Macro Picture

PRESSURE POINT

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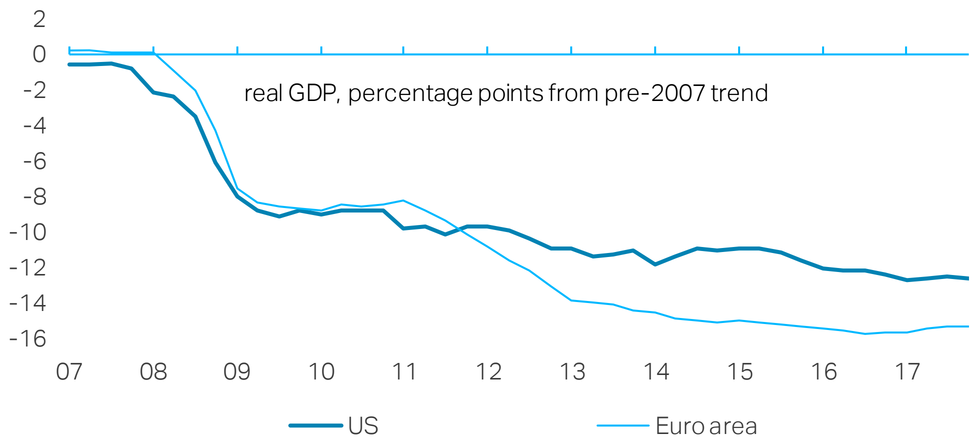
There are risks associated with Trump's late-cycle stimulus, including wage-price spirals and twin fiscal/current-account deficits. But perhaps the policy is not as reckless as it seems and a 'high-pressure' economy could even be beneficial if it reversed previous supply damage – assuming we avoid global trade wars.

Chart 1: High-pressure economies?



Source: BEA, Eurostat, TS Lombard

TWIN DEFICITS

Investors are concerned about the impact of US fiscal stimulus, which amounts to around 2% of GDP through 2019 and is arriving unusually late in the economic cycle. With the US economy apparently close to full employment, they worry President Trump's policies will ignite inflation and/or prompt a major widening in the twin deficits.

HOT PURSUIT

The US administration is effectively experimenting with the 'high pressure' economy, an idea Arthur Okun pushed in the early 1970s. Economists may have become too gloomy about US supply potential and stronger demand could reverse some of the supply damage that has occurred since 2008 – by lifting productivity and participation rates.

SEVENTIES FLASHBACK

While the high pressure economy went badly wrong in the early 1970s, there seems little threat of repeating those policy disasters today. Faster wage growth would actually be desirable and is unlikely to trigger a serious wage-price spiral. The main risk is that Trump's protectionism sparks a global trade war, undermining any incipient supply revival.

PRESSURE POINT

18 months ago, when secular stagnation was the dominant market theme, most investors wanted policymakers to do more to support the global economy. Monetary policy had failed, so attention shifted to a fiscal response – either the traditional government variety (tax and spend), or 'backdoor' via the central bank (helicopter money). Investors now have what they wanted, but they forgot about the lags. The US administration finally passed its tax reforms in December 2017 and, topped up with generous spending caps agreed in January 2018, we are now looking at a stimulus worth 2% of GDP over the next two years. Yet the market narrative has moved on and nobody seems to believe in secular stagnation anymore. The global economy is enjoying strong, synchronized growth and deflation fears have disappeared. In fact, since the US economy appears to be at full employment, many investors believe President Trump's stimulus is downright reckless.

Is fiscal stimulus at this stage of the cycle dangerous? There will always be economists who believe cutting taxes improves the 'supply side' of the economy, unleashing capex and productivity. These claims are often based on ideology rather than actual historical evidence. We think it is more interesting to think about this question in the context of the 'high pressure' economy, an idea sometimes associated with Arthur Okun in the early 1970s. Okun believed allowing the economy to 'run hot' would improve potential output, lifting productivity and labour force participation. Given that the post-2009 recovery has been rather unsatisfactory, it is easy to see why this idea might be relevant again today. US unemployment is low by historical standards, but the picture is less impressive when we look at employment ratios. Output gap measures are notoriously unreliable and have only closed because economists have become much more pessimistic – probably too pessimistic – about supply potential. And we shouldn't discount the prospect of a productivity revival, especially when nobody can explain the recent weakness.

The trouble, of course, is that previous experiments with 'high pressure' economics didn't always end well. Some investors are already drawing parallels with the 1970s/80s, when policymakers assumed a structural slowdown was just a temporary period of deficient demand. Yet high inflation regimes such as the 1970s are relatively rare in economic history and the prospect of another serious wage-price spiral seems rather remote. A moderate acceleration in wages is more likely, which companies could partly absorb in their profit margins (tax cuts should will also help them do this). To the extent faster wages would help the Federal Reserve meet its inflation objective while also providing monetary insurance against the next downturn, this could even be a healthy development. On this basis, President Trump's fiscal policies do not seem particularly reckless. But his protectionist agenda is much harder to justify, especially as global trade wars would undermine any supply-side benefits his high pressure economy unwittingly delivers.

