The Trump Effect: Is This Time Different?

Michalis Nikiforos

April 18, 2016

presentation prepared for the 26th Hyman P. Minsky Conference, Levy Economics Institute of Bard College, April 18–19, 2017
Index of Real GDP in US Recoveries, 1949Q4–2016Q4 (trough=100)

Quarters since End of Recession

Sources: BEA; National Bureau of Economic Research (NBER); authors’ calculations
Index of E/P Ratio in US Recoveries, 1949Q4–2016Q4 (trough=100)

Sources: BEA; NBER; authors’ calculations
Three Major Structural Problems

In recent reports we have identified three main structural impediments to a robust, sustainable recovery:

1. high income inequality
2. weak net-export demand
3. the fiscal conservatism
Three Major Structural Problems

- If an economy faces weak net-export demand and at the same time there is a restrictive fiscal policy, economic growth becomes dependent on rising private borrowing.
- Growth is the result of a spectacular rise in private expenditure relative to income and thus an increase in the debt to income ratio of the private sector.
- Because of rising inequality this increase in the debt-to-income ratio falls unevenly on households at the bottom of the distribution.
- This process is facilitated by asset inflation; the “Main St” is at the mercy of the Wall St to an unusual extent.
Index of Personal Consumption Expenditures in US Recoveries, 1949Q4–2016Q4 (trough=100)

Sources: BEA; National Bureau of Economic Research (NBER); authors’ calculations
Index of Gross Private Investment in US Recoveries, 1949Q4–2016Q4 (trough=100)

Sources: BEA; National Bureau of Economic Research (NBER); authors’ calculations
Index of Government Expenditure in US Recoveries, 1949Q4–2016Q4 (trough=100)

Sources: BEA; National Bureau of Economic Research (NBER); authors’ calculations
Index of Imports in US Recoveries, 1949Q4–2016Q4 (trough=100)

Sources: BEA; National Bureau of Economic Research (NBER); authors’ calculations
Baseline Scenario

- Builds on the CBO’s *The Budget and Economic Outlook: 2017–2027*
- Examines the conditions necessary for these projections to materialize.

<table>
<thead>
<tr>
<th>Year</th>
<th>Deficit</th>
<th>Outlays</th>
<th>Revenues</th>
<th>Growth Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>3.2</td>
<td>20.9</td>
<td>17.8</td>
<td>1.6</td>
</tr>
<tr>
<td>2017</td>
<td>2.9</td>
<td>20.7</td>
<td>17.8</td>
<td>2.3</td>
</tr>
<tr>
<td>2018</td>
<td>2.4</td>
<td>20.5</td>
<td>18.1</td>
<td>2</td>
</tr>
<tr>
<td>2019</td>
<td>2.9</td>
<td>21</td>
<td>18.1</td>
<td>1.7</td>
</tr>
<tr>
<td>2020</td>
<td>3.2</td>
<td>21.3</td>
<td>18.1</td>
<td>1.5</td>
</tr>
</tbody>
</table>

Note: Deficit, Outlays and Revenues as percentage of GDP

**Table:** CBO baseline projections, 2016-2020
Real GDP Growth Rate: Actual and CBO Projections, 2010–18

Sources: CBO; authors’ calculations
Baseline Scenario: Main Sector Balances, Actual and Projected, 2005–20

Sources: BEA; authors’ calculations
Baseline Scenario: Ratio of Household Debt to GDP by Sector, Actual and Projected, 2005–20

Sources: BEA; Federal Reserve; authors’ calculations
The Trump Effect

The most important of the economic proposals of the new administration include:

- Repeal and replacement of the Affordable Care Act
- Investment of $1 trillion over 10 years in public infrastructure projects
- Tax cuts for corporations and households
- Reduction of the government deficit
- Aggressive renegotiation of trade agreements and reform of taxation policy to reduce the trade deficit
The Trump Effect

- Financial Markets have reacted exuberantly
- The proper question to ask is, to what extent is this optimism warranted?
- Any policy measures need to be evaluated in terms of the three major structural problems of the US economy:
  
  (1) high income inequality  
  (2) pervasive fiscal conservatism  
  (3) weak net export demand
Mick Mulvaney, the new director of the Office of Management and Budget, is one of the most fiscally conservative politicians in Washington.

