The Trump Effect: Is This Time Different?

Michalis Nikiforos

Levy Economics Institute of Bard College

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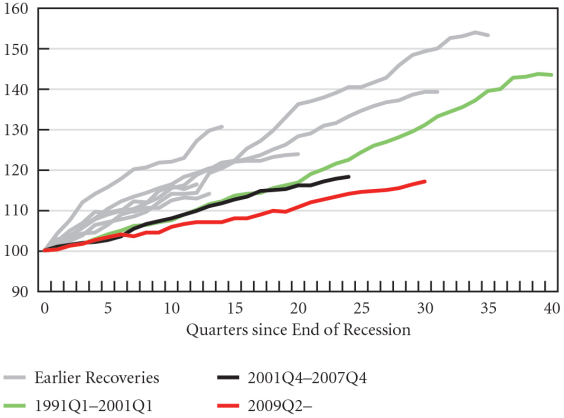
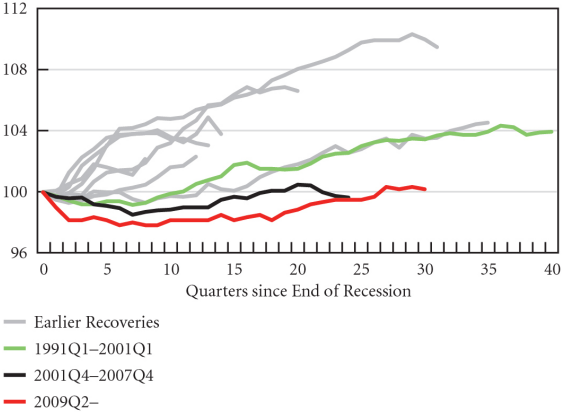
Index of Real GDP in US Recoveries, 1949Q4–2016Q4 (trough=100)



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

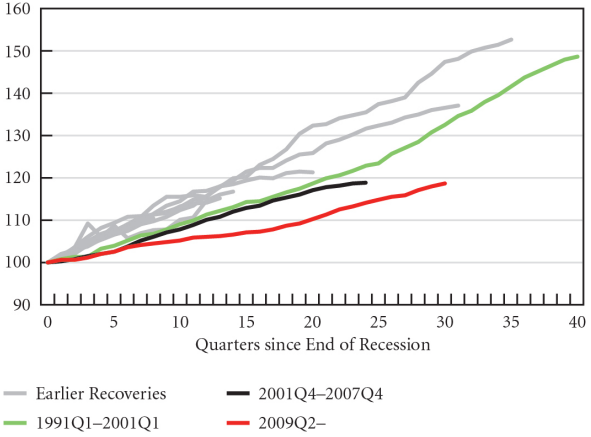
In recent reports we have identified three main structural impediments to a robust, sustainable recovery:

1. high income inequality
2. weak net-export demand
3. the fiscal conservatism

Three Major Structural Problems

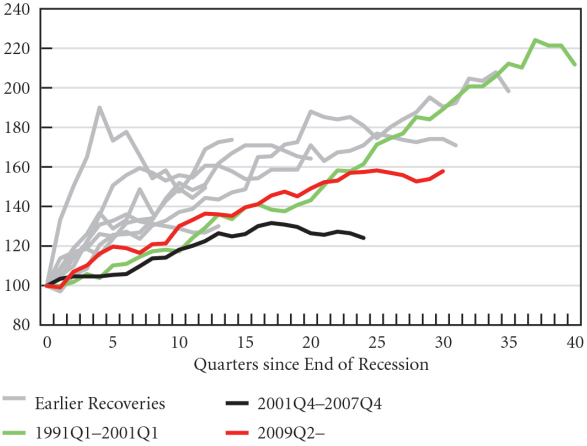
- If an economy faces weak net-export demand and at the same time there is a restrictive fiscal policy, economic growth becomes dependent on rising private borrowing
- Growth is the result of a spectacular rise in private expenditure *relative to income* and thus an increase in the debt to income ratio 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)



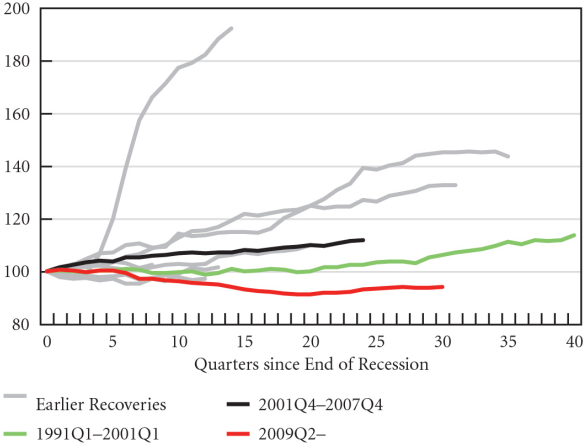
Sources: BEA; National Bureau of Economic Research (NBER); authors' calculations