1. TWIN DEFICITS

Using fiscal policy to manage the economic cycle has always been problematic, particularly as there are often long implementation lags involved. In the US, it took an election followed by almost a year of political wrangling in Congress before investors got the fiscal stimulus they had been calling for 18 months earlier. President Trump finally secured his tax cuts in December 2017, in a deal worth around $1.5 trillion over the next decade. In January 2018, the administration also passed a budget agreement that significantly raises government spending caps. The net result is a substantial stimulus, worth 2% of GDP over two years (Table 1). Yet, far from welcoming these policies, most investors now think Trump's stimulus is dangerously reckless – worries about 'overheating' and 'twin deficits' have replaced concerns about secular stagnation.

Table 1: US fiscal stimulus

	Impact on US deficit, $ billions			
	2017	2018	2019	2020
CBO baseline deficit	-660.5	-594.5	-710.5	-801
Tax cuts and Jobs Act		-205.7	-274.7	-249.3
Bipartisan Budget		-99.4	-143.9	-51.5
Total fiscal impact:		-305.1	-418.6	-300.8
Cumulative stimulus, per cent of 2017 GDP		-1.57	-2.16	-1.55

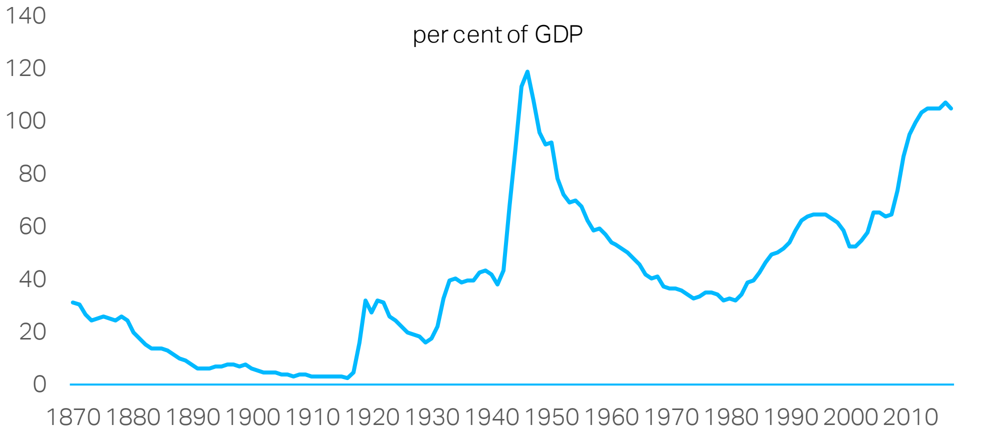
Source: CBO baseline, CBO report on Bipartisan Budget, Joint Committee on Taxation,

Fiscal impact

The impact of Trump's stimulus depends on the size of the 'multiplier', the sensitivity of GDP to changes in fiscal policy. A multiplier of '1' means a one percentage point increase in the budget deficit raises overall output by around 1 per cent. If the multiplier is less than one, stimulus damages the fiscal position more than it boosts GDP. Economists have had a hard time agreeing on the size of the multiplier. Research shows a wide distribution of outcomes and popular commentary is often divided along political lines. To the extent a consensus exists, it finds (i) the multiplier depends on the cyclical position of the economy – it is larger during recessions, particularly if monetary policy is close to the zero bound; (ii) changes in government spending are more effective than changes in taxation, since the private sector can save a proportion of any tax cut, and (iii) tax reductions will be more powerful when recipients are cash constrained e.g. low-income individuals or SMEs.

On this basis, President Trump's fiscal stimulus looks poorly designed. It is focused on highly regressive tax cuts and arrives late in the cycle, with the economy apparently close to full employment. But 'poorly designed' doesn't necessarily mean it will be ineffective. We suspect the stimulus programme could still have a significant impact on US GDP over the next couple of years. Indeed, there is recent evidence – from so called 'narrative studies' – that suggest even badly targeted tax cuts, such as President Bush's 2001-03 programme, can have a significant influence on aggregate demand. One study showed that households eventually spent around two-thirds of the Bush windfall. There is also evidence that corporate tax cuts can lift investment, particularly among SMEs. FOMC member Lael Brainard hinted at a multiplier or around 0.5, which seems reasonable.

