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Trumponomics

Donald Trump's economic agenda promises epochal changes to the economies of the United States and the world. "Trumponomics" does not attempt to manage inequalities in income, well-being or education. However, the new administration's macroeconomic policies should reinforce and accelerate the current expansion, creating a strong stock market and stronger dollar.

The 2016 US elections produced a sea change in American politics, rivaling – and perhaps surpassing in long-term consequences – previous shifts (such as that after World War II, or thanks to Johnson's Great Society). The US political upheaval comes from what has been brewing a long time: mainly, the economic squeeze of the middle class. This has been poorly understood by most and certainly not at all by the American establishment. The upheaval also stems from social inequalities, a dysfunctional Washington, and unhappiness with the intellectual and policy elite who do not seem to understand the angst of ordinary people.

A disgruntled American public – indicated clearly in

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a “disconnect” between excellent statistics on the US economy and the unhappiness of the US body politic – is in line with the restive nature sweeping much of the world. Other examples include Brexit, the growing influence of the far right in Europe, the referendum result in Italy, dissatisfaction in Japan, and geopolitical terror and conflict all over.

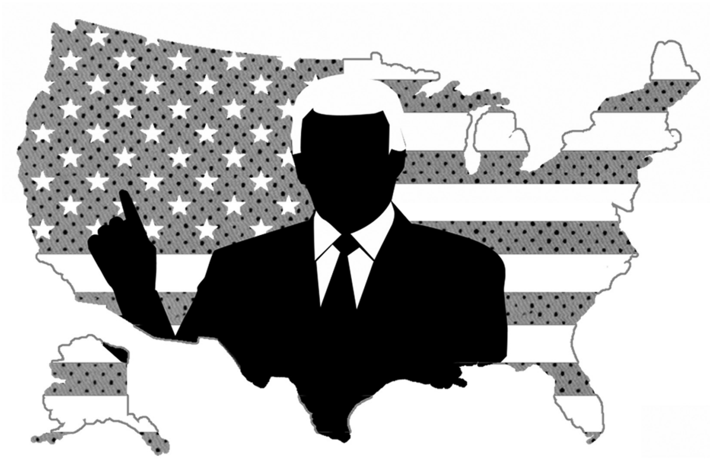
In the United States, the surprising victory of Trump came in a bizarre campaign and election process, with the candidates spending most of their time reviling each other. In their fighting, little attention was paid to major economic and social issues. But these issues are enormous and numerous, and beneath the politics of the election and its aftermath are huge waves emanating from that epochal sea change. The world is now going to be buffeted by a host of looming disruptive changes under the rubric of “Trumponomics”.

Will the US economy grow faster and gain strength? How will the United States behave as regards trade and immigration? What effects will the sea change have on global economies? Overall, is a brighter or dimmer future ahead?

ECONOMICS UNDER THE NEW ADMINISTRATION. Trumponomics encompasses tax policies, federal government outlays, international trade agreements, potential protectionism, immigration, government regulation, healthcare, and such things as appointments to the Federal Reserve and Supreme Court, where decisions not only affect society but can also have an impact on the economy. It does not include climate change, perhaps an unfortunate omission.

The Republican president and Republican Congress feel they have been given a mandate to achieve sweeping change. And indeed, despite having lost the popular vote, Trump and the House Speaker Paul Ryan will have their way in legislation on a variety of matters.

On taxes, Trump has an important ally in Ryan, a man of details and data (perfect for a president who does not do details nor retain the figures and data necessary for such things as macroeconomic policy and policies). Ryan spearheaded Republican recommendations and documents, such as "A Better America" (a June 2016 publication), and for years has been a student of tax reform and proponent for changes to simplify the tax code. He aims to



reduce individual income and corporate profits tax rates, close some loopholes – such as carried interest – and phase out some tax expenditures. Such changes in the US tax system lie at the heart of Trumponomics.

Reductions in individual income and corporate profits tax rates to 33% and 15% maximum rates – offsetting tax changes on exemptions, carried interest and a one-time 10% rate on bringing back funds companies hold abroad – will cost approximately a net $400 billion per annum, ex ante, and be quite stimulative to consumer spending, business outlays and capital spending. It is bound to stimulate the economy overall.

Individual tax rates are to be reduced from a maximum rate of 39.3% to 33% in a system of three tax brackets versus the current seven, with the 33% reaching down to families with adjusted gross income of $200,000 and up. The propensity to spend income from tax reductions in this bracket is quite high, going up to almost $400,000 of family income. The propensity to save is extremely high for families in higher income brackets. Funding and liquidity flowing through financial intermediaries to new businesses, entrepreneurs and innovators are supported strongly by the savings out of high-income and high-net-worth families: it represents a supply-side stimulus. Lower marginal income tax rates provide incentives to spend, to save, and to work.

