Cross-Atlantic implications of the New US policy mix

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Outline

1. TrumpEconomics one year later: what is left? what is new?

2. Trump's economic policy agenda and global imbalances: a quantification of spillovers using QUEST

3. Are Trump policies sowing discord? Implications for global policy coordination

4. Conclusions: making effective use of the benign outlook to address global challenges
The policies (then/now)

Fiscal policy
- ↓PIT  ↓CIT  Border Adjustment Tax
- ↑Infrastructure investment, ↑Military expenditure
- Repeal and replace Obamacare

‘America-first’
- Trade (withdrawal from TPP, renegotiation of NAFTA)
- Migration
- Distrust of international policy fora

De-regulation
- Energy and Environmental (Paris Accord)
- Financial (Dodd-Frank Act)
The economic situation and outlook

- US in late 2016 – a Goldilocks economy?
  - Robust growth [BUT growth potential dented by the crisis]
  - Tight labour market [BUT low participation]
  - Still accommodative monetary policy [BUT weak inflation]

- Strong underlying momentum (high equities, sentiment)

- Indicators related to monetary policy fell from early-2017 peaks (T-bill yields, exchange rate)
Global imbalances in 2017: where are we?
# Trump's economic agenda - spillovers and global imbalances

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- **Fiscal stimulus (tax cuts):**
  - Low multipliers at this stage of the cycle
  - Overheating → Faster rate hikes → → Stronger dollar
  - ↑ CA deficit
  - ↑ deficit and debt
  - tighter financial conditions exacerbating EME vulnerabilities

- **Protectionist policies (tariff hikes):**
  - Modest improvement in the trade deficit
  - Higher import prices → negative effect on domestic demand and employment
  - Stronger dollar
  - Risk of retaliation and trade war
Impact on growth of tax reform: two views

negligible effect on real GDP in the next decade

Significant (e.g. +5%)

- Mature cycle → more decisive response of monetary policy
- Effective US CIT rate in line with G7 peers and falling
- Companies already awash with cash, but not investing
- Moving to a territorial system may encourage outsourcing
- Past efforts to incentivise profit repatriation not successful in boosting investment

- Economic models suggest lower taxes spur investment and growth
- Capital expensing and falling user cost of capital to boost investment
- Elimination of profit-shifting incentives attracting activity back to the US
- Repatriated profits supporting higher employment and wages
But, can the tax reform really boost investment?

United States: Corporate taxes as a share of GDP and pre-tax profits (10-year moving average)

- Corporate Taxes as % of pre-tax Profits (with IVA&CCAdj), lhs
- Taxes On Corporate Income as % of GDP, rhs

United States: Investment and corporate profits as % of GDP (10-year moving average)

- Corporate profits (with IVA and CCAdj), rhs
- Gross Private Domestic Fixed Investment as % of GDP, lhs

Source: U.S. Bureau of Economic Analysis (BEA)
# Fiscal stimulus spillover effects to EA (QUEST)

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<th>(effective corporate profit tax cut of 1% of GDP)</th>
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- **US**: higher investment and GDP → rising inflation and wages → faster normalisation of interest rates → appreciation of the USD → offsetting some of the benign growth effects

- Lower exports and higher imports → widening of the CA deficit

- **EA**: GDP effect small as two effects offset each other:
  - Positive demand spillover to EA and
  - Negative investment spillover due to capital fleeing to the US

- Depreciation of the euro leads to a slight improvement in the trade balance

- **Effect on global imbalances** – US and EA pushed further into disequilibrium
Trump's economic agenda - spillovers and global imbalances

Fiscal stimulus

- CA > 0, OG < 0
- CA > 0, OG > 0
- CA < 0, OG < 0
- CA < 0, OG > 0

End 2017

External Equilibrium
Full Equilibrium
Internal Equilibrium
Tariff increase spillover effects to EA (QUEST model)

Protectionist policies
(+4% tariff hike vis-à-vis the EA, +6% non-tariff barriers no retaliation)

• Higher tariffs and NTBs raise costs of imports and domestic prices → overall loss of wealth weighing on domestic demand and GDP both in US and EA

• The effect on trade balance is modestly negative in the US, and also negative in the euro area

• Retaliation amplifies negative economic impacts

• Effect on global imbalances: GDP loss across the board, marginal widening of the US deficit and narrowing of the EA surplus
Trump's economic agenda - spillovers and global imbalances

Trade protection

CA>0
OG<0
CA>0
OG>0
CA<0
OG<0
CA<0
OG>0

Full Equilibrium
Internal Equilibrium
External Equilibrium

US
[end 2017]

{[tariffs]}

Y
Challenges to multilateralism

- Trade shift to bilateralism
- International Monetary System (Crisis Management, IMF) → US disengagement
- Tax competitive tax shifts
- Financial Regulation risk of partial roll-back
- Migration lacking cooperative solutions
- Climate change US reneging
Challenges to multilateralism: role of the G20 and G7

A new dynamic game?
Conclusions

- At the end of 2017 the US economy seems to be in good shape...
- ...but long-standing challenges remain largely unaddressed [e.g. fiscal sustainability, slow growth potential, etc.]
- The economic policy agenda of the current Administration is not likely to solve these...
- ...but rather risks aggravating the problems
- Important to make use of the benign outlook to address these problems
- Case for international cooperation stronger than ever