Chart 2: US public sector debt

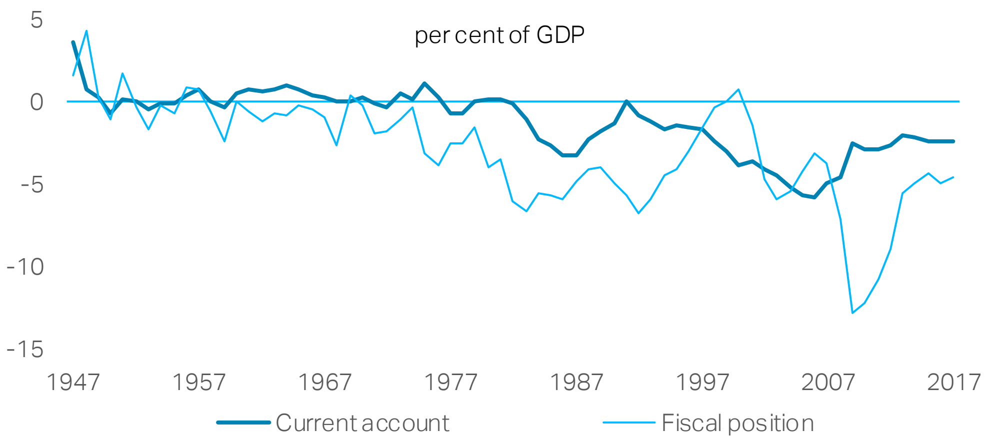


Source: TS Lombard estimates using Macrohistory Database

Double trouble

The size of the fiscal multiplier is important, not just for the impact of Trump's stimulus on overall GDP, but also for inflation and the 'twin deficits'. Suppose, for example, that the multiplier was zero – either because households saved all the money they received in tax cuts or because government spending 'crowded out' private investment. The government's budget position would deteriorate but there would be an offsetting improvement in private-sector balances (higher saving). The current-account deficit wouldn't necessarily widen. But with a larger multiplier – the more likely scenario – there would be no offsetting improvement in private sector net saving and the current-account position would deteriorate. The US would experience another episode of 'twin deficits'.

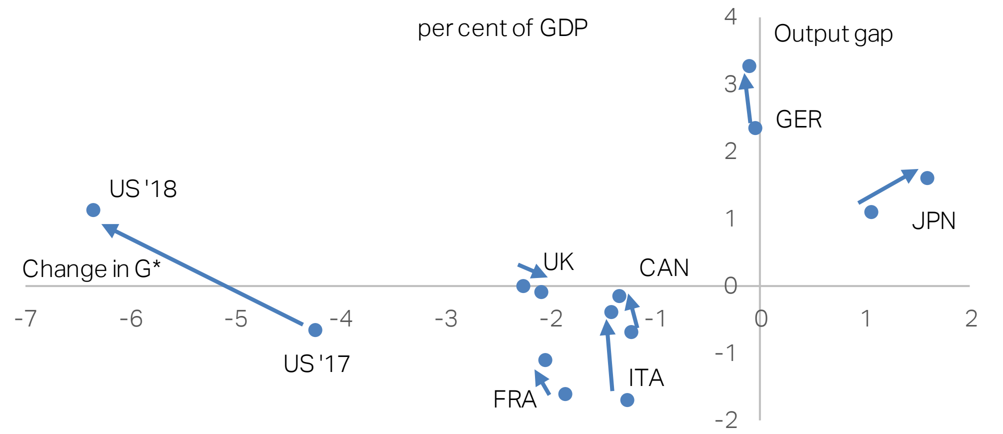
Chart 3: The twin deficits



Source: TS Lombard using official data and Macrohistory Database

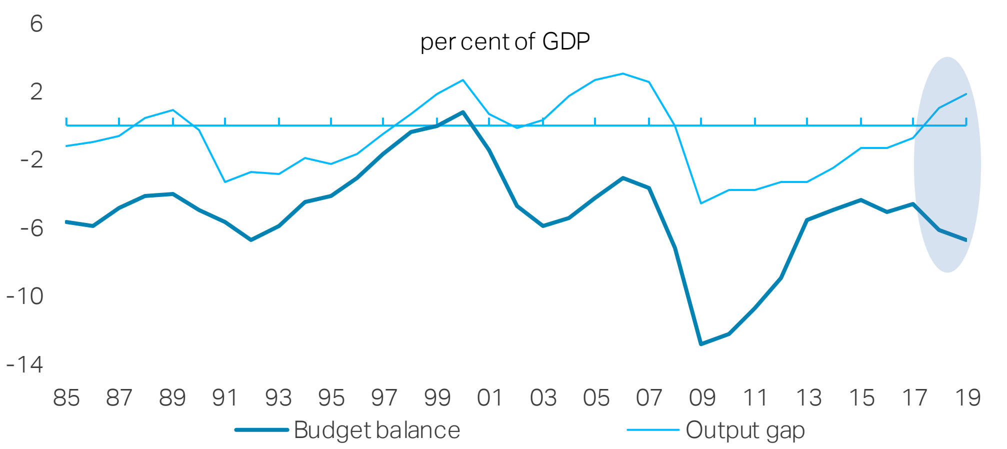
In recent weeks, investors have become increasingly worried about US twin deficits and what this might mean for the dollar exchange rate. The currency has continued to weaken, even as US bond yields have risen. Some commentators believe this is because there is less appetite for holding US assets. Perhaps investors are more reluctant to fund a deficit that reflects 'unproductive' fiscal stimulus rather than one underpinned by – for example – a private capex boom with the promise of future productivity gains. While we suspect there are more important external forces that have driven America's exchange rate down, particularly the reversal of large QE-related flows from Japan and the euro area, the commentary on the 'twin deficits' neatly illustrates how investors are becoming more concerned about US policy risks – particularly as these feed into a wider inflation narrative.

