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Focal Point

Trumponomics and the case for higher US rates

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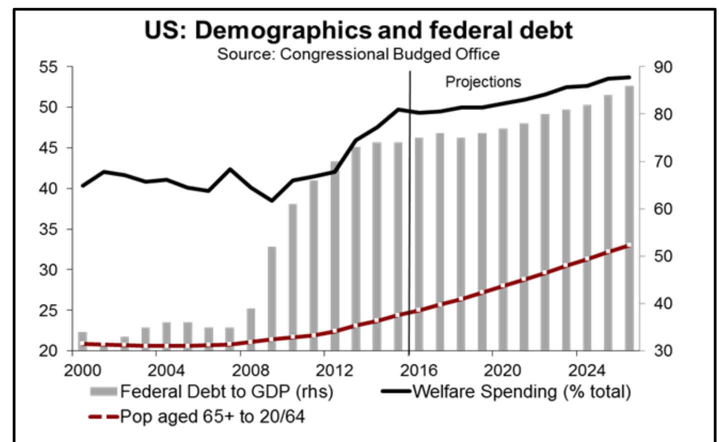
- Financial markets have hailed the election of Donald Trump as next US President with strong reflationary hopes.
- The full details of the next US administration's fiscal policies are still unclear. Mr. Trump's ambitious tax cuts and infrastructure expenditures plans will unlikely be implemented in full amid resistance by parts of the Republican Party.
- In a base case, we expect tax cuts of around 1% of GDP and extra infrastructure investment of 0.4% of GDP, effective no earlier than Q4 2017. Broader protectionist measures seem unlikely to bite before H2 2018.
- The fiscal package would help lift GDP growth from 1.6% in 2016 to 2.2% in 2017 and 2.4% in 2018 and will mildly add to existing price pressures, with upside risks if tariffs are implemented.
- While further Fed tightening will remain much more gradual than in earlier hiking cycles, the new measures will further strengthen the case for a normalization of US monetary policy, likely resulting in three key rate hikes in 2017.

The election of Donald Trump as the next US President backed by a Republican majority in Congress has triggered broad-based hopes of a growth-friendly and reflationary outlook for the US economy and financial markets. Quickly brushing aside concerns about political risks, US equity markets have rallied by more than 6% since the Election Day (November 8). Yields on 10-year US-Treasury bonds have soared by 70 bps to the highest level since autumn 2014 along with a further rise in long-term inflation expectations. The actual implementation of the new policies is still subject to large uncertainties. Nonetheless, in this note we attempt to shed some light on how they could unfold and affect the economy, including updated projections for US growth and inflation and the implications for monetary policy.

Concerns over debt to limit tax cuts

Trump's electoral campaign program foresees a reduction of rates on personal income tax, more pronounced for the highest brackets, and a cut to the rate on corporate income taxation from 35% to 15%. The non-partisan Tax Foundation has estimated the impact on the budget at around US$ 400 bn per year (2.5% of GDP). Additionally, the fiscal package targets some US$ 550 bn extra infrastructure investment over the next five years, mostly financed by the private sector. Finally, a tax holiday is foreseen to incentivize US multinationals to repatriate the large amounts of cash held abroad. Many crucial details are still missing, but jointly with Mr. Trump's pledge not to cut welfare expenditure, the measures would worsen the outlook for US public debt. According to the latest Congressional Budget Office's projections, even under current legislation federal debt is set to increase by full 12 pp to 86% of GDP over the next decade; at the same time welfare entitlements will continue to increase their share in government expenditure, reducing the scope for cuts to other budget items in order to accommodate tax cuts.

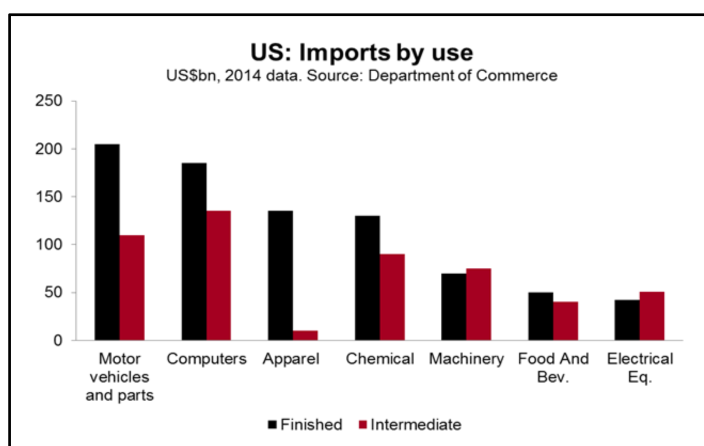


Therefore, the announced large tax cuts are likely to meet resistance by the debt-conscious Republican majority in Congress, whose fiscal agenda foresees tax reductions worth only half of those announced by Trump, to be balanced by expenditure cuts. Moreover, the Republicans do not have the 60-seat majority in the Senate required for measures that increase the deficit, necessitating a compromise with the Democrats. In Mr. Trump's plans, private money for infrastructure will be mobilized through a tax credit and by participation in the revenues generated by

the projects. While this approach reduces the burden on the federal deficit, it may also dampen the impact on GDP. First of all, it restricts funding to revenue-generating projects, which may not be those with the largest economic benefit. Secondly, subsidies may simply lead to a substitution of other forms of financing for existing projects rather than generating additional ones.

