A dim outlook for Trumponomics

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Now that US President Donald Trump has been in office for six months, we can more confidently assess the prospects for the US economy and economic policymaking under his administration. And, like Trump's presidency more generally, paradoxes abound.

The main puzzle is the disconnect between the performance of financial markets and the real. While stock markets continue to reach new highs, the US economy grew at an average rate of just 2% in the first half of 2017 – slower growth than under President Barack Obama – and is not expected to perform much better for the rest of the year. Stock-market investors continue to hold out hope that Trump can push through policies to stimulate growth and increase corporate profits. Moreover, sluggish wage growth implies that inflation is not reaching the US Federal Reserve's target rate, which means that the Fed will have to normalise interest rates more slowly than expected.

Lower long-term interest rates and a weaker dollar are good news for US stock markets, and Trump's pro-business agenda is still good for individual stocks in principle, even if the air has been let out of the so-called Trump reflation trade.

And, there is now less reason to worry that a massive fiscal-stimulus program will push up the dollar and force the Fed to raise rates. In view of the Trump administration's political ineffectiveness, it is safe to assume that if there is any stimulus at all, it will be smaller than expected.

The administration's inability to execute on the economic-policy front is unlikely to change. Congressional Republicans' attempts to replace the Affordable Care Act (Obamacare) have failed, not least because moderate Republicans refused to vote for a bill that would deprive some 20 million Americans of their health insurance.

The Trump administration is now moving on to tax reform, which will be just as hard, if not harder, to enact. Earlier tax-reform proposals had anticipated savings from the repeal of Obamacare, and from a proposed "border adjustment tax" that has since been abandoned. That leaves congressional Republicans with little room for maneuver. Because the US Senate's budget-reconciliation rules require all tax cuts to be revenue-neutral after ten years, Republicans will either have to cut tax rates by far less than they had originally intended, or settle for temporary and limited tax cuts that aren't paid for.

To benefit American workers and spur economic growth, tax reforms need to increase the burden on the rich, and provide relief to workers and the middle class. But Trump's

proposals would do the opposite. Depending on which plan you look at, 80% to 90% of the benefits would go to the top 10% of the income distribution.

More to the point, US corporations aren't hoarding trillions of dollars in cash and refusing to make capital investments because the tax rate is too high, as Trump and congressional Republicans claim. Rather, firms are less inclined to invest because slow wage growth is depressing consumption, and thus overall economic growth.

Beyond tax reform, Trump's plan to stimulate short-term growth through US$1 trillion in infrastructure spending is still not on the horizon. And, instead of direct government investment of that amount, the administration wants to provide modest tax incentives for the private sector to spearhead various projects. Unfortunately, it will take more than tax breaks to bring large infrastructure projects from start to finish, and "shovel-ready" projects are few and far between.

On trade, there is good news and bad news.

The good news is that the administration has not pursued radically protectionist policies, such as branding countries as currency manipulators, introducing across-the-board tariffs, or pushing for the border adjustment tax.

The bad news is that Trump is sticking to his "buy American, hire American" credo, and his protectionist gestures will hurt growth more than they save jobs. He has already abandoned the Trans-Pacific Partnership and negotiations for the Transatlantic Trade and Investment Partnership with the European Union. He is renegotiating the North American Free Trade Agreement, and he may try to renegotiate other free-trade agreements, such as the bilateral deal with South Korea. And, he could still start a trade war with China by introducing tariffs on steel and other products - especially now that China has been uncooperative in responding to North Korea's escalating nuclear threat.

Trump could also limit the US's growth potential by restricting immigration. In addition to barring visitors from six predominantly Muslim countries, the administration is intent on restricting migration for high-skill workers and is ramping up deportations of undocumented immigrants. This, along with the much-ballyhooed border wall, will cut future labor supply and thus economic growth, especially as the American population continues to age and drop out of the labor force.

Lastly, Trump's deregulation agenda will not boost economic growth, and may actually weaken it over time. If financial regulations are loosened too much, the result could be another asset and credit bubble, and even another financial crisis and recession.

Meanwhile, Trump's decision to withdraw from the Paris climate agreement, combined with a rollback of environmental regulations, will lead to ecological degradation and slower growth in green-economy industries such as solar power. And weaker labor protections will further

reduce workers' bargaining power, thus holding down wage growth and overall consumption.

It is little wonder that actual and potential growth is stuck at around 2%. Yes, inflation is low, and corporate profits and stock markets are soaring. But the gap between Wall Street and Main Street is widening. High market valuations that are fueled by liquidity and irrational exuberance do not reflect fundamental economic realities. An eventual market correction is inevitable. The only question is whom Trump will blame when it happens.

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