On the spending side, a constituency has emerged in the US and worldwide for more aggressive central government spending given the anemic performance of the US and other economies for so many years, as well as price inflation, which has been too low.

Large increases in infrastructure and military spending – to some extent already begun in the US on a recently passed $305 billion highway bill – will be forthcoming, expected roughly at about $100 billion per annum. Overall, the fiscal stimulus, both in tax reductions and spending increases, should average about 2.5% of nominal GDP per annum. This is a smaller package than under Reagonomics, a little larger than in the Kennedy-Johnson years, and similar to the George W. Bush tax reductions. In contrast, over the past five years there has been no fiscal stimulus; indeed, taxes have been raised and federal government purchases have remained flat, with a sequester in place, after adjustment for inflation.

The upcoming fiscal stimulus, qualitatively and quantitatively, represents a sea change in fiscal policy, turning the long period of fiscal restraint and austerity (in place since 2012) on its end.

ON TRADE AND IMMIGRATION. Trade and globalization, two major thrusts of the past, are likely to undergo a sea change as well. Previous treaties and trade agreements will be revisited and changed, and the long-time security relationships of the United States with its allies will be re-examined. It is uncertain how the degree of protectionism, possible trade wars, and the effects of changing or repudiating trade agreements such as NAFTA might affect US and global trade. But, certainly, trade flows will be impeded as measures emerge that abort the tendencies toward free trade and globalization. For the United States, exports and imports range from between 12 to 14% of real GDP – not that large – and both US exports and imports and other countries' exports would be casualties of tariffs, volume restrictions, various sorts of trade frictions, and even trade wars.

The net effect from this on the American economy is likely to be minimal, however. When arrayed against the aggregate size of consumption and business spending in the economy, US trade is small. Aggregate consumption, residential construction, and business capital spending total 80 to 85% of real GDP in the United States; these are the areas of spending that will call the tune on growth. All told, even in a worst case scenario, the power of the tax cuts and increased government spending versus the damage on trade from protectionism and trade wars will still leave the economy growing much more strongly than before.

Immigration affects the supply side of the US economy, although it has some effect on aggregate spending as well. The deportation of 2 or 3 million Mexican immigrants, for example, or the stemmed flow of foreigners into the United States, together with the fear of retribution from a tough program on immigration, would reduce the supply of labor, hinder the growth of potential output, and produce higher wages for workers in the United States, along with higher price inflation from cost-push. Also, interest rates would rise as a consequence.

American consumers would lose out in the end. The way of life of immigrant America would also be altered irrevocably. But here, too, the weight of the macro pro-growth tax cuts and spending increases would far surpass any limitations on the economy from the supply side having to do with immigration.

DEREGULATING THE REGULATED. The watchword for now will be deregulation. Trump will undo much of what was legislated in Obamacare and embodied in the Dodd-Frank legislation. The "Repeal and Replace" slogan of candidate Trump remains the guideline on Obamacare.

It should be noted that there is agreement across parties about medical insurance for all those without pre-existing conditions and for young adults under their parents' policies if still living at home, as well as regards portability. But hundreds and hundreds of regulations since Obamacare was passed – set by regulators and the executive – will be reviewed and examined and likely ended or rolled back. The economic impact of healthcare is large and getting larger in the US economy; however, in truth, amending or repealing Obamacare will not have much macroeconomic impact.

On the other hand, a rolling back of Dodd-Frank financial services legislation will have significant economic and financial market consequences. This legislation, which increased the capital requirements of banks and eliminated trading from bank profits and losses (with the Volcker rule), among other things, has been, and remains, very controversial.

To start with, the Volcker rule, which ended all non-customer trading in financial institutions, could go. The ending of trading at financial institutions probably was overdone. The glaring problem was the use of depositors' funds as the capital of the institution and the leveraging up of that "capital" into extremely risky trading and investments to pump up profits. It was through this mechanism that many derivatives were created and traded that helped bring down the financial system. What is needed now is not a return to Glass-Steagall, but barriers that prevent the depositors' funds – meant to be held safely – from being diverted into P&L trading units. Carried out safely and carefully, trading is a proper function of financial institutions; it is a source of revenues and earnings and serves to offset other risky investments that financial institutions may be making. An undoing of numerous regulatory changes in Dodd-Frank augurs well for banks and banking health, and hence for financial intermediation in the United States' economy and the spending that relates to it.