Index of Gross Private Investment in US Recoveries, 1949Q4–2016Q4 (trough=100)



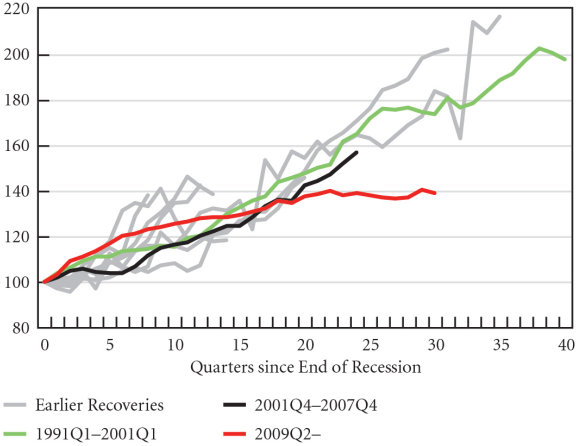
Sources: BEA; National Bureau of Economic Research (NBER); authors' calculations

Index of Government Expenditure in US Recoveries, 1949Q4–2016Q4 (trough=100)



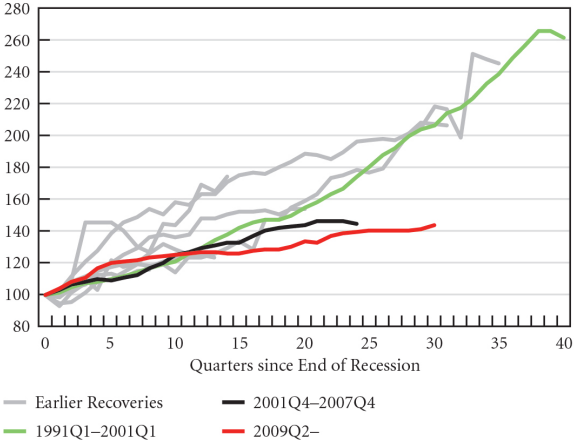
Sources: BEA; National Bureau of Economic Research (NBER); authors' calculations

Index of Exports 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

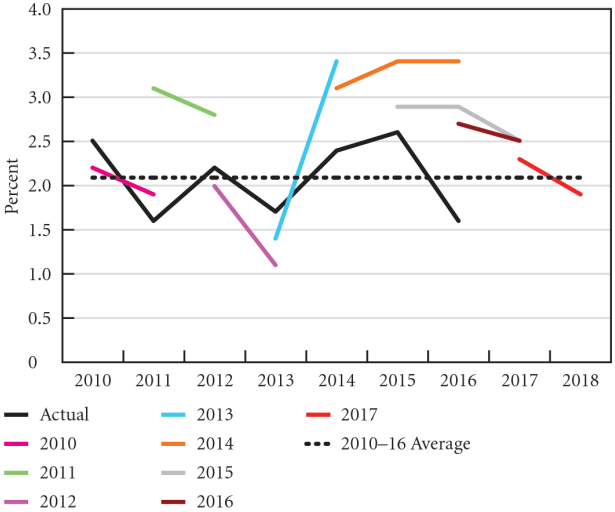
- Builds on the CBO's *The Budget and Economic Outlook: 2017–2027*
- Examines the conditions necessary for these projections to materialize.

Year	Deficit	Outlays	Revenues	Growth Rate
2016	3.2	20.9	17.8	1.6
2017	2.9	20.7	17.8	2.3
2018	2.4	20.5	18.1	2
2019	2.9	21	18.1	1.7
2020	3.2	21.3	18.1	1.5

Note: Deficit, Outlays and Revenues as percentage of GDP

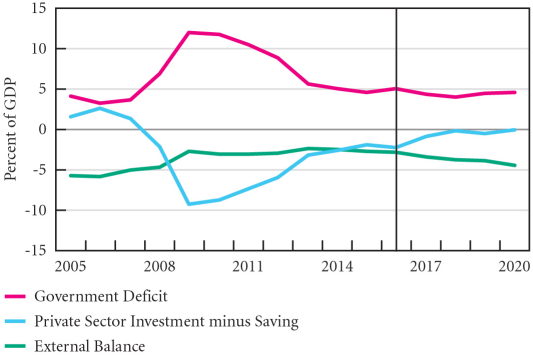
Table: CBO baseline projections, 2016-2020