Chart 4: US fiscal experiment



Source: OECD, TS Lombard, * the government's structural budget balance

Chart 5: Procylical policy



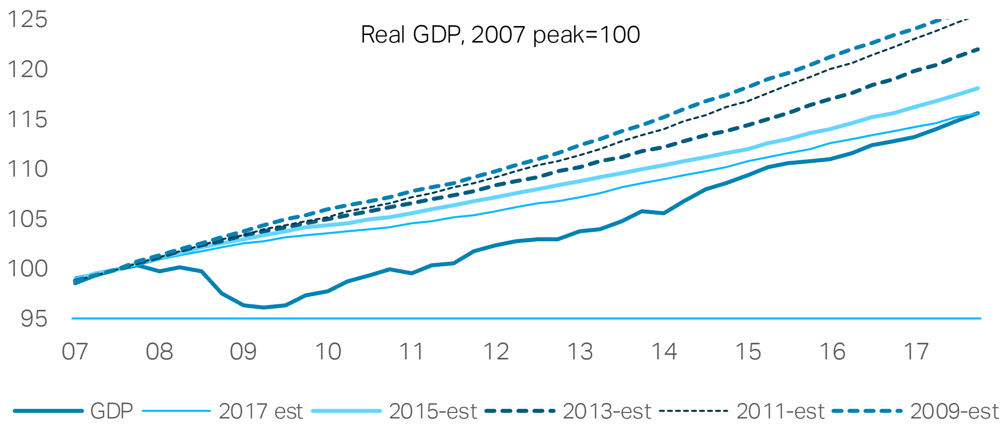
Source: TS Lombard based on OECD forecasts and multiplier of 0.5

2. HOT PURSUIT

With markets focused on inflation, it's easy to see why President Trump's policies are making investors nervous. If the multipliers are non-zero and the output gap is closed, fiscal stimulus could cause the economy to overheat. A wider current account deficit might mask these pressures for a while, by drawing on overseas capacity, but not if the dollar continued to depreciate. We also know that the US administration wants a smaller trade deficit and is introducing protectionist policies to try to curb imports. This seems like a contradictory and dangerous combination of policies, so it is no wonder sellside analysts are warning about the risks involved. But is there any scenario in which Trumponomics might actually work? We think the answer is 'yes', assuming his recent push towards protectionism doesn't spark full-scale trade wars.

Supporters of President Trump's policies often point to the potential 'supply side' benefits of lower corporate taxes and reduced regulation. They believe the new administration will unleash a major productivity and growth revival, which might even mean the fiscal stimulus is self-financing. For the most part, this 'analysis' is based on ideology rather than actual historical evidence. But we still think Trump's stimulus could be an interesting experiment in 'high pressure' economics, particularly given the economy's disappointing performance over the last decade. From a pure inflation point of view, the President's strategy may not be as dangerous as everyone is assuming.

Chart 6: Estimates of US 'potential'



Source: CBO estimates of potential GDP

High pressure economies

Former Fed chair [Janet Yellen resurrected the idea of the high-pressure economy] recently when she spoke about a situation where the economy might be allowed to run hot, with output pushed above consensus estimates of 'trend'. This is not a new idea, it was also the subject of much discussion in the 1950s and again in the late 1960s. For example, in 1973 the influential economist Arthur Melvin Okun noted:

''At the present time, the controversial range for the target unemployment rate extends from 4 to 5 per cent. Generally, high-pressure advocates concede that, with existing labour market institutions, unemployment rates below 4 percent would be associated with unacceptable inflation; while most low-pressure advocates agree that unemployment rates above 5 percent are intolerable. The difference between 5 percent and 4 percent extends far beyond the creation of jobs for 1 percent of the labour force. The submerged part of the iceberg includes (a) additional jobs for people who do not actively seek work in a slack labour market but nonetheless take jobs when they become available; (b) a longer workweek reflecting less part-time and more overtime employment; and (c) extra productivity from fuller and more efficient use of labour and capital".