WHAT IS IN STORE. Despite some offsetting negative economic effects, the upshot of Trumponomics should be much stronger real economic growth in the United States. This economic expansion should continue well into 2019, along with higher inflation, rising interest rates, a stronger US dollar, and bigger federal budget deficits. The supply of workers, depending on what transpires in immigration and immigration reform, may shrink in growth, damping down a rise in potential economic growth (that is, the supply side of the economy) and marginally adding to wage and price inflation. Secular stagnation should fall by the wayside.

How much more real economic growth should be expected? How much more price inflation? And what are the likely macroeconomic results? Initial estimates by Decision Economics, Inc. (DE) suggest 0.5 to 1 percentage points higher real economic growth than otherwise, beginning in the second half of 2017 and continuing well into 2019. Price inflation should rise by 0.3 to 0.7 percentage points. This would put expected real economic growth, as forecast by DE, into a 2.75 to 3.5% range. Price inflation would be thrust into a 2.5 to 3% range. The unemployment rate, instead of falling to 4.3% (the previous DE forecast), would decline to 4% or below.

With a clear "overshoot" on economic growth, full employment and price stability, the Federal Reserve would likely raise interest rates faster and by more than otherwise. Nominal and real interest rates would still be relatively low (although considerably higher than in recent years), but should not derail the economic expansion unless inflation spikes, causing interest rates to be increased even more.

Federal budget deficits – currently at about 3% of GDP – would move higher, to as high as 5%. But, on feedback effects from the fiscal stimulus, anywhere from 25 to 35 cents on a dollar of ex-ante stimulus would flow back in increased tax receipts to the federal government (in personal, corporate, capital gains, social security, and somewhat on excise taxes). Additional sales and capital gains tax receipts would accrue to state and local governments.

THE REST OF THE WORLD. Stronger growth and high inflation in the United States will likely carry over to much of the global economy. Exporters to the United States will benefit greatly from increased consumption and business capital spending. The US consumer sector is huge, almost as large as the eurozone economy itself. Business purchases and production overseas are also quite large. Even with trade frictions on the rise, the overall size of aggregate demand from the United States to the rest of the world should carry other economies higher.

In addition, a strong dollar will make numerous countries more competitive with the United States and make products and services from abroad much cheaper for Americans. Inflation and interest rates will likely move up in countries where currencies fall. Export-oriented commodity producers may well suffer. Though politically tempting, economists will never applaud a world of trade protectionism, tariffs, quotas, and the like. This simply produces net losses for all. A more selective fair trade approach would be better.

FINANCIAL MARKETS. The US stock market, because of stronger earnings growth, is likely keep moving to new highs. In the United States, stronger growth and higher inflation will likely produce faster-growing revenues and higher earnings growth, year-over-year, raising the projected earnings stream to a higher path and providing a source of increased stock market valuations. Rising interest rates on an overshooting of the economy would certainly provide an offset, tending to reduce price-to-earnings ratios against rising earnings.

Historically, in this, a later stage of the business expansion, earnings growth tends to outweigh the rises in interest rates in terms of stock market behavior, promising repeated new highs in equity markets. Equities will remain the allocation asset of choice.

Stronger growth, rising inflation, a hiking of the federal funds rate by the Federal Reserve, increased deficits and deficit financing – along with expectations of further increases of inflation and in federal budget deficits – will tend to push long-duration interest rates up, perhaps quite sharply. A more normal cyclical upturn of inflation and interest rates is the likely consequence. The US dollar could well be super strong, benefiting from growth and interest rate differentials that favor the US currency and standing as a safe haven and "king currency" for the foreign exchange reserves of institutions and countries. Weak currencies against the dollar could lead to unwanted inflation in a number of countries, but that would be met by higher interest rates. Generally, levels of interest rates would rise throughout the world in a classic "bear" fixed income interest rate cycle.

WHAT COULD GO WRONG? A significant feature missing from Trumponomics is any attempt to deal with widening gaps in income, wealth, and educational levels. And yet it is egregious inequality in the United States and in other countries that, in part, has been responsible for the unhappiness of voters. On the surface, Trumponomics appears that it will exacerbate inequality, not alleviate it. In numerous countries, rising inequality has led to political upheaval and political instability, which is definitely damaging to economies.

Yet another problem is the timing of the very large Trumponomics fiscal stimulus: it is coming late in the business expansion rather than early. As such, the possibility of an overheating economy, surprisingly high inflation and subsequent reactions on the part of the Federal Reserve would be a classic set of signs presaging the next recession.

All of these possibilities, and others, could crop up to spoil what, under Trumponomics, looks like a long American and global expansion. All told, however, the DE expectation is for greater global growth and worker gains, not less, under the new US administration.