Real GDP Growth Rate: Actual and CBO Projections, 2010–18



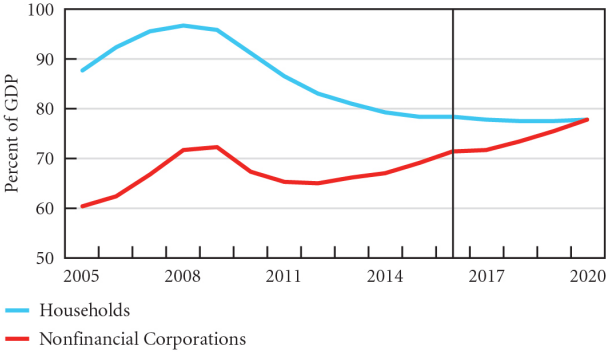
Sources: CBO; authors' calculations

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

Fiscal Expansion

- 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

Inequality

- 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

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- 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

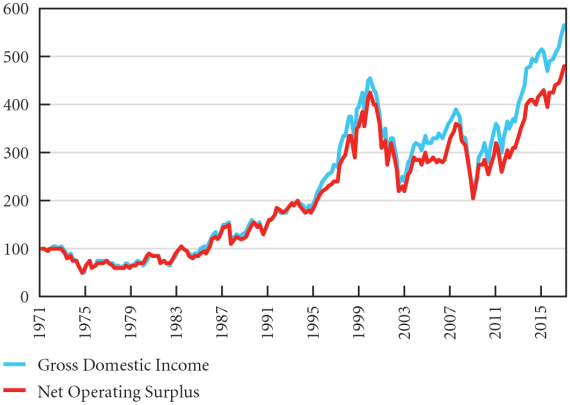
- A remaining issue with the new administration's proposed measures is that they are unlikely to satisfy the conflicting interests of the two principal factions within the Republican majority.
- The case of the health-care bill that aspired to replace the Affordable Care Act is telling.
- Someone can 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%***

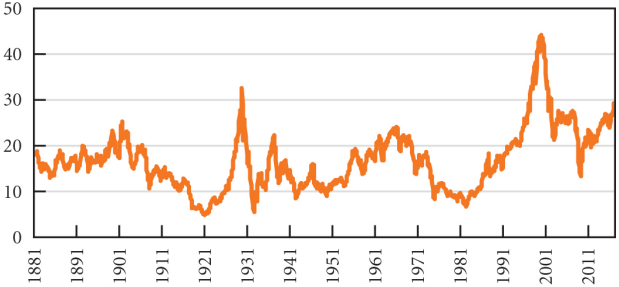
Ratio of Market Capitalization to GDI and Net Operating Surplus, 1971–2017M01 (1971M01=100)



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.

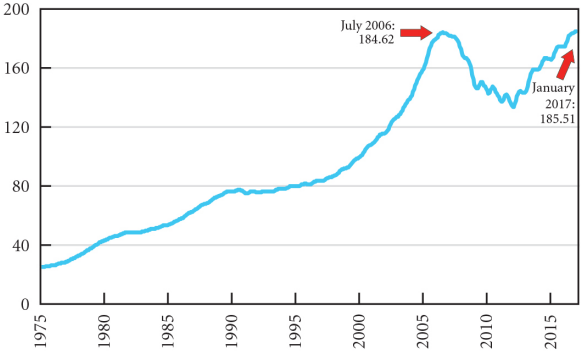
Sources: BEA; Wilshire Associates; authors' calculations

Shiller Cyclically Adjusted Price–Earnings Ratio P/E 10, 1881–2017M03



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

S&P/Case-Shiller US National Home Price Index, 1975–2017M01 (2000M01=100)



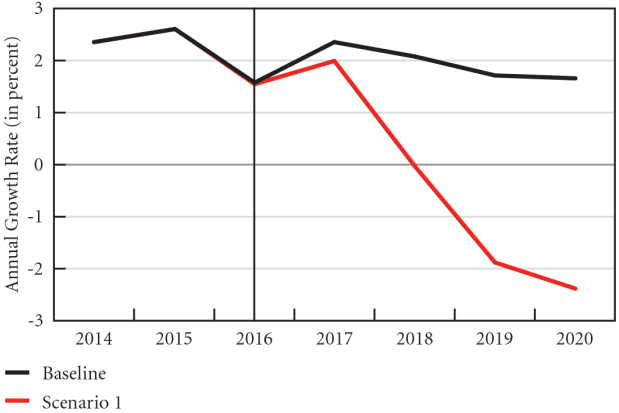
Source: S&P Dow Jones Indices LLC

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