Untapped potential

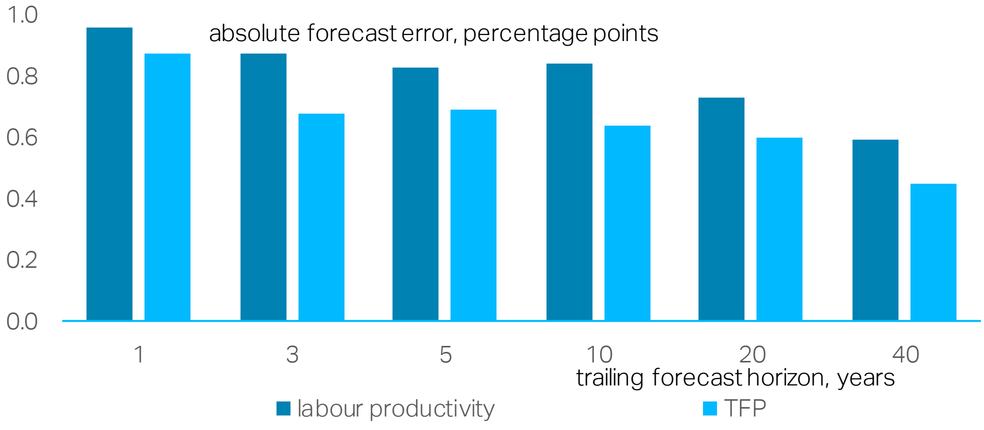
The basic idea is that by stimulating demand and testing prevailing ideas of 'full employment', the supply side of the economy will improve, creating new capacity which prevents a dangerous acceleration in inflation. While in normal circumstances this would seem like a high-risk strategy, the macro environment of the last decade arguably warrants such an unusual policy response. Most economies have suffered extremely slow and disappointing recoveries from the global financial crisis, while inflation has continuously fallen short of central bank targets. Output gaps have closed, but mainly because economists have continuously lowered their estimates of potential GDP (Chart 6). While unemployment rates are down significantly, broader measures of labour market performance – particularly employment ratios – show a less impressive performance.

There is a good chance that global supply potential hasn't deteriorated as much as policymakers are assuming. Economists have lowered their estimates of trend GDP mainly because actual output has been persistently and unexplainably weak. Their models are little more than moving averages. In fact, one recent study has shown that estimates of potential GDP have no real predictive power, in part because they are unable to identify the underlying cause of 'shocks' hitting the economy (i.e. demand vs supply). When we look at older models, which do try to make this distinction – including the Olivier Blanchard and Danny Quah framework – we find the hit to potential output is not as large as recent estimates suggest. Likewise, investors should remember that standard calculations of the NAIRU/output gap are notoriously unreliable and prone to substantial revisions.

Productivity puzzles

The evolution of productivity will be particularly important in deciding whether the experiment with a high pressure economy is successful. In the mid-1990s, Alan Greenspan effectively took Arthur' Okun's advice, ignoring Fed models that were predicting a surge in inflation. Greenspan believed productivity would improve, which was probably his most prescient forecast as Fed chairman. Thanks in part to heavy investment in computers and other IT equipment, US productivity surged during the late 1990s, a trend that early vintages of US data simply failed to capture.

Chart 7: Forecasting US productivity



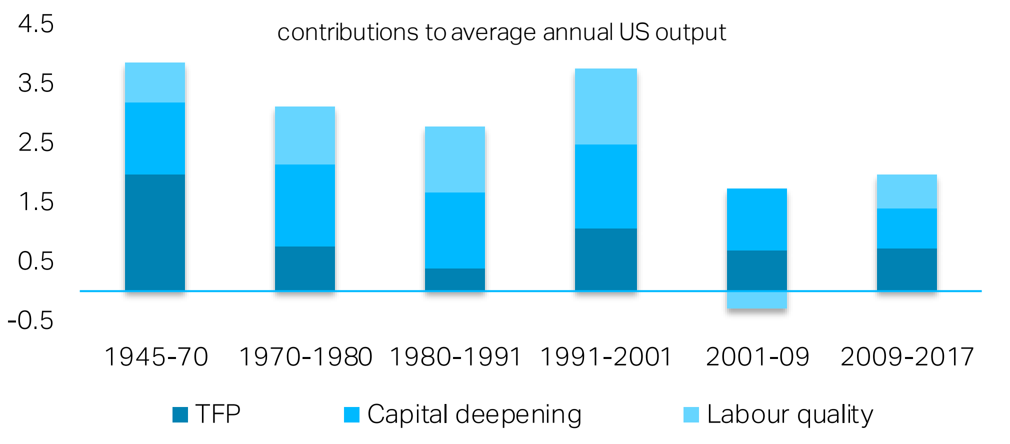
Source: Jason Furman, Chairman or Obama's Council of Economic Advisors

Policymakers have been dealing with a similar productivity puzzle in recent years, a slowdown in measured output per hour that nobody is fully able to explain. This is one of the main reasons economists have revised down their estimates of US supply potential – they are assuming productivity will remain depressed by historical standards. But there are good reasons to think this approach is too pessimistic, particularly if statisticians are again failing to capture the benefits of new technologies. We think that mismeasurement explains a significant part of the 2008 deterioration. More generally, there are good statistical reasons to think policymakers should not pay too much attention to the latest data. Chart 7, taken from a paper by Jason Furman (linked here), shows that economists typically make smaller errors in forecasting productivity when they ignore recent outturns and instead assume output per hour reverts to longer-term trends.

