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THE TRUMP EFFECT: IS THIS TIME DIFFERENT?

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Introduction

From a macroeconomic point of view, 2016 was an ordinary year in the post–Great Recession period. As in prior years, the conventional forecasts predicted that this would be the year the US economy would finally escape from the "new normal" of "secular stagnation." But just as in every previous year, the forecast was confounded by the actual result: lower-than-expected growth—just 1.6 percent in 2016.

The labor market continued its recovery by adding around 180,000 jobs per month (a number that has risen slightly in the first two months of 2017) and the unemployment rate inched down to 4.7 percent, which was just sufficient to justify the Federal Reserve Board's decision to increase interest rates twice, in December 2016 and again in March 2017. Nevertheless, nominal wage growth remained anemic and the performance of the labor market conditions index—although generally positive—has been subdued.

Expectations of radical changes in economic policy promoted by the newly elected president of the United States dominated economic conditions in the closing quarter of the year and the beginning of this year. Initial skepticism was quickly overcome and markets responded with exuberance after the elections. The stock market, already close to historic highs before the end of the presidential campaign, advanced very rapidly after the election. For example, the S&P 500 Index, already around 600 points above its pre–Great Recession peak, increased by another 250 as of early March 2017—a 12 percent increase in only four months. Overall, the S&P 500 has risen a full 53 percent above its precrisis level in 2007. Normalized for cyclically adjusted earnings (the so-called Shiller P/E ratio), the index is now around the level it had reached on the eve of "black Tuesday" in October 1929.

The rationale provided by market participants for this bubbly behavior is the expectation that the policy measures proposed by the new administration will increase profitability by boosting

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growth and cutting personal and corporate taxes. A more cynical observer would say that a market bubble needs this kind of rationalization in order to justify its advance. In any case, as will be discussed in more detail below, economic policy measures under the new administration are unlikely to produce a significant boost to economic growth, either because there is a misidentification of the underlying problems faced by the US economy; or because the measures proposed correctly identify those problems but are insufficient to solve them; or because some of the proposed measures seem unlikely to generate sufficient support in a fractious Republican caucus and are not likely to be passed into law.

A more enlightening approach to evaluation of the recent performance of and future prospects for the US economy would focus on the principal characteristics of the economy identified in recent Levy Institute Strategic Analyses (Papadimitriou et al. 2013, 2014, 2015, 2016; Papadimitriou, Hannsgen, and Nikiforos 2013). These reports have identified three main structural impediments to a robust, sustainable recovery: income inequality, fiscal conservatism, and the weak performance of US net exports. The increase in income inequality over the last four decades has redistributed purchasing power from low-income households with a high propensity to consume, to rich households whose propensity to consume is much lower. This is an impediment to aggregate demand and growth, especially since private investment expenditures have not responded to the increase in profit flows that has been the consequence of the increase in income inequality.

In the years before the Great Recession, the negative impact of the rise in inequality on demand was counterbalanced by the increased debt financing of private household expenditures, especially those at the bottom of the distribution. Borrowing by the household sector became the main engine of growth for the US economy.

This kind of debt-financed private expenditure was additionally important in supporting growth and employment because it served to counterbalance two other factors: the increasingly conservative fiscal stance of the government and the weak performance of net exports. Both factors had a negative influence on demand and growth, which was offset by the rise in household consumption.

It is worth stressing that these three structural problems are interrelated. To a large extent, fiscal conservatism and the trade agreements that allowed for the increase in the trade deficit are manifestations of the same (political) process that led to the rise in income inequality. In this sense, some recent arguments that treat trade and income distribution as unrelated issues are not useful in understanding their evolution.

In the early years of the recovery from the Great Recession, the debt-to-income ratio of the household sector decreased, largely as a result of defaults reducing debt rather than repayment, but it has nonetheless remained at historically high levels. At the same time, inequality has continued to rise. These two factors (high inequality and fragile balance sheets) have led to the slowest increase in consumption expenditures compared to any previous postwar recovery. In addition, this is the only recovery that has seen negative growth in real government expenditure, while net exports have also not performed well—with the important exception of petroleum products, related to new methods of extracting shale gas after 2011. Therefore, the persistence of the same structural factors that led to the financial crisis and Great Recession remain the major factors behind the slow recovery of the last eight years.

Against this background, it is not hard to understand why the optimism of most economic forecasts has been misplaced. As explained in previous Strategic Analysis reports, given the fiscal stance of the government and the performance of the foreign sector, the acceleration of growth predicted by institutions like the Congressional Budget Office (CBO) and the International Monetary Fund (IMF) is contingent upon either another round of rising household indebtedness similar to that of the 1990s and 2000s or stronger growth in wage incomes. The former is not very likely to happen given the already fragile state of households' balance sheets; but even if it were to happen, it would simply set the stage for another financial crisis. As already mentioned, an outstanding characteristic of the current recovery has been the absence of rising wage incomes, a precondition for increased consumption expenditure or support for higher levels of household indebtedness. Accordingly, solving these three basic structural problems is a necessary condition for the US economy to escape from the disappointing new normal of stagnant growth experienced in the last decade.

The policy proposals of the new administration need to be evaluated with reference to their ability to deal with the structural issues impeding a return to a higher trend rate of

expansion. Interestingly, the electoral campaign of Mr. Trump touched upon all three of these issues either directly or indirectly. Its focus was on the conditions of white working class workers whose incomes had stagnated or declined as their jobs were outsourced, with a promise to drive higher demand for their services via corporate and personal tax reductions, combined with a huge infrastructure spending plan of $1 trillion over 10 years and aggressive trade and tariff policies to generate export demand for US products.

Nearly 100 days into the new administration's management of the economy, evidence that the structural problems will be dealt with is not encouraging; if anything, the recent economic policy proposals are often contradictory and seem to have lost the sharp focus of Mr. Trump's campaign promises. The shift in spending priorities in the proposed budget, the bill to repeal the Affordable Care Act, and the plans for tax reform that have circulated would do nothing to reverse inequality, but rather are more likely to cause it to increase.

