

What Lies Ahead for US Economic Policy in the Trump Administration

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The Trump Revolution

- The presidential election highlighted a deeply polarized America, and
- The outcome marks a dramatic shift in U.S. foreign policy and economic relations with the rest of the world.
 - The Republican party now controls all three branches of the federal government, and
 - That party is itself being redirected towards a nationalist, 'America First,' and protectionist view of the U.S. role in global affairs.

Sources of Trump' Victory

- Exit polls show that Trump won a majority of male and female *white* voters.
 - Strong support among those who are most opposed to immigration, identify terrorism with Muslims, and fear the economic consequences of globalization.
 - White voters in rural and small urban areas with less than a college education.
- Large realignment of blue-collar workers that were formerly the core of the Democratic party.
- Same groups had strong antipathy to Hillary Clinton.

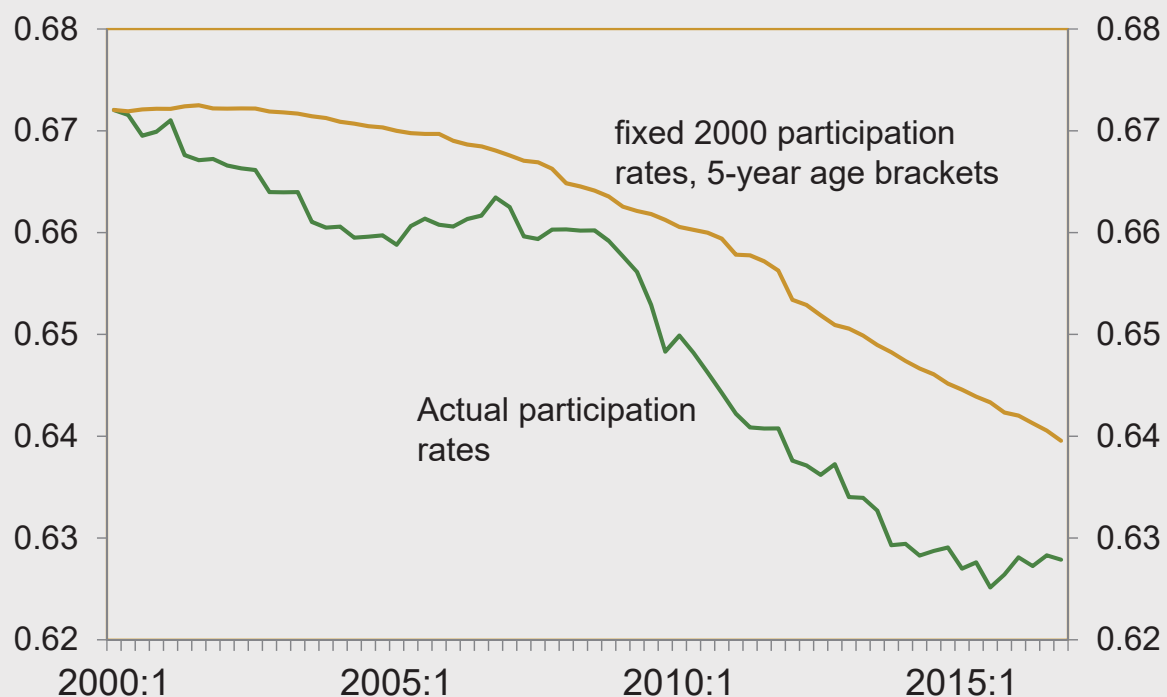
Donald Trump's New Economic Order

- In his inaugural address President Trump articulated a foreign policy perspective centered on putting American interests first.
 - An extreme version of economic nationalism that makes virtues of protectionism and mercantilism.
 - Opposition to multilateral negotiations and institutions in favor of
 - Bilateral negotiations that will maximize U.S. leverage.
- May mark the end of the dominant liberal order of the post-WWII years.