Investment revival

It is also useful to decompose productivity into its main components: multi-factor efficiency plus contributions from labour and capital deepening. John Fernald provides the most detailed and timely estimates for the US (Chart 8). These estimates suggest that weak capital spending has been playing a particularly important role since the subprime crash. This is encouraging because we are now seeing a revival in investment. Business capex has accelerated sharply over the past 12 months, both in the US and globally. If this improvement continues, productivity should follow. While it would be wrong to attribute this revival in productivity to Trumps 'supply side' measures, his stimulus will probably help at the margin – particularly if lower corporate taxes boost capex among SMEs.

Chart 8: Decomposing US GDP



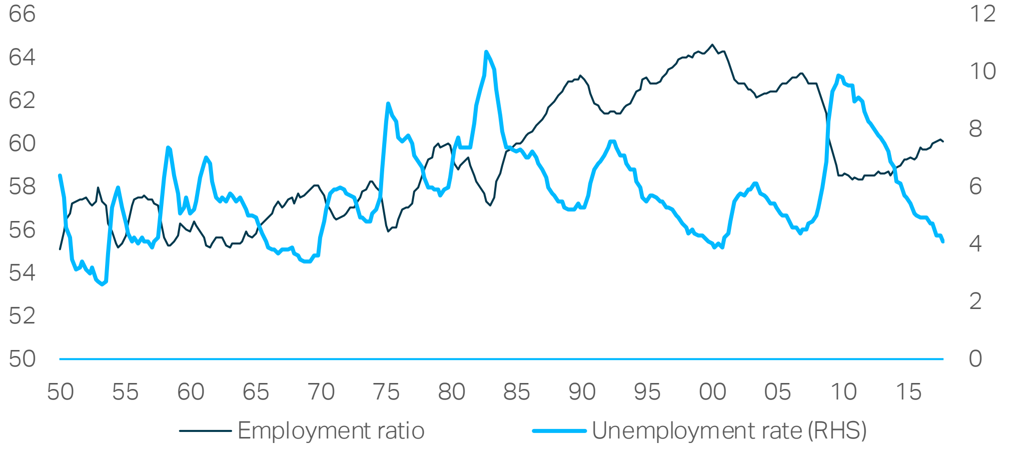
Source: Federal Reserve Bank of San Francisco

Labour response

Even if productivity remains subdued, it seems premature to worry about US fiscal stimulus causing an inflationary surge. Given relatively low employment rates (Chart 9), the economy might not be as close to full capacity as some investors are assuming. Recent analysis from Blanchflower and Levin suggests there is still significant slack in the US jobs market when we take account of depressed labour force participation and underemployment – people working part time who would rather be working full time. It is possible that stronger wages would prompt a supply response in these areas, which in turn would cap any inflationary consequences.

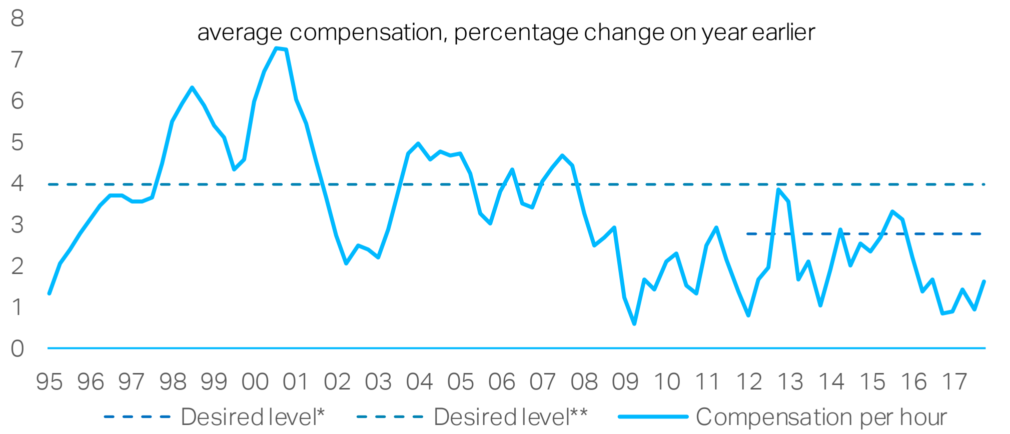
Investors should also bear in mind that recent wage trends have been below the levels needed for 2% inflation – even if we assume that the slower productivity rate after 2011 is a persistent feature (Chart 10). This is because it is not wage growth per se that matters for inflation, but rather wages adjusted for productivity. If trend productivity grows at 1%, the central bank needs nominal labour costs to grow by 3% per annum to be consistent with its 2% inflation mandate. Put another way, an acceleration in wages from current levels would hardly be an inflationary disaster and if productivity improves – as we suspect it will – the Federal Reserve would actually need an even stronger pickup in wages to meet its inflation target on a sustained basis.