Moreover, according to the new secretary of the Treasury and the president himself, fiscal discipline and fiscal neutrality will be among the basic principles of the new administration's budget policy. That means that not only will there be little fiscal stimulus, but several of the proposed policy initiatives (like the increase in defense spending and the tax cuts for the upper-income tax brackets) will require compensatory cuts elsewhere. In particular, the cuts in budgetary support for large-scale transportation projects seem to vitiate the promises on increased infrastructure investment. Budgeted reductions in spending on social services will further increase inequality. Although still not fully articulated, early indications suggest the infrastructure plan would be based on a scheme of tax incentives for the private sector rather than direct government expenditure. Besides the slim chance that such a bill has to pass both houses of Congress, a tax-incentives scheme will certainly have a much narrower impact on the economy compared to a program of direct government spending.

Finally, although government action to decrease the trade deficit would have a positive impact on the economy, this result depends on the absence of any retaliatory action by US trading partners, and that Congress would be able to pass such a bill; both are unlikely. Moreover, the new administration's rhetoric on trade seems to ignore the complexities of modern production and trade patterns. US companies use a large proportion of imports as intermediate goods for production. A tariff on these imports would merely increase costs for US corporations.

In conclusion, it is hard to see how the proposals put forward by the new administration so far respond to the resolution of the basic structural problems of the US economy. A careful assessment shows that beyond the rhetorical flourishes, growth prospects will most likely worsen.

What will happen when the markets' euphoric expectations are disappointed and their confidence and optimism start eroding? This is a significant cause for concern. A sharp correction in the stock market, which could hasten another round of deleveraging in the private sector, could reverse the meager forces driving the current secular stagnation.

A reversal could also be reinforced by the Federal Reserve policy of returning interest rates to a more "normal" level and the impact on longer-term credit markets of an increased supply of assets created by consolidation of its balance sheet. Although the direct effects on demand are likely to be small, they could have serious side effects domestically and abroad.

Finally, the present recovery is already the third longest in the postwar history of the United States, and only three quarters away from claiming runner-up status. Therefore, even from a statistical point of view, a downturn is becoming more and more possible. The difference is that it will now come on top of a recovery that has been slow by historical standards.

As usual, the purpose of the Levy Institute's Strategic Analysis is not to produce short-run forecasts of the future path of the economy. Our discussion—and the related simulations of the prospects for the US economy—has a more strategic orientation, and is focused on the internally consistent evolution of the major economic variables over the medium term.

The Recovery So Far

Over the last year the economy experienced rising growth and falling unemployment. As of the second quarter of 2017 the recovery has entered its ninth year, making it the third-longest recovery in postwar history, only three quarters shorter than the upswing of the 1960s and eight quarters shorter than the upswing of the 1990s. However, for yet another year, the economy's rate of growth in this recovery was a disappointing 1.6 percent, well below conventional expectations.

Thus, as shown in Figure 1, the main macroeconomic features of the US economy continue to move along the same trajectory as in previous years. Panel A shows that real GDP continued to grow in 2016, but at a pace that is by far the slowest in the postwar period. This is an important difference compared to the lengthy upswing of the 1960s, which stands out as the economy's most dynamic expansion.

Consumption (panel B) has a similar pattern. Eight years into the recovery, real consumption has grown only about 18 percent compared to the trough of 2009—similar to the expansion of GDP—and also stands out as the slowest recovery of consumption growth in the postwar period.

Panel C shows that investment decreased in the first half of the year but bounced back in the second. Overall, gross private domestic investment decreased by 1.6 percent during 2016. This is the first year of the current recovery with a negative growth rate for investment, which is usually correlated with a recession. The figures from the Bureau of Economic Analysis (BEA) show that in the three most recent cycles, the years with negative growth in investment were 1990–91, 2001–2, and 2007–9, all of them clustered around business cycle troughs.

Turning to real government expenditure (panel D), there was a mild increase in 2016 (0.8 percent), but overall, at 6 percent it is still lower than eight years ago. This is the only postwar cycle in which real government expenditure has decreased. This fiscal stance is common to both the federal and state and local levels of government, and is one of the main reasons for the economy's slow recovery.

Panel E shows that exports are another major drag for the US economy. Although exports recovered quickly in the early period following the crisis, the strong dollar and slow growth of many of the United States' trading partners have led to very slow growth in more recent years. Essentially, real net exports have not grown at all since the second quarter of 2014—a period of more than two and a half years.

Despite the slow performance of exports, the trade balance (as a percent of GDP) has remained stationary over the last four years. This is obviously related to the parallel slow increase of imports. Panel F shows that the increase in imports during the last three years has been quite small. This is mostly due to the very sharp decline in the imports of petroleum products—which have decreased by almost two percentage points (as a share of GDP) compared to 2011—but also to the slow growth of the domestic US economy and therefore the demand for imports. Without the structural change in US energy production over the recent past, the negative impact of the external sector on growth would have been even greater.

The recovery of GDP, albeit slow, has led to a rapid reduction in the unemployment rate, which dropped below 5 percent in 2016 and reached 4.7 percent in February 2017, close to its lowest point during the previous cycle (Figure 2). Nevertheless, seen from a different angle, the labor market is not as dynamic as the unemployment figures imply. Figure 2 also presents the U6 rate of labor underutilization, which adds all marginally attached workers and those employed part-time for economic reasons to the total number of unemployed. It shows that although the U6 rate decreased significantly, it is still closer to its peak than its trough during the previous cycle. Moreover, a big part of the decline in the unemployment rate is due to workers dropping out of the labor force and the slow increase in the employment-to-population (E/P) ratio. Figure 3 shows that, like GDP, the recovery of the E/P ratio during the last eight years has been the slowest in postwar US economic history; it was only in 2016—seven years after the recovery began—that the E/P ratio returned to the level it held at the beginning of the recovery.[1]

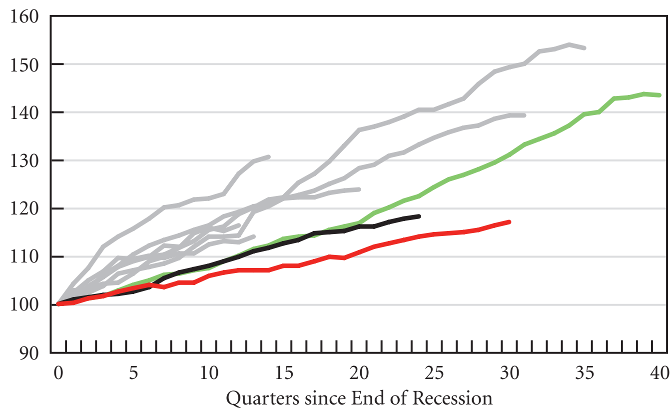
Baseline Projections: "Business as Usual"

It is customary in this series of Strategic Analyses to build our baseline scenario around the projections of the CBO's *Budget and Economic Outlook*. The reason for that is that the CBO provides projections both for the macroeconomic performance of the US economy and the fiscal stance of the federal government. It is therefore a convenient and comprehensive benchmark.