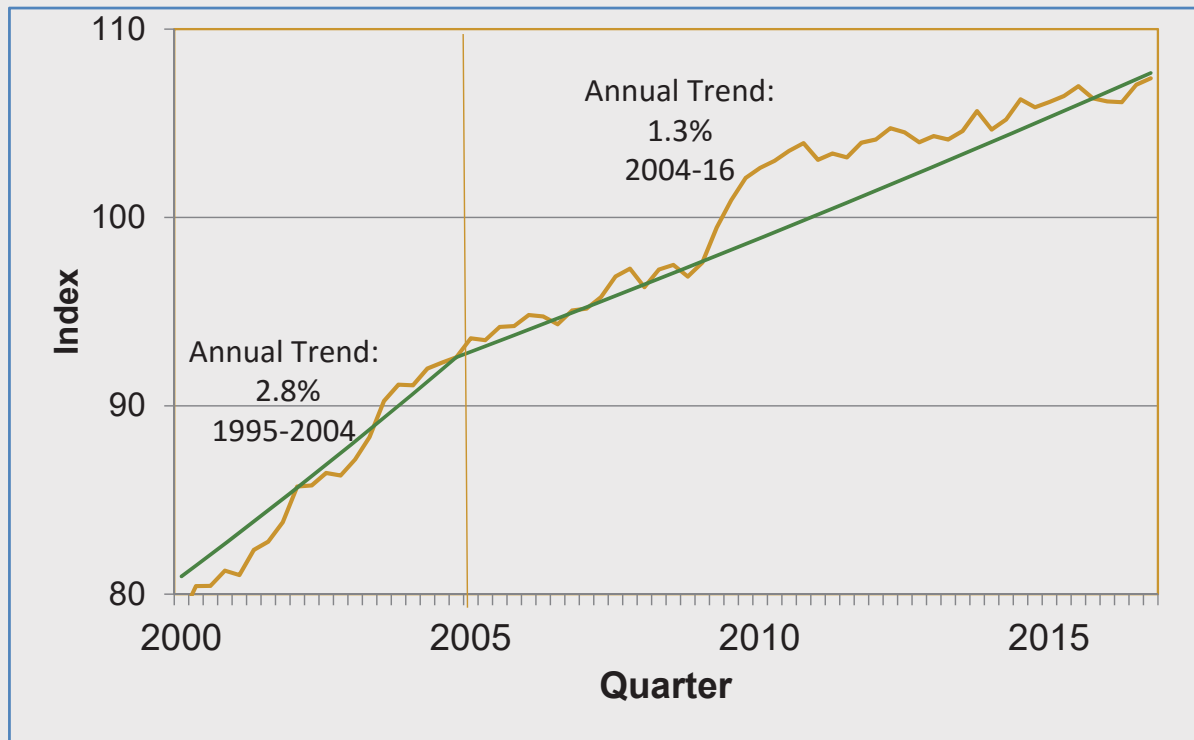
Baseline Economic Outlook

- Economy near full employment
- Unemployment rate of 4.8%
- Slow supply-side growth because of aging labor force and slow productivity growth
 - GDP growth of 2.0-2.5% in 2017 and 2018
 - Inflation rising toward 2% annually
 - FED interest rate increases totaling 0.75 by end of 2017.
- Continued appreciation of exchange rate.

Labor Force Participation Rate



Output Per Person Hour



The Trump Economic Agenda (1)

■ Macroeconomic Policy

- A large tax cut of about 2% of GDP per year
 - Personal income tax rates consolidated at 12, 25, and 33% and increase the standard deduction.
 - Corporate tax rate cut from 35% to 15-20%.
- A large infrastructure (near \$1 trillion) investment program.
 - Introduce significant private control and operation financed by tax credits.
- Represents a large fiscal stimulus that would greatly stimulate GDP, but
- It implies large increases in budget deficits.