Chart 9: US labour market performance



Source: BLS

Chart 10: The case for wage reflation

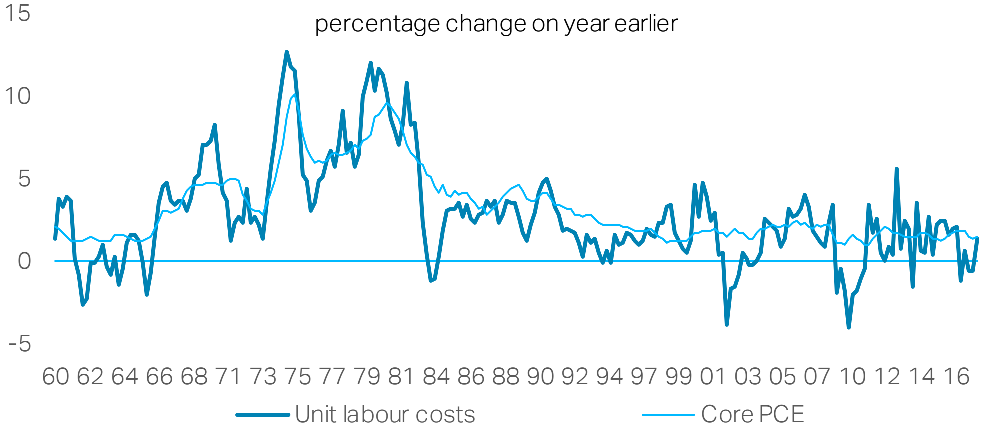


Source: BLS, TS Lombard estimates, *Based on 1991-07 productivity, **Based on post 2012 productivity

3. SEVENTIES FLASHBACK

Our analysis suggests, as least from an inflation perspective, experimenting with a high pressure economy isn't totally unreasonable. President Trump's stimulus has certainly arrived late in the economic cycle, but it will not necessarily cause the cycle to come to an abrupt end. After years of subpar performance, the economy probably has untapped supply potential and stronger demand might put any underutilized resources to work. But there is an obvious criticism of this approach – after all, isn't this the same mistake policymakers made in the late 1960s and early 1970s? Back then, policymakers were too optimistic about potential GDP and ended up in a dangerous inflationary spiral.

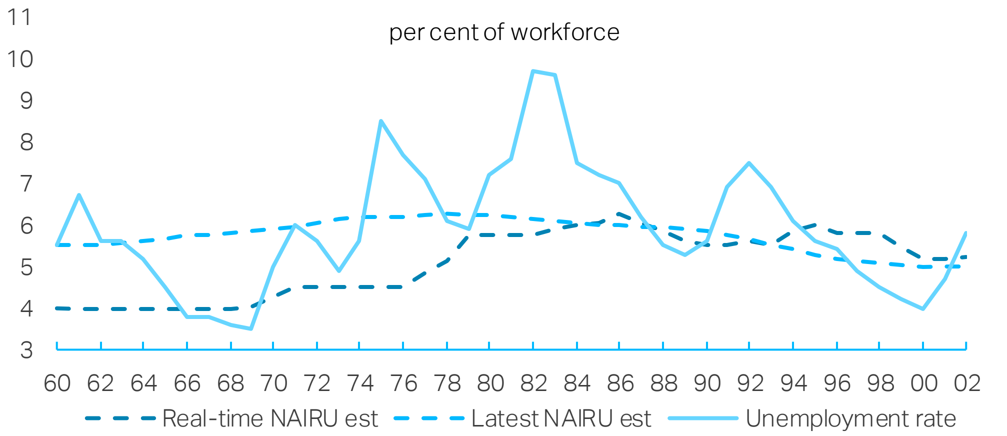
Chart 11: Wage-price spirals in the 1970s



Source: BLS, TS Lombard

Athanasios Orphanides and John Williams provide [a detailed account] of what went wrong in the 1970s. They highlight several major errors: First, policymakers placed a high priority on stabilizing real economic activity relative to price stability. Second, they severely overestimated the productive capacity of the economy during the critical period of 1965 to 1975 – contemporaneous measures of the unemployment rate corresponding to full employment were significantly lower than retrospective estimates. (Note Arthur Okun made his recommendations for the high pressure economy in 1973.) Third, policymakers were overly confident about their understanding of the precise linkage between measures of utilization gaps and inflation. Worryingly, the paper concludes that even modern central banking frameworks wouldn't have avoided these errors.

