to name China a currency-manipulator on day one of his administration and with so many other promises. But, for now, businesspeople and government officials have little choice but to consider the possibility that the currently stated policy will be in fact be pursued.

Mexico's leaders, for their part, have apparently taken the position that, if renegotiation of NAFTA is what the US wants, then "let's get on with it already."

It has been 23 years since the three-country trade agreement went into effect. If NAFTA is seriously to be renegotiated, how could it be improved? There are a number of ways.

- Updating for some new issues that did not exist when NAFTA was originally negotiated, such as e-commerce and data localization.
- Greater safeguards for labor [such as guaranteeing throughout the region that workers can form independent unions, banning child labor, and strengthening enforcement against human trafficking].
- Greater safeguards for the environment [such as protecting the oceans and beefing up enforcement of bans on illegal logging and trade in endangered species].
- Environmental and labor provisions should be backed up by a dispute settlement process and threats of economic penalties that are as serious as those that back up regular mercantile disputes.
- Some protection against corporate abuse of Investor-State Dispute Settlement. There should be provision for summary dismissal of frivolous suits and unmistakably

explicit clarification that multi-national corporations can't block a new regulation simply on the grounds that it diminishes their ability to earn profits.

- Include more countries in the agreement. Good candidates would be some in South America, including Peru and Chile, and others in Asia/Pacific. There are various benefits to a broader multilateral approach.
    - For one thing, even though the Trump Administration has expressed a preference for bilateral deals [and for tracking bilateral trade balances], it is in fact easier to come up with deals that benefit everyone when thinking multilaterally. E.g., US dairy producers want Canada to reduce barriers to US dairy products, but Canada wants Japan to remove barriers to its exports of pork, beef and wood products, more than it wants anything from the US.
    - For another thing, bringing more countries into the agreement might allow making the Rules of Origin less onerous. RoOs are written to prevent Americans, for example, from buying tariff-free products that are assembled in Canada or Mexico but derive much of their value-added in Asia or elsewhere. The Rules of Origin are currently so disruptive that some US importers choose simply to pay the low normal tariff that would apply even without NAFTA, rather than deal with the paperwork. This is the opposite "reform" from White House advisor Peter Navarro's wish to raise NAFTA's domestic content requirements.

Updating for new issues, strengthening protections for labor and the environment, improving settlement mechanisms, and including more countries in the agreement…. Is this all pie in the sky? Would it be impossibly difficult to negotiate a new agreement that had all these properties? The trade negotiators already did it. It is called TPP.[vi]

- The biggest worries for me, as for many, are broader than these policy issues.
    - Domestically, I worry that we may be doing permanent damage to standards to truth, fair play, consistency, rule of law and avoidance of conflict of interests.
    - Internationally, I worry that we may now be seeing **the end of a 70-year liberal international order**, that had achieved global progress toward free trade, shared prosperity, multilateral institutions, rules, democracy & human rights.

End-notes

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[i] The Nov-Dec. appreciation in the dollar against the euro and yen has held, but against other currencies has reversed so far in 2017 (to Apr 14).

[ii] On April 12 alone, Trump reversed his oft-stated hostile positions on NATO ("no longer obsolete"), Chinese currency policy ("they're not currency manipulators") and the Export-Import Bank ("a very good thing"). Other reversals include military intervention in Syria. Partial reversals include the plans to build a wall along the entire Mexican-US border and to depart all undocumented immigrants.

[iii] Trump during the campaign also expressed sympathy for Republican proposals to constrain the Fed institutionally from excessive money creation, as via a monetary rule or a return to the gold standard.

[iv] Even before the review of Dodd-Frank gets going, Trump has gotten financial policy badly wrong. At the same time as issuing the executive order, he also took a step toward canceling the fiduciary rule for financial advisors that is scheduled to go into effect in April.

[v] Most recently, the House in March voted to repeal a Dodd-Frank provision called "Publish What You Pay," designed to discourage oil and mining companies from paying bribes abroad. Score one for the natural resource curse.

[vi] Frankel, "The Trans-Pacific Partnership," outline, *Fox Hill Foreign Affairs series*, Bethesda MD, Dec. 29, 2015. "Congress Should Approve TPP," *Boston Globe.* Nov. 11, 2015; "Why Support the TPP?" *Project Syndicate,* Oct.8, 2015; "Critics Should Keep an Open Mind," *The Guardian*, Oct. 11. "Revising International Trade Agreements," *in World Finance,* July 14, 2015; "New and Improved Trade Agreements," *Project Syndicate,* May 7, 2015.