Simplified Individual Tax

- Reduce present seven tax brackets to three
 - starting at \$30, \$105, and over \$490 thousand.
 - Rates of (12%, 15%, and 33%), and special 15% for business income.
- Simplified tax structure
 - Replace personal deductions with standard deduction of \$30 thou, and cap itemized deductions at \$100 thou. About $\frac{2}{3}$ of taxpayers will use the standard deduction.
- Eliminate Estate and Gift Tax.
- Revenue loss of about 1.5% of GDP.

Corporate Tax

- Two broad approaches under consideration
 - Rate Reduction Within Traditional Corporate Tax
 - Plan put forth as part of Trump tax cut proposals
 - Rate reduction from 35 to 15%
 - Eliminate most special deductions and tax foreign profits on a realized basis—no deferral.
 - Cash Flow Tax with Border Adjustment (DBCFT)
 - Proposal of Republican House of Representatives
 - Similar to a VAT with additional deduction for payroll taxes. Tax imports, exempt exports.
 - 20% rate with full expensing and no interest deduction.
 - Potential exchange rate offset with large international impacts on net debtor- creditor status.

Analysis of destination-based cash-flow tax (DBCFT)

- Redefine taxable revenues and expenses to exclude foreign transactions.
- Similar to VAT with added deduction of domestic labor costs.
- Immediate expensing of all tangible investments; and elimination of interest deduction.
- Tax simplification with elimination of incentives for income-shifting across border.
- Economic impact is critically dependent on exchange-rate offset.
- Border-tax component is revenue raising if country has a net trade deficit.
- Not WTO compliant.

Economic Implications

- Macroeconomic policy unlikely to be enacted before late 2017 with largest impact in 2018.
 - Some potential conflict within Administration and Republican Congress over expenditure increases and budget deficit.
 - Stimulative policy will drive up interest rates and exchange rate, and worsen trade deficit.
- Administration objectives for faster growth and its focus on reduced trade deficit will be in conflict.
- Whither the exchange rate?

Public Debt Projections

- Pre-Trump Budget Outlook (Congressional Budget Office)
 - Baseline debt-GDP ratio steadily rising under current policies from 77% in 2016 to 87% in 2026.
 - Trump tax plan could raise that by as much as a further 25 percentage points in 2026 if not offset by expenditure cuts.
 - House Republican plan would increase debt-GDP ratio by only about 10 percentage points in 2026.
 - Trump would also raise defense and infrastructure spending and cut other nondefense programs.
 - Very uncertain outcome with current proposals