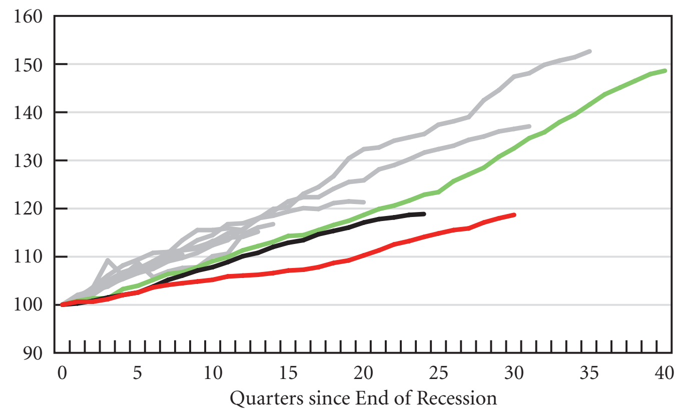
The projections from this January's *Budget and Economic Outlook* (CBO 2017a) are summarized in Table 1. The CBO projection is for a slight decrease in the government deficit in 2017 and 2018, which will be reversed in the two following years. Overall, the government deficit in 2020 will be at the same level (as a percentage of GDP) as 2016. The increase in the deficit and outlays is mostly due to increases in mandatory spending (mainly Social Security, Medicare, and Medicaid) and to a smaller degree to increases in interest payments. At

Figure 1 Indices of Real GDP and Its Components in US Recoveries, 1949Q4–2016Q4 (trough=100)