Trade restrictions not simple to implement

The other cornerstone of Trump's program, shifting manufacturing jobs back to the US via an increase in protectionist measures, may also run into implementation problems. Nearly one half of US good imports are intermediate inputs used for finished products. As a consequence, import restrictions will directly hit US manufacturers' costs and supply chains. Moreover, they will also result in retaliation hitting US exports. Furthermore, while the President has strong executive powers to impose temporary tariffs on specific countries, any revisions of international agreements like the NAFTA need approval by the Congress.



Fiscal policy prioritized over trade

Taking into account the mid-term elections (Nov. 2018), a realistic path for policy measures could be the following: The Administration may start with tax reforms, offering to the Democrats public money for infrastructures in exchange for corporate tax cuts. It could then force the approval of regressive personal tax cuts by using the "reconciliation" process, which requires just a simple majority in the Senate but is employable only once a year. Corporate tax cuts and infrastructure plans could be approved in Q2 2017, followed by personal income tax cuts in Q3.

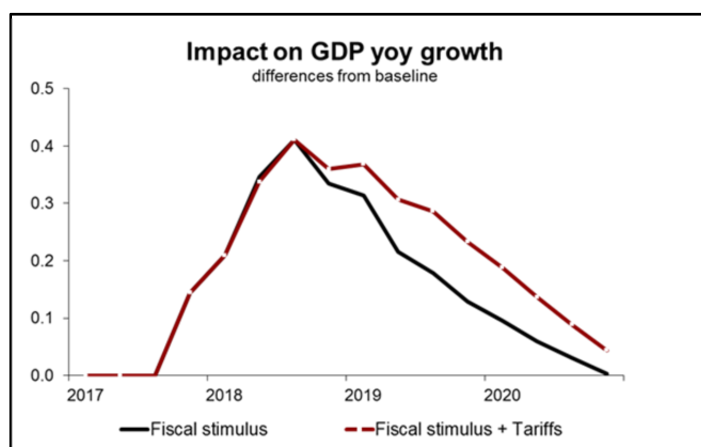
Ultimately, the scale of tax cuts could be similar to the Republicans' plan proposed in 2015. We assume personal income tax revenues to be reduced by US$ 150 bn per year (against US$ 250 bn proposed by Trump) and corporate ones by US$ 100 bn (versus 160 bn). An extra US$ 20 bn/year would be spent on public infrastructures, taking the annual volume of the entire fiscal package to around 1.3% of GDP. Tax credits should trigger US$ 60 bn/year in privately financed infrastructure spending. Due to lack of details, we do not yet consider foreign cash repatriation.

Disentangling the web of trade treaties and strong lobbying by manufacturers will likely lead the Administration to postpone protectionist measures. Tariffs are less likely to be enacted earlier than in the H2 2018. We assume that tariffs raise import prices by 5%, half of what would happen in case Trump's suggestion of a 35% and 45% tariff on respectively Mexican and Chinese exports were to be implemented.

Boost to GDP growth to peak in mid-2018

We gauge the macroeconomic impact of the measures using the FRB/US model used by the Federal Reserve. We devised two scenarios: one with just the fiscal measures, the other with also the increase in tariffs. For simplicity we do not include any retaliation by trade partners.

Higher household and corporate income will spur domestic demand from late 2017. We expect a slightly slower implementation of the infrastructure plans, as firms have to select projects, with extra investment kicking in at the start of 2018. As a result, the contribution to annual GDP growth would peak at just above 0.4% by mid-2018, before petering out. This implies a fiscal multiplier peaking at no more than 0.6. The relatively small boost to the economy is due to two main reasons. First, with the economy operating close to full capacity, the fiscal impulse will provide only a mild growth contribution, much less than e.g. the 2008/09 stimulus that helped reduce a large output gap. Second, the bulk of the fiscal action is on tax cuts, whose impact hinges on households' and corporations' propensity to spend. But the tax cuts would benefit most the richest households with a lower propensity to consume.