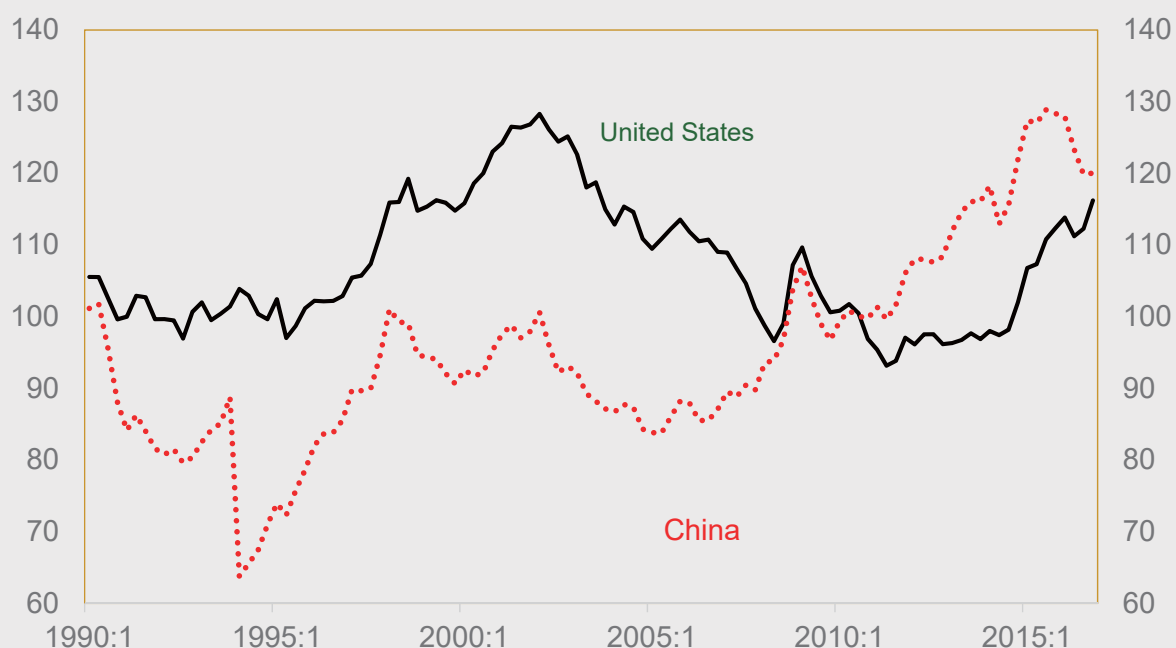
Monetary Offset

- Federal Reserve officials have questioned assumption of a significant potential GDP gap.
 - Implication that interest rates and exchange rate will rise to offset much of the macroeconomic gain.
 - Supply-side benefits are expected to be small.
- Potential for major conflict between Administration and the Federal Reserve
 - Yellen's term expires in February of 2018, and the President will be able to appoint 2-3 board members in 2017.

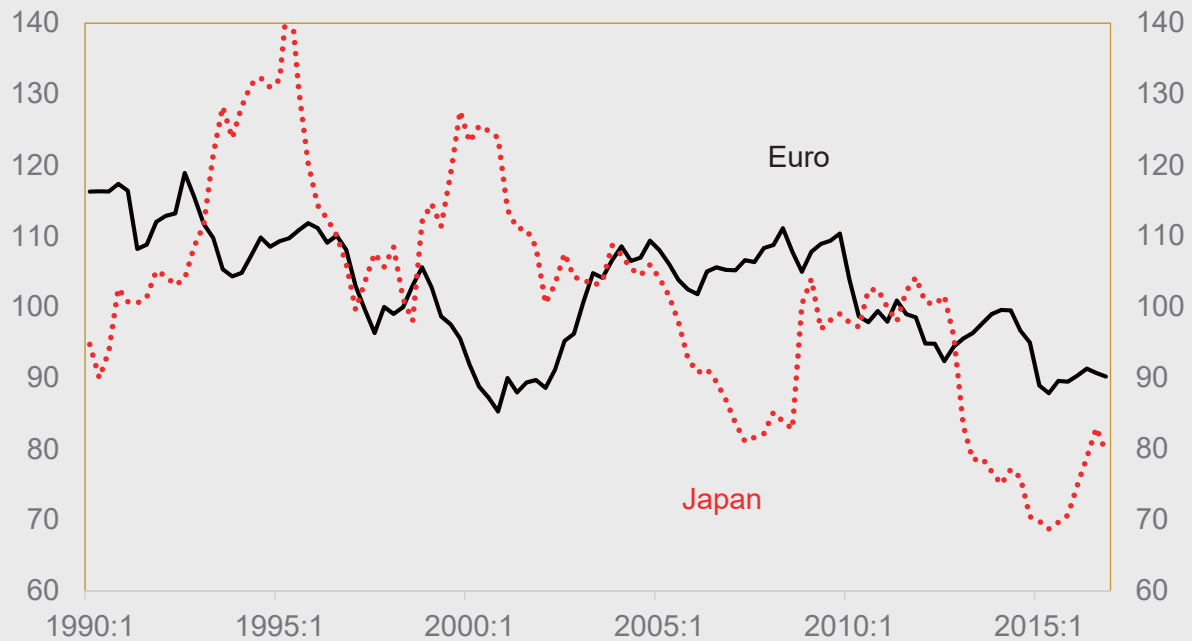
Exchange Rate Outlook

- Stronger economic outlook and prospect for interest rate increases have already increased trade-weighted exchange rate by 15 percent over past two years.
 - An offset for an across-the-board 20% tariff would raise that by another 25 percent.
 - Impact on trade flows suggests a gradual adjustment.
 - Analysis is complicated by role of asset markets and financial investment responses. Asset reactions could lead to an overshooting.