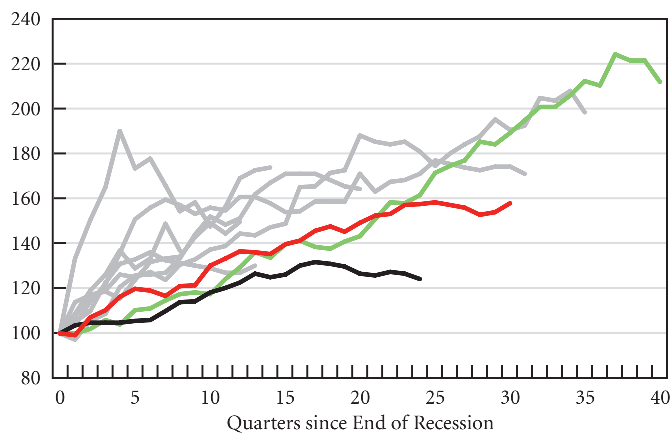
(A) GDP



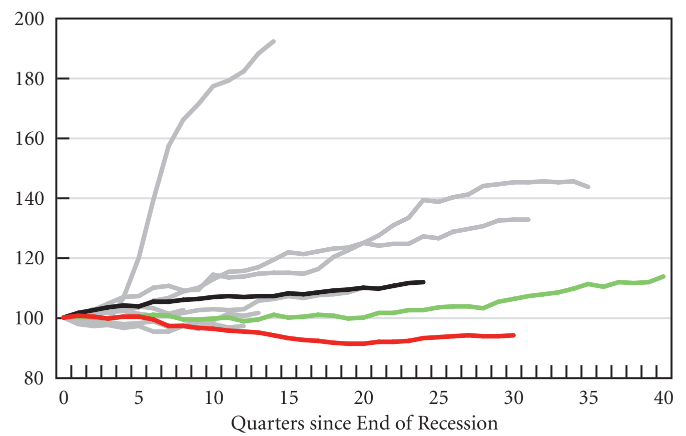
(B) Personal Consumption Expenditures



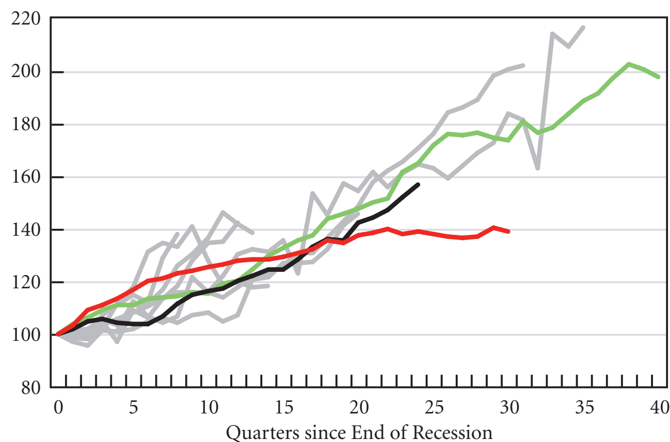
(C) Gross Private Investment



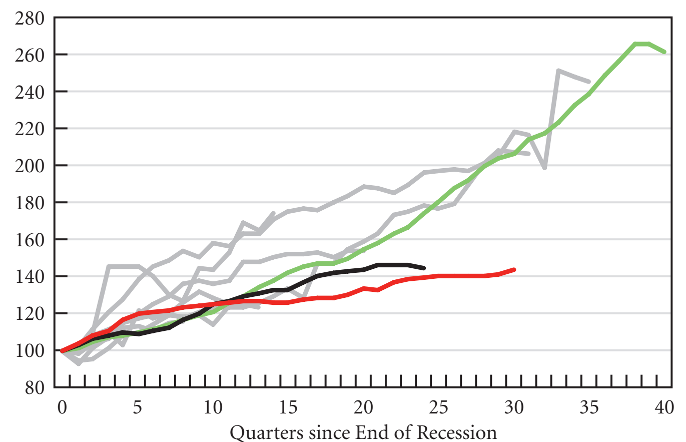
(D) Government Expenditure



(E) Exports



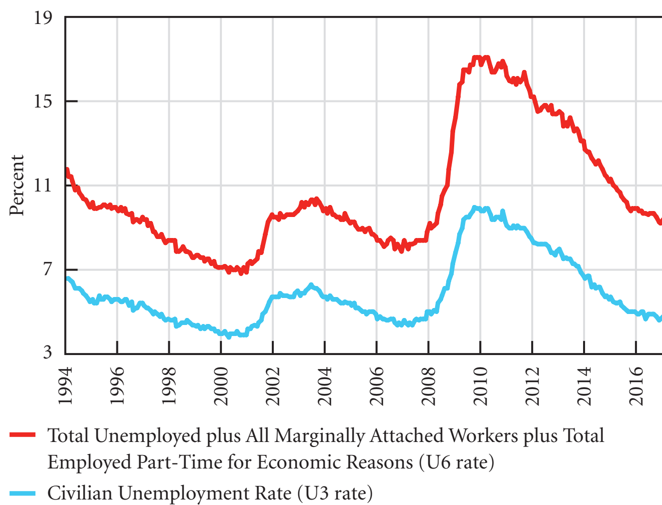
(F) Imports



Earlier Recoveries 1991Q1–2001Q1 2001Q4–2007Q4 2009Q2–

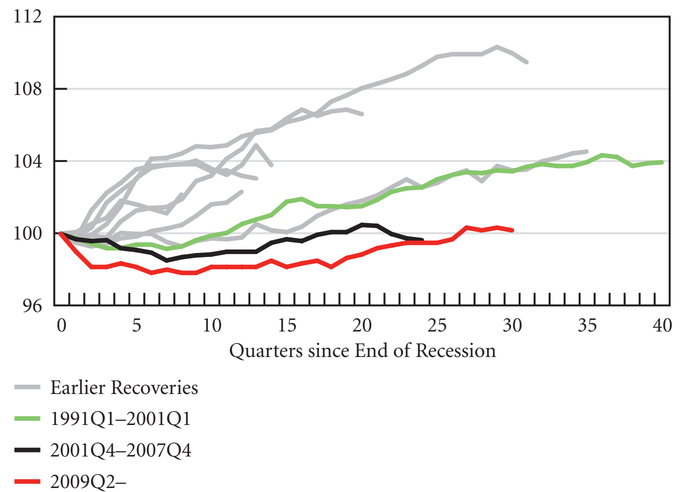
Sources: BEA; National Bureau of Economic Research (NBER); authors' calculations

Figure 2 Measures of the Rate of Unemployment, 1994–2017



Source: Bureau of Labor Statistics

Figure 3 Index of E/P Ratio in US Recoveries, 1949Q4–2016Q4 (trough=100)



Sources: BEA; NBER; authors' calculations

the same time, the CBO is projecting a small pickup in the growth rate to 2.3 percent in 2017, which will decline to 2 percent in 2018 and to 1.6 percent the year after. The latter is what the CBO now estimates as the "natural" growth rate of the US economy, in line with commentators who speak of a "new normal" and "secular stagnation."

These projections are interesting because they are considerably lower than the projections of the CBO in previous years. Figure 4 presents the short-term projections of the *Budget and Economic Outlook* in the years after the crisis, published in January of each year. What we see is that except for 2010, the very first year after the crisis, and 2012, the CBO has been overoptimistic about the economic outlook of the US economy, predicting an acceleration in growth each year.

This kind of overoptimism has been common in the projections of major institutions and international organizations in the period after the crisis and is not limited to forecasts for the US economy. For example, the projections of the European Union and the IMF for the eurozone economy and especially the crisis-stricken peripheral countries have been subject to the same problems. This issue was highlighted in last year's *Economic Report of the President* (CEA 2016), with reference to the IMF's "World Real GDP Growth Forecast, 2010–2020."

Table 1 CBO Baseline Projections, 2016-20 (in percent)

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	2.0
2019	2.9	21.0	18.1	1.6
2020	3.2	21.3	18.1	1.5

† Percentage of GDP

Source: CBO 2017a

The Levy Institute projections in recent years have been more cautious (Papadimitriou, Hannsgen, and Nikiforos 2013; Papadimitriou et al. 2013, 2014, 2015, 2016). These reports have highlighted the fact that high income inequality, fiscal conservatism, and weak net export demand have made growth and employment creation dependent on debt-financed expenditure by the private sector. Therefore, we have repeatedly argued that given these structural characteristics and the fiscal consolidation of the federal budget, another round of debt accumulation by American households would have been necessary for the acceleration of growth forecasted by the CBO and others to materialize. This was—and still is—not very likely, since the balance sheets of the household sector

have not improved enough to support increased borrowing without generating increased financial fragility. Moreover, even if such a debt-fueled growth acceleration were to happen, it is clear that it is not sustainable, and its resolution would not be a welcome alternative.

Table 1 and Figure 4 show that this year's CBO short-term projections for GDP growth rates are around the post-crisis average of the US economy—a sort of "business as usual" projection. Our model simulations confirm this.

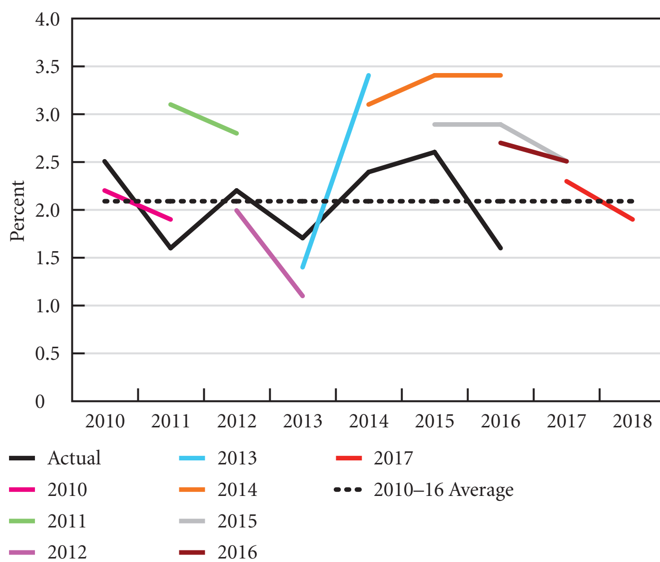
For these simulations, we make assumptions that are as "neutral" as possible. We assume a small increase in the price level and a constant nominal exchange rate. The growth and inflation rates of US trading partners follow the IMF's October 2016 *World Economic Outlook* (IMF 2016) and its recent January update (IMF 2017). Finally, we assume that equity and real estate market prices will increase mildly—by 2 percent annually—until 2020, and that there will be a gradual and slow increase in the effective federal funds rate, which will reach 2.5 percent by 2020.