The first budget proposal of the new administration does not foresee any fiscal expansion.

Recent negotiations in Congress about the new health-care bill show that the fiscally conservative wing of the Republican Party has gained unprecedented leverage.

The budget proposal is a good example
The zero-sum character of the new administration’s fiscal decisions will have a negative impact on inequality.

Income inequality will also be affected if the contemplated tax reform is successfully negotiated.

Two Republican plans for tax reform:

1. Ryan plan: 99.6 percent of the tax cuts will benefit the wealthiest 1 percent
2. Trump plan: 50 percent of the tax cuts will benefit the wealthiest 1 percent
Infrastructure Investment

- We have argued in favor of a large public infrastructure investment plan.
- The promised infrastructure investment plan will be a plan of tax cuts for corporations that engage in infrastructure investment.
- Inferior compared to implementation of direct government expenditures: a big portion of the tax cuts will be tied to public works that would materialize in any case.
- Given the desired fiscal neutrality of the government negative side effects on inequality.
- Unclear what proportion would be made up of projects to increase border security.

For the moment, the only concrete infrastructure-related measure has been the proposed reduction of the Department of Transportation spending by 13%.
Infrastructure Investment

- We have argued in favor of a large public infrastructure investment plan
- The promised infrastructure investment plan will be a plan of tax cuts for corporations that engage in infrastructure investment
- Inferior compared to implementation of direct government expenditures: a big portion of the tax cuts will be tied to public works that would materialize in any case
- Given the desired fiscal neutrality of the government negative side effects on inequality
- Unclear what proportion would be made up of projects to increase border security
- For the moment, the only concrete infrastructure-related measure has been the proposed reduction of the Department of Transportation spending by 13%
Trade Policy

- The new administration has also promised an aggressive trade policy to reduce the trade deficit (tariffs, “border adjustment tax”)
- It is very unlikely that the US trading partners will not react to such aggressive policy measures.
- The underlying analysis of these measures is based on a “Ricardian” view of trade
- Nowadays, trade along integrated international value chains.
- A big portion of US imports from Mexico and China is made up of this kind of intermediate or capital goods
- In this case, the imposition of tariffs or border adjustment taxes has uncertain effects.
Republican conflicts

- A remaining issue with the new administration’s proposed measures is that they are unlikely to satisfy the conflicting interests of the two principal factions within the Republican majority.
- The case of the health-care bill that aspired to replace the Affordable Care Act is telling.
- Someone can imagine similar deadlocks over most of the administration’s proposed measures.
Financial Markets

- The stock market increased 12% in only four months
- The new president recently boasted that the stock market had gained $3.2 trillion since his election.
- This last run started from an already elevated level:
  1. As of April 17, the S&P 500 Index stood at 2,349 points.
  2. This is 350% higher than its trough in March 2009.
  3. Over the same period output prices increased by 13%
Ratio of Market Capitalization to GDI and Net Operating Surplus, 1971–2017M01 (1971M01=100)

Note: The index is calculated as the ratio of the end-of-period Wilshire 5000 Total Market Index to GDI and net operating surplus, respectively.

Sources: BEA; Wilshire Associates; authors’ calculations
Shiller Cyclically Adjusted Price–Earnings Ratio P/E 10, 1881–2017M03

Source: econ.yale.edu/~shiller/data.htm

Source: S&P Dow Jones Indices LLC
Scenario 1

What will happen when the optimism fades?

- Stock market falls in the second half of 2017 and the first half of 2018, then stabilizes for the rest of the projection period.
- The S&P 500 Index falls to around 1600 by the second quarter of 2018—still above its precrisis levels in 2000 and 2007.
- The fall in the stock market induces a second round of deleveraging lasting from the end of 2017 to the end of the projection period.
Real GDP Growth Rate, Actual and Projected, 2014–20

Sources: BEA; authors’ calculations
Conclusion: This time is not different

Achieving sustainable economic growth in the United States requires addressing its three fundamental problems:

- a decrease in income inequality,
- improve the US external position, and
- relaxation of the government’s fiscal stance.

The Trump administration is unlikely to solve any of these—if anything they will get worse

- Asset markets pose a threat for the economy
- Reversal could be triggered by other reasons