Trade-Weighted Real Exchange Rates, Consumer Prices, 1990-2016



Trade-Weighted Real Exchange Rates, Consumer Prices, 1990-2016



The Economic Agenda (2)

- Trade Policy
 - United States has withdrawn from TPP, and Trump is opposed to all multilateral trade pacts.
 - Administration will place major pressures on trade with countries that have large bilateral trade surpluses with the United States (ie China and Mexico).
 - Cancel or renegotiate NAFTA
 - Label China a currency manipulator (an outdated issue?)
 - Pursue unfair trade charges against China, primarily over issue of subsidies.
 - Potential tariffs of 35% (Mexico) and 45%(China)
 - Trump expresses very mercantilist views and focuses on bilateral trade balances.
 - His business supporters may moderate his views, but policies are a huge part of his appeal to his core constituency.

U.S. Bilateral Trade Balances, Billions, 2016

Country	Exports	Imports	Trade Balance Goods	Balance Goods & Services
Global	1,460	2,210	-750	-501
EU	270	417	-165	-102
Germany	49	114	-64	-77
Canada	267	278	-11	6
Mexico	231	294	-63	-57
China	116	463	-347	-334
Japan	63	132	-69	-55
Korea	42	70	-28	-18
Other	471	556	-67	62

NAFTA

- Formal agreement will probably be scrapped and replaced with bilateral agreements with Canada and Mexico.
- Cancellation of NAFTA only implies a return to MFN tariff rates
- A bilateral agreement with Canada raises few new issues, but
- Renegotiation with Mexico threatens large disruptions.
 - Bilateral trade imbalance in the range of \$60B.
 - US investment in Mexico of about \$100B
 - Potential tariff of 2-35% on imports from Mexico; Impact will be initially on US consumers, but large long-run cost to Mexico.
 - Demand that Mexico pay for a border wall.

International Institutions

- Trump's "America first" approach suggested that he will be dismissive of major international institutions, G-20, IMF or World Bank, given his preference for bilateral negotiations; but
 - He may be attracted to the public forum that they provide.
 - Appointed major figure as UN ambassador.
 - Will not be supportive of expanded role of large emerging economies.

Immigration

- Initial actions adhere closely to Trump's campaign themes.
 - A ban on visitors from seven Muslim-majority countries and all refugees.
 - Deportation of those at US airports has been temporarily blocked by courts.
 - Law forbids discrimination in the issuance of an immigrant visa because of the person's race, sex, nationality, place of birth or place of residence.
 - Expanded deportation program for undocumented workers.
 - Construction of a wall on border with Mexico.

Climate Change

- Trump has vowed to cancel US participation in the Paris accord of 2015
 - While formal withdrawal would involve a 3-year delay, he could simply not enforce the provisions.
- Reverse President Obama's regulations—Clean Power Plan--on electric power generation which were aimed as reducing emissions, largely from coal.
 - Coal industry will not expand without direct subsidy.
- Expansion of production from domestic oil and natural gas will continue; but the Administration will scale back promotion of alternative fuels.

Environmental Regulation

- Restore regulatory approval for pipelines
 - Previously halted by Obama administration.
 - May be delayed or blocked by court challenges.
- Remove some regulatory constraints on Coal.
 - Primary issues is economic not regulatory.
 - Coal is losing out to natural gas from fracking.

Implications for Asia

- The United States has withdrawn as a major advocate and participant in multilateral economic alliances in Asia.
- Heightened conflict between the United States and China over trade and investment policy.
- Prior participants in TPP could move ahead with a regional FTA broadened to include China and South Korea.
 - Trump has reopened the battle over protectionism.
 - Need for an Asian FTA to promote tariff reduction and the codification of next generation rules for trade and cross-border investment.