The results of our simulations are summarized in Figures 5 and 6. The government deficit, in line with the CBO projections, decreases slightly in the first two years of the projection period and then inches up again. The small increase in the domestic growth rate in the first years of the projection period, the appreciated dollar, and the rise in income payments abroad (due to the higher interest rate) lead to an increase in the current account deficit, which reaches 4.5 percent in 2020. Finally, the private sector slightly decreases its net lending position in the first two years of the sample to almost zero, where it remains for the rest of the projection period. Essentially, the financial balance of the private sector continues along its post-2013 trajectory.

The continuation of the trajectories of recent years is also clear in Figure 6. The decline in household sector debt (as a percentage of GDP) flattens out and remains practically stable over our projection period. On the other hand, the debt of the nonfinancial corporate sector continues to increase rapidly and converges with the level of household debt by the end of the projection period. Thus, the indebtedness of the private sector as a whole increases.

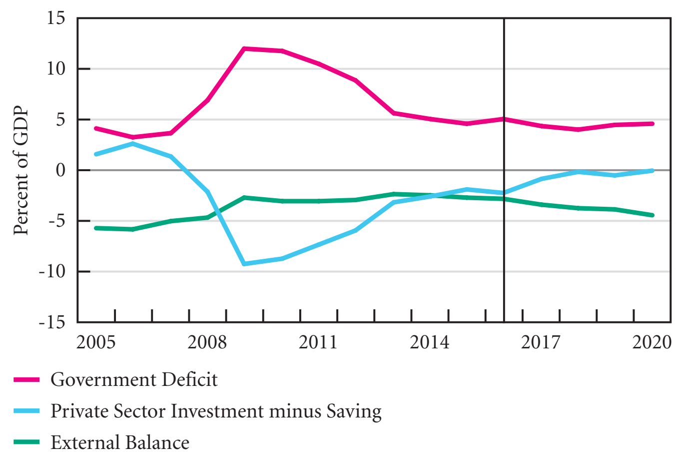
The main difference between the debt of the two sectors is that the indebtedness of the household sector is one of the main drivers of private expenditure and growth, while the debt of the corporate sector has been gradually decoupled

Figure 4 **Real GDP Growth Rate: Actual and CBO Projections, 2010–18**



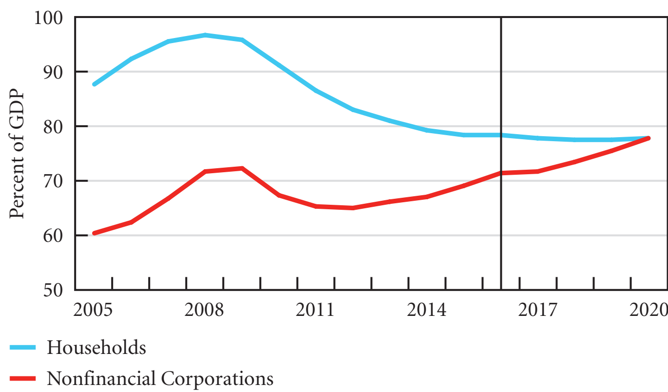
Sources: CBO; authors' calculations

Figure 5 **Baseline Scenario: Main Sector Balances, Actual and Projected, 2005–20**



Sources: BEA; authors' calculations

Figure 6 **Baseline Scenario: Ratio of Household Debt to GDP by Sector, Actual and Projected, 2005–20**



Sources: BEA; Federal Reserve; authors' calculations

from the behavior of investment and thus growth; as a result, it has very little explanatory power over the behavior of private expenditure. This means that the stability of household debt is one of the main reasons behind the stagnation of income but the contribution of the corporate sector—despite this increase in debt—is minimal.

The Trump Effect

During his presidential campaign Mr. Trump proposed several economic policies that promised to make the American economy "great again." The most important of these proposed measures include:

1. Repeal and replacement of the Affordable Care Act
2. Investment of $1 trillion over 10 years in public infrastructure projects
3. Tax cuts for corporations and households
4. Reduction of the government deficit
5. Aggressive renegotiation of trade agreements and reform of taxation policy to reduce the trade deficit

Even a casual and quick look at these policy proposals reveals some fundamental contradictions. For example, it is impossible to reduce the government deficit and at the same time implement a $1 trillion infrastructure investment plan and reduce tax rates (unless trade policy is successful in producing a massive reversal in the external balance).

Nevertheless, the markets—which were skeptical before the elections—have reacted exuberantly, with the expectation that when these policy measures are implemented net profitability will rise, either because growth will be boosted by increased expenditures or because the tax rates on profits and earnings will decrease.

The question then becomes the extent to which this optimism is warranted. Although we are still early into this administration's term, some initial comments and predictions can be made based on the appointments to positions in charge of economic policy, the recent budget proposal, and the outcome of its first legislative efforts—including, of course, the remarkable failure of a Republican majority in the House of Representatives to fulfill its promise to pass legislation to repeal the Affordable Care Act.

As mentioned in the introduction, the US economy has three major structural problems: (1) high income inequality, (2) pervasive fiscal conservatism, and (3) weak net export demand. Therefore, any policy measures need to be evaluated in terms of their impact on these three problems. To make the American economy "great again," one needs to address these issues.

To begin with, it is noteworthy that the electoral campaign of Mr. Trump identified all three of these problems. For example, the harsh rhetoric about trade was obviously related to problem number three and at the same time addressed the concerns of that part of the population whose incomes have stagnated in recent decades and who blame—rightly or wrongly—the trade policies implemented over the same period. Similarly, the promises on public infrastructure investment seemed to defy the fiscally hawkish rhetoric of the majority party. The correct identification of these issues was certainly a contributing factor in the electoral success of Mr. Trump.

However, the various campaign proposals were often radically different and contradictory (usually when addressing different audiences). At the same time that he was courting the white working class of the rust belt with the promise of high-paying jobs, he was proposing tax cuts that would mainly benefit corporations and wealthy households, based on a supply-side "trickle-down" argument. This might have been convincing in the early 1980s, but the three and a half decades that followed have disproved it. In another example, the promises to fix American public infrastructure and to cut

taxes have been accompanied by pledging allegiance to fiscal neutrality and balanced budgets.

So, what is the likely outcome? One possible conclusion that can be drawn with relative certainty based on the initial evidence of this new presidency is that fiscal conservatism will be emboldened. 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 (entitled "America First: A Budget Blueprint to Make America Great Again"), which his office prepared, does not foresee any fiscal expansion. Moreover, the recent negotiations in Congress about the new health-care bill show that the fiscally conservative wing of the Republican Party has gained unprecedented leverage. Based on these observations, it is hard to see any possibility of a major fiscal expansion.