Chart 12: The 1970s policy error

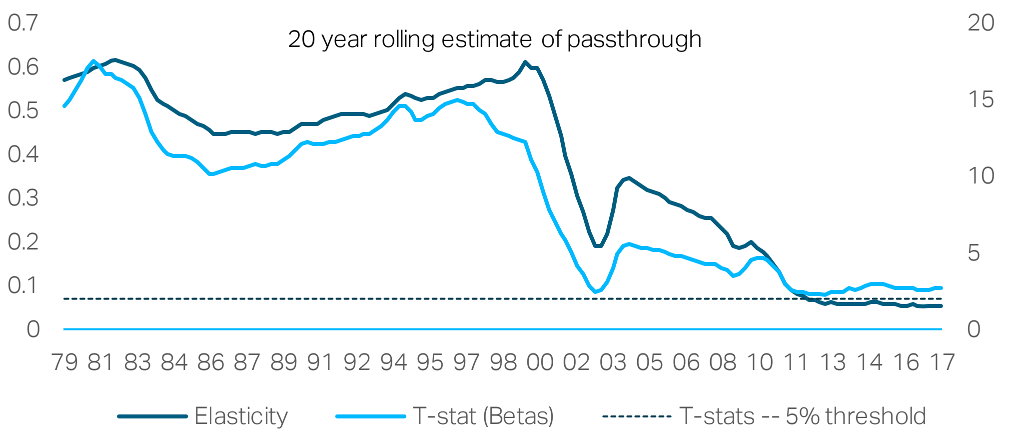


Source: Orphanides and Williams (2011) updated with latest CBO vintages

Wage-price spirals?

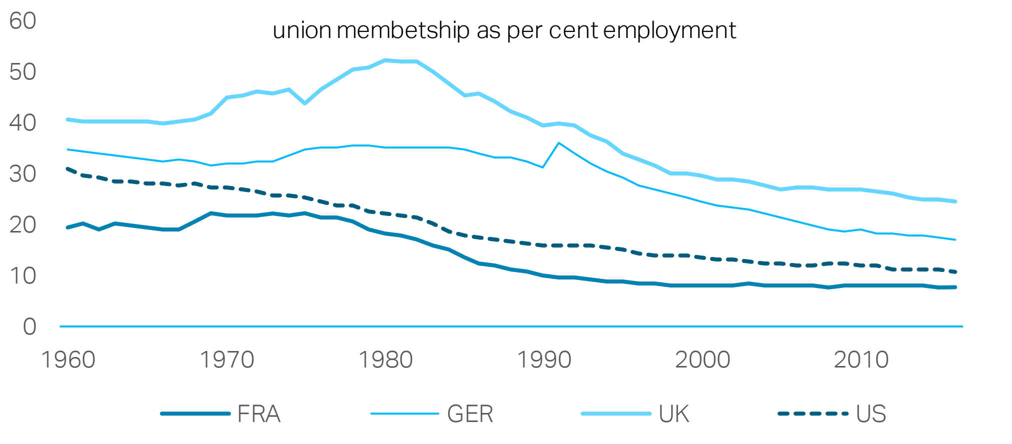
While we accept the Orphanides-Williams warning about the role of poor information in the late 1960s/1970s – particularly the failure of standard NAIRU estimates – it is clear that inflation dynamics are quite different these days. Not only have wages been unusually subdued, even relative to productivity, but the pass-through from wages to inflation has diminished substantially over time (Chart 13). Consistent with several recent academic studies (see this Fed report for a useful summary), there is little prospect of a serious wage-price spiral. A number of structural changes have taken place, including more intense international competition and major evolutions in labour market institutions – notably reduced trade union power (Chart 14) and less reliance on wage-price indexation. When we look at long-term trends in inflation, the 1970s/80s are the outlier, not the norm.

Chart 13: Impact of labour costs on core PCE



Source: TS Lombard estimates

Chart 14: Trade union power



Source: OECD, BLS

Monetary response

Suppose we see a modest acceleration in wages, how will the Federal Reserve respond? This is also a broader question about the Fed's response to Trump's fiscal stimulus. On one level, officials should welcome a period of above-target inflation, particularly as they have undershot the 2% level for more than a decade. Some FOMC members have alluded to this recently by pointing out that their inflation objective is 'symmetric'. Higher inflation would also provide a degree of 'insurance' against the next recession – officials would not want to enter a new downturn with inflation already below 2%. But it is not clear whether Jerome Powell shares this view. He recently told Congress that he wanted to prevent 'overheating', which Tim Duy suggests is an important shift. Still, even if President Trump's fiscal stimulus forced the Fed to raise interest rates more aggressively, this would not necessarily mean the 'high pressure' economy had failed – particