

Striving for Growth and Stability in a Time of Unparalleled Uncertainty: An Economic Outlook

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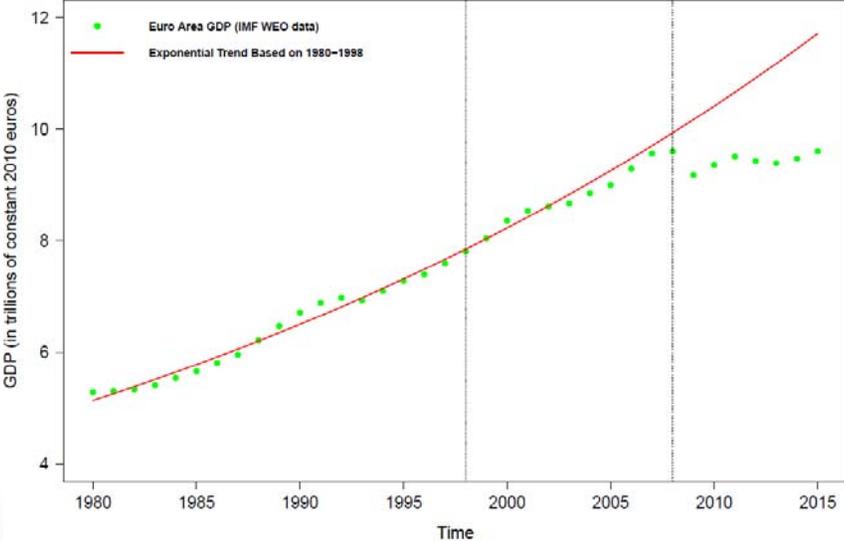
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2017 is not an ordinary year

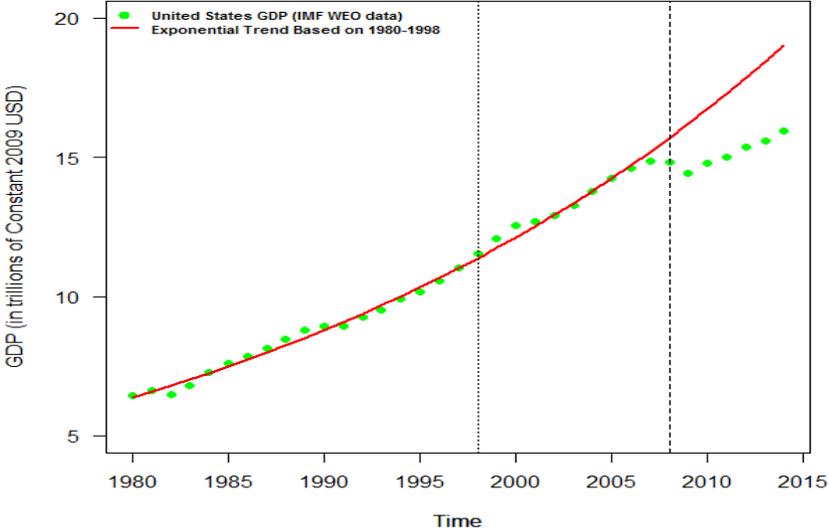
- In an ordinary year we would look at trends in 2016 and underlying economic forces to predict 2017
 - US recovery on way—not robust, but unemployment low, growth between 2 and 3 per cent
 - No expectation that the gap between where economy would have been and where it is will be made up
 - Europe too growing, very slowly
 - And gap continues to increase
 - Key issue: structural problems of the *Eurozone* itself

Contrast between where Europe and US are and where they would have been

Euro Area GDP Trend Analysis



United States GDP Trend Analysis



China's growth slightly under 7% too remains limited

- Though impressive by historical standards *for the world as a whole*
 - Disappointing compared to China's own performance
- No longer source of global growth that it was
- And many problems
 - Continuing risks of bubbles
 - Continuing worries about capital outflows
 - Continuing problems posed by anti-corruption campaign
 - Continuing debates about “supply side” vs “demand side” actions
 - Continuing (worsening) problems posed by the environment

Underlying problem

- Lack of global aggregate demand
 - Inequality
 - Austerity
 - Structural transformation
 - Volatility in energy markets
 - Though around much lower levels than a few years ago
- Finance no longer binding constraint
 - Except in certain countries in Europe
 - Part of Eurozone's structural problem
- These problems are not being addressed, not going away
 - Some are getting worse

But 2017 is unusual

- Big uncertainties, potential first order effects
 - Brexit
 - Trump
 - Coming elections in Europe
 - Possible (likely?) break-out of the next episode of the eurocrisis
- Post World War II economic and political order is being question, upset

The future of US economic policy

- Inconsistencies within what Trump promised and between Trump and traditional Republican stances
 - Protectionism vs. free trade
 - Not just no new trade agreements, but renegotiating existing agreements
 - And promises to break international trade law
 - Will there be direct retaliation
 - More likely: indirect retaliation, not breaking international law, e.g. through procurement
 - US will be perceived as the “rogue” state

Spending

- Promised: \$1 trillion infrastructure
 - Financed through tax credits
- Historical position: shovel ready projects (Obama's program) are a waste and don't stimulate economy
- Reality
 - Tax credits expensive way of supporting infrastructure
 - Especially in an era when government can borrow at very low interest rates
 - Today, multipliers are much lower than in 2009
 - Much of spending may go to "privatizations, which will have no stimulative effect
 - Only limited kinds of infrastructure can be supported by fees
 - Effect of fees much like tax—decrease spending elsewhere
 - No evidence that hedge funds which are likely to take advantage of tax credits are good infrastructure managers

Deficits

- Promised to reduce deficits
- Increased spending and reduced taxes will produce larger deficits
 - Little room for cutbacks—federal employment already cut deeply
 - Some room for redirecting spending in military
 - More likely: another area of increased spending
- Will justify through “dynamic multipliers”—4% growth promised
 - With unemployment rate low, this will not happen
 - Especially because of poor design of infrastructure and tax cuts
 - And likely reaction of interest rates and exchange rates

Tax cuts

- One part of promise that is likely to be fulfilled
 - Even more directed at top 10% than usual tax cuts
 - Even less likely to stimulate economy
 - Lowering corporate income tax rate will have little effect
 - Proposed WTO illegal change in corporate income tax—destination based principles, not allowing deductions for imported goods
- Beggar-thy-neighbor policy will largely be offset by exchange rate changes

Exchange rate

- Underlying macro-economics: capital inflows must equal difference between domestic investment and domestic savings
 - Domestic savings will go down because of increased deficit
 - Likely to be larger than any changes in private investment and savings
- Capital inflows has to equal trade deficit (more accurately, current account deficit)
 - Achieved through adjustment of exchange rate
- Beggar thy neighbor protectionist policies simply increase offsetting magnitude of exchange rate adjustment
 - Adjustment in exchange rate smaller if others take certain retaliatory actions
- Thus trade deficit will act as a dampener
 - Hurting manufacturing export sector—very sector he has promised to help
- Combination of ad hoc protectionist measures may distort the economy

Interest rates

- Trump has criticized low interest rates
 - Surprising stance for real estate developer or someone who wants to encourage real sector investment
 - Some of his hedge fund “economic” advisors have been worried about inflation, taken large positions in gold, want government to increase interest rates
 - Two appointments to Fed give him chance to appoint those who support his view
- Already strong pressures within Fed to increase interest rates
 - Not just worry about inflation
 - Worry about how long term low interest rates have distorted financial markets
 - Contributed to mispricing of risk
 - Risk of a bubble
 - Want “ammunition” to respond to next downturn
- Increased interest rates will reinforce downward pressure on exchange rate
- May dampen investment

Adding it all up

- There are likely to be long run geo-political consequences
- The US had been at the center of creating the international rule of law and the global economic architecture
 - Its role had already begun to diminish
 - With Europe pre-occupied with its own problems, it will be difficult for it to fill the gap
- The underlying problems in the US—the growing inequality, with little of the fruits of growth going to those in the middle and bottom—are shared by other advanced countries
 - And if not well managed, could lead to the growth of extremist and populist leaders with the risk of growing authoritarianism and an attack on enlightenment values

Adding it all up

- The economic consequences are likely to be smaller than the political consequences
 - We have already moved to a multi-polar world
 - Though with the high level of economic integration and with China at the center of many global supply chains, economic tensions between China and US may well have global consequences
 - Role of corporate interests and systems of checks and balances are likely to circumscribe what Trump can do
- But this much is certain: we are entering into an era of almost unprecedented uncertainty