Fiscal conservatism, the second of the abovementioned problems, will remain the order of the day. A corollary of this is that whatever policies will be enacted will be designed to have a zero-sum character.

The example of the budget proposal is telling: the increase in defense spending will be matched by decreases in spending in a number of other areas like the environment, labor protection, research and education, foreign aid, and improved transportation facilities. This kind of budget is strangely reminiscent of the famous "guns versus butter" model based on full employment that is studied in elementary economics courses. Looking at the long run, the widespread cuts could have significant negative effects on the growth prospects of the US economy. For example, most economists —even those with a "supply-side" mind-set—would agree that cuts in education and research will have a negative long-run effect on the growth rate. Similarly, climate change is probably the most important problem the world is facing today. The weakening and defunding of the Environmental Protection Agency could have very negative medium- and long-run consequences.

The zero-sum character of the new administration's fiscal decisions has important implications for inequality as well. As the budget proposal shows, the spending priorities of the Trump administration will be financed with cuts to programs that benefit low- and medium-income households.

Income inequality will also be affected in a more direct way if the contemplated tax reform is successfully negotiated. For the moment, there are two Republican plans for tax reform, one proposed by House of Representatives Speaker Paul Ryan, and a second one based on the electoral promises of the new president. According to some recent estimates by the Tax Policy Center (Nunns et al. 2016a, b), over a 10-year horizon 99.6 percent of the tax cuts in the Ryan plan will benefit the wealthiest 1 percent. In the case of the Trump campaign plan this number is 50 percent, with the other 50 percent accruing mostly to the rest of the top decile but also to middle-class households. All in all, it is hard to see how income inequality, the first of the problems identified above, will decrease; if anything, it will remain unsolved or, most likely, worsen.

In this context, it now seems more probable that the promised infrastructure investment plan will be a plan of tax cuts for corporations that engage in infrastructure investment. In many previous Levy Institute reports (e.g., Papadimitriou et. al. 2013) we have argued in favor of the beneficial effects of a large public infrastructure investment plan. Model simulations show that in addition to its direct effect on aggregate demand, such a plan could potentially have beneficial effects on US productivity and competitiveness, thereby reducing the trade deficit. However, such a plan is very different from the proposed reductions in taxation in the Trump plan. The results of a plan like this would be inferior compared to implementation of direct government expenditures not only in terms of growth and employment creation but also with regard to the secondary productivity effects. The reason is that a big portion of the tax cuts will be tied to public works that would materialize in any case. Given the government's desire for fiscal neutrality, such tax cuts will have the aforementioned negative side effects on inequality and thus the performance of the economy. Finally, it is not clear what proportion of the infrastructure spending would be made up of construction projects to increase border security and how these would be financed. However, it does seem clear that if an agreement is reached with Congress on a border wall, it will also be subject to fiscal revenue measures.

For the moment, the only concrete infrastructure-related measure has been the proposed *reduction* of Department of

Transportation spending by 13 percent (part of the across-the-board cuts in the budget proposal). Needless to say, that this will have a negative effect on transport infrastructure spending.

The new administration has also promised an aggressive trade policy to reduce the trade deficit. One proposed method to achieve this objective would be the imposition of tariffs on imports or a "border adjustment tax," which would effectively tax imports and subsidize exports. Assuming that the trading partners of the United States would not retaliate against these measures, they would indeed have a positive impact on net exports and growth.

Several economists and analysts have countered that the improvement in the trade balance would lead to an automatic dollar appreciation, which would eventually offset the higher import charges and any improvement in the trade balance.[2] However, there is no guarantee that exchange rates would respond in this way. In the face of a hypothetical improvement in the trade balance, the dollar might—or might not—appreciate, and would largely depend on the impact on capital flows.

Nevertheless, there are two problems with the proposed measures. The first is that it is very unlikely that the United States' trading partners would not react to such aggressive policy measures. Therefore, it is possible that such measures could initiate a trade war, with uncertain consequences. Second, the analysis of these measures is based on an old-fashioned "Ricardian" view of trade, whereby each country is supposed to produce one or more finished goods that are then exported and consumed in another. However, nowadays, trade among countries consists to a large extent of trade along integrated international value chains. A good that is produced in one country is then exported to another, where it is used as an intermediate input for another good, which is then exported to a third country (or back to the first country), and so on. In this case, the imposition of tariffs or border adjustment taxes has uncertain effects because they affect the costs of the domestic firms that use imported goods in their production. For example, a very significant portion of US imports from Mexico and China is made up of this kind of intermediate or capital goods, and the imposition of an import tariff would hurt the US companies that use these imported goods.

This is not to suggest that government has no role to play in trade policy and the economic development of an economy—quite the contrary. However, its interventions are much more complicated and have a more long-run character than what the new president seems to expect. A simple mechanistic view that maintains that trade deficits could be eliminated through a tariff or border tax is certain to be confounded by the results.

Finally, a remaining issue with the new administration's proposed measures is that they are unlikely to accommodate 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. It was criticized, on the one hand, by the conservative wing of the Republican Party as not being strict enough and, on the other, by the party's more centrist wing because it would have led to the loss of insurance by millions of people.[3] One can imagine similar deadlocks over most of the administration's proposed measures. For that reason, the expectations of a quick change in economic policy will most probably be met with disappointment.

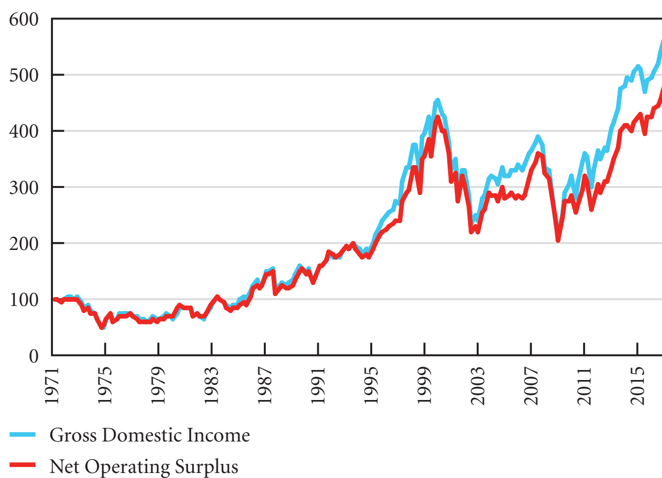
In conclusion, it is unlikely that the economic policy of the new administration will have a positive effect on growth, either because the intended measures will not resolve any of the main structural problems facing the US economy or because they will fall victim to the political deadlock in Washington. In any case, such failure can have grave consequences in an environment where all hope is based on "animal spirits." The spirits will ultimately face the reality. What will happen then?