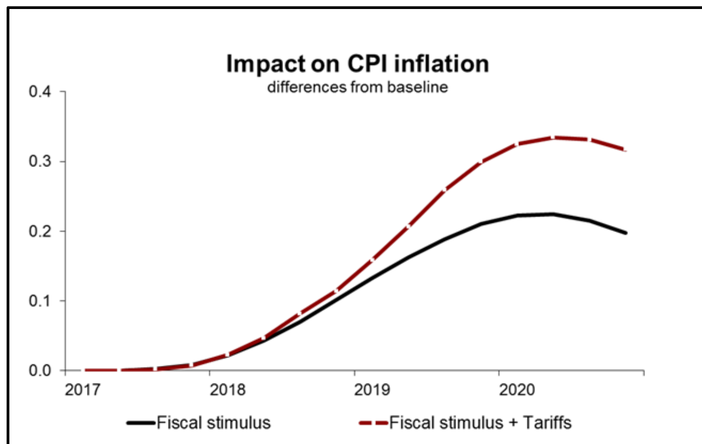
The inflationary pressures stemming from stronger demand would materialize slowly, with a meaningful impact (quantifiable in 0.2 pps of extra annual inflation) no earlier than in H2 2019. Yet already a mild increase in tariffs would have a larger impact on inflation.

Based on this evidence, we now see US GDP growth at 2.2% in 2017 (from 1.6% this year) and 2.4% in 2018, with a similar pattern for CPI inflation (2.2% in 2017 and 2.4% in 2018). The fiscal deficit is likely to increase by 1.2 pp by 2018, to just below 4% of GDP.

Strengthened case for Fed policy normalization

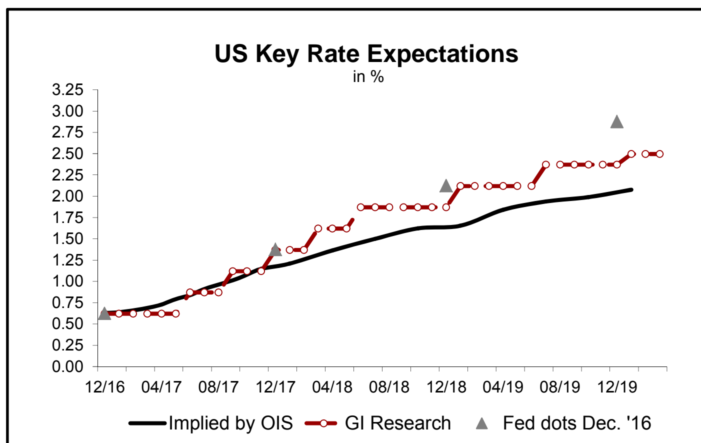
Against this picture, the case for faster monetary normalization by the Fed has strengthened. On Dec. 14, as widely expected, the FOMC increased the Fed funds rate by 25 bps to a range between 0.5 to 0.75%. More surprisingly, the Fed also raised its 2017 median rate projections ('dots'), implying three 2017 rate hikes (by cumulated 75 bps) instead of just two as envisaged in September. This was accompanied by only a modest upward revision of economic forecasts, which did not yet incorporate prospective new policy measures by the new Administration. This is likely to change, however, once details on fiscal

measures become clearer. We expect this to happen over H1 2017, triggering higher Fed growth and inflation forecasts and a steeper rate trajectory for 2018.



The Fed may yet pause at the March meeting (the next entailing new projections and a press conference), lacking details of plans by the new Trump administration. Furthermore, too quick an appreciation of the US dollar could harm the US manufacturing sector and spell trouble for emerging markets. A stronger exchange rate alongside rising long-term yields would also tighten monetary conditions, substituting for a more immediate rate hike. Finally, with inflation pressures unlikely to accelerate strongly, the Fed may well tolerate some overshooting in the core PCE inflation rate beyond the 2% threshold.

By mid-year, however, the case for monetary tightening may well have grown stronger. The possibilty to fall behind the curve (with the risk of sharper rate hikes at a later stage) may then induce the Fed to act in June, followed by quarterly further hikes thereafter. This tightening cycle would still be much more gradual than previous ones (between 2004 and 2006, the Fed under Chair Alan Greenspan hiked rates by 50 bps every quarter). But it would still mark a strong departure from the ultra-accommodative US monetary policy prevailing over the past decade.



Plenty of risks to this scenario remain. Most prominently, a much stronger rise in US yields and the US dollar may prompt renewed financial market concerns about emerging markets and the global economy. The Fed may also feel obliged to react to unexpected stability risks emanating from Europe. In 2016, such concerns have repeatedly delayed rate hikes. Overall, however, a solid labor market, normalizing inflation rates and a fiscal stimulus make it likely that 2017 will be the year in which the Fed will accomplish a true lift-off in rates.

Imprint

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