The Asset Markets

Asset price inflation has been a central aspect of the debt-led growth process of the American economy over the last three decades. The increase in the indebtedness of the private sector in the 1990s and 2000s became possible for such a sustained period because of the behavior of equity and real estate prices over that period.

In the aftermath of the 2007–9 crisis most economists and practitioners admitted that this increase in asset prices was not based on any sort of fundamentals and could therefore be characterized as a bubble. In a fast-forward Minskyan process, the memories of that time and the (ex post at least) recognition of the bubbles have quickly faded.

Figure 7 Ratio of Market Capitalization to GDI and Net Operating Surplus, 1971–2017 (1971=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

As of March 24, the S&P 500 Index stood at 2,343 points. This is 350 percent higher than its trough in March 2009. Over the same seven-year period, consumer prices and the GDP deflator increased by a mere 13 percent. This is a worrisome observation. As Hyman Minsky observed in his "two-price" theory, it is output prices that generate the income to support asset prices; the liabilities incurred to buy financial assets need to be serviced with earnings from the sales of goods and services.

Another way to evaluate the situation is with the examination of the ratio of market capitalization to gross domestic income (GDI). The blue line in Figure 7 presents an index of this ratio. One can easily see the peaks in 2000 and 2007. More interestingly, the ratio is now (as of 2016Q4) at higher levels compared to both of these previous peaks.

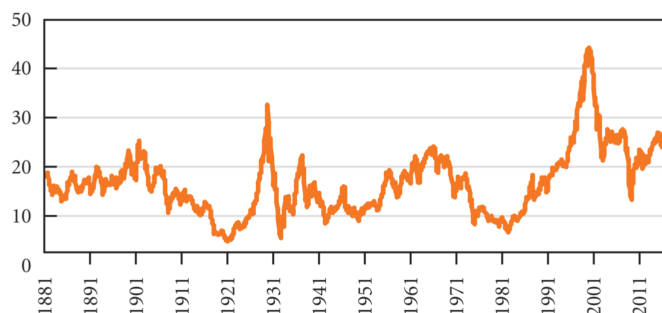
A common counterargument is that because of the redistribution of income toward profits, the cash flows available for stock purchases are now bigger, and therefore the higher capitalization-to-GDI ratio is something to be expected. To assess this argument, we calculated the ratio of market capitalization to net operating surplus, a proxy for the profit share in income. The red line in Figure 7 presents an index of this ratio. Not surprisingly, the two indices have diverged in recent decades, due to the increasing share of profits in overall income; the valuation–profits index is lower than that measuring the ratio of valuation to income. However, even with the operating surplus in the denominator we can observe that the level of the ratio is now higher compared to its peaks in 2000 and 2007.

Finally, another common measure of the valuation of the market is the Shiller P/E ratio for the S&P 500 Index, which normalizes the prices of S&P 500 stocks with a cyclically adjusted measure of earnings. We present the index in Figure 8. The Shiller index has increased during the last year, especially in the last months of 2016 and the first months of 2017, and is now close to 30. The only periods in the past when the index was higher were July–September 1929 and the late 1990s. Both periods resulted, as we know, in sharp declines in the market.

In addition to the stock market, real estate prices have also recovered rapidly from their trough in 2012. Figure 9 presents the S&P/Case-Shiller US National Home Price Index. It shows that in 2016 real estate prices in the United States reached—and slightly passed—their precrisis peak. As of January 2017, the index stood at 185.51 points, slightly higher than its precrisis high of 184.62 points in July 2006.

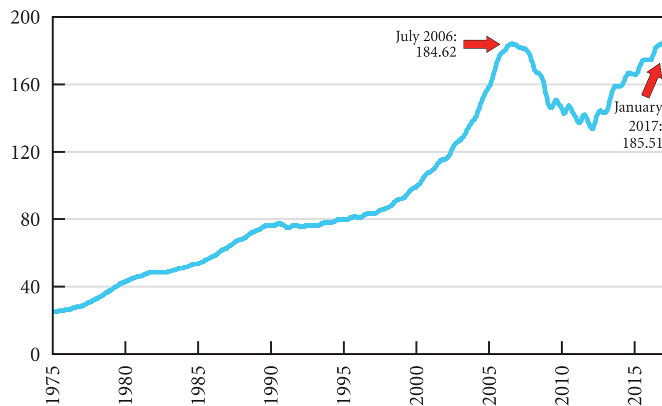
The latest push in the long bull market began immediately after the November elections. The anticipation of fiscal stimulus and the tax reform and other measures promised by Mr. Trump during his campaign led to a period of euphoria and a further increase in the stock market of 12 percent in only four months (this is roughly equivalent to the increase in output prices over the previous seven years). The new president recently boasted that the stock market had gained $3.2 trillion since his election.

Figure 8 Shiller Cyclically Adjusted Price–Earnings Ratio P/E 10, 1881–2017



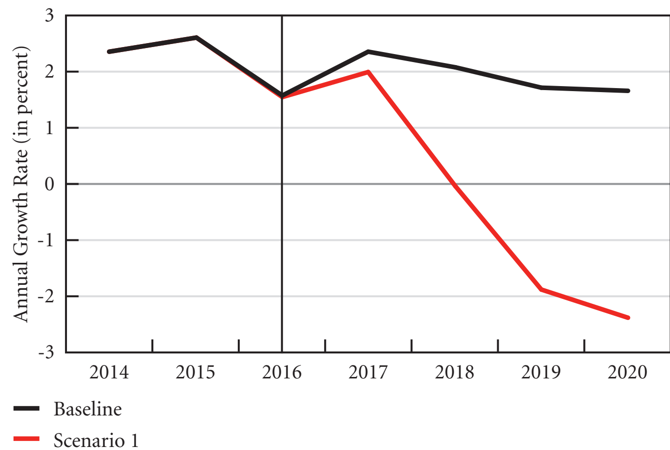
Source: econ.yale.edu/~shiller/data.htm

Figure 9 **S&P/Case-Shiller US National Home Price Index, 1975–2017 (2000=100)**



Source: S&P Dow Jones Indices LLC

Figure 10 **Real GDP Growth Rate, Actual and Projected, 2014–20**



Sources: BEA; authors' calculations

However, as we explained in the previous section, this euphoria is unwarranted, the proposed measures will not have the anticipated results even in the unlikely event they are passed into law. When the euphoria and the optimism fade away, the effects not only for the stock market but also for the "real" economy are likely to be severely negative.

To evaluate the effects of such a market correction we simulate a scenario where it is assumed that the stock market falls in the second half of 2017 and the first half of 2018, then stabilizes for the rest of the projection period. More precisely, the S&P 500 Index falls to around 1600 by the second quarter of 2018 (still above its precrisis levels in 2000 and 2007).

Moreover, 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. The deleveraging is relatively mild, and the debt-to-income ratios of the household and nonfinancial corporate sectors fall to their early-2000s levels by 2020 (an already high level by historical standards).

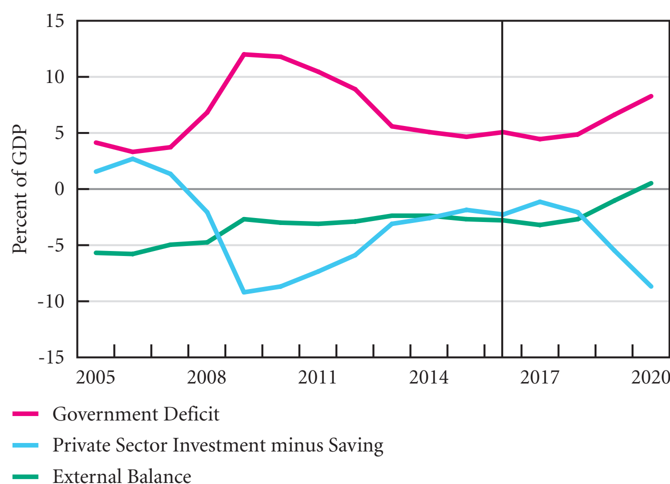
The results of our simulations are presented in Figures 10 and 11. Figure 10 shows that the fall in the stock market and the deleveraging of the private sector result in the growth rate dropping to zero in 2018, -1.8 percent in 2019, and -2.4 percent in 2020. In Figure 11 we can see the effort of the private sector to deleverage and the resulting increase in its financial balance. On the other hand, the drop in the growth rate leads to a better current account balance compared to the baseline and an increase in the government deficit, which reaches 8.3 percent in 2020. Essentially, under the assumptions of scenario 1 we have a repeat of the recent crisis of 2007–9.

Concluding Remarks

Secular stagnation, with slow GDP growth and even slower productivity growth that allowed employment to increase, continued to characterize the US economy during 2016. In past Strategic Analyses and in the present report we have explained that the US economy faces three fundamental and structural problems that led to this situation: (1) high income inequality, (2) fiscal conservatism, and (3) weak net export demand. As long as these problems persist, acceleration in growth to the new administration's promised 4 percent per annum would require yet another, extremely large round of increasing indebtedness on behalf of households, which would simply repeat the experience of the recent past and result in an unavoidable collapse. Thus, unless these issues are addressed—and absent another round of household debt accumulation—it is hard to see how the economy will escape its current stagnant state in a sustainable manner.

The financial markets seem to think differently. The election of Donald Trump as president of the United States created the anticipation of an increase in profitability due to the acceleration of growth and lower taxes (both the result of the

Figure 11 **Scenario 1: Main Sector Balances, Actual and Projected, 2005–20**



Sources: BEA; authors' calculations

promised policy actions of the new administration). Thus, the period after the November elections was marked by an exceptionally fast four-month climb in equity prices to levels that were already close to historical high valuation levels when it began.

Is this "Trump effect" optimism warranted? Is this time different? The results of this Strategic Analysis are that the policy proposals of the new administration are unlikely to solve any of the three aforementioned fundamental problems. If anything, the situation will worsen, especially with regard to income inequality. Therefore, as in previous years, absent an economic downturn the baseline forecast is one of slow growth in line with the postcrisis trend.

This time is also *not* different with respect to the financial markets. Depending on the specific measure chosen, the valuation of the markets compared to the value of output or earnings is either at its highest level in recorded history or at levels similar to the fall of 1929 or the late 1990s. The situation is made even worse by the baseless optimism of the postelection period. A sharp "correction" in the financial markets combined with another round of private sector deleveraging could destabilize the fragile recovery and lead to another crisis.

The hike in interest rates by the Federal Reserve could also trigger a reversal. Although the direct effects of higher interest rates on aggregate demand and saving may not be significant, some indirect channels might prove more important. For example, it remains to be seen to what extent the financial markets will continue their exuberant course as monetary policy tightens and the Fed deleverages its balance sheet. Additionally, in many of the US trading partner countries—especially in emerging markets—the private sector has accumulated vast amounts of debt, which was made possible by the easy monetary policy of the Federal Reserve. The rise in the cost of borrowing is likely to have very severe results, which will ultimately affect the demand for US exports.

Moreover, the current recovery is already the third-longest in the postwar history of the United States, and will very soon be the second-longest. Therefore, even from a statistical point of view, it is becoming more and more likely that the forces of the business cycle—whatever they may be—will cause a reversal.

Finally, it is worth mentioning that the above factors are interrelated. For example, a slowdown in the economy—for whatever reason—would have an impact on the earnings of firms and raise the valuation to output and earnings ratios (e.g., the P/E ratio), making a stock market dip more inevitable, which in turn would have a further negative impact on macroeconomic performance.

We would like to thank Jan Kregel for extensive discussions as well as comments and suggestions that he made on previous versions of this paper. Any remaining errors or omissions are, of course, our responsibility.

Notes

1. See Dantas and Wray (2017) for a comprehensive examination of the state of the labor market.
2. No lesser authorities than Paul Krugman and Martin Feldstein have recently made this claim. Krugman (2017) writes that "we should expect the dollar to rise by enough to wipe out any competitive advantage," while, according to Feldstein (2017), the border adjustment tax will *automatically* result in an increase in the international value of the dollar and offset the rise in import prices.
3. According to an estimate by the CBO (2017b), the number of people without health insurance would have increased by 24 million within 10 years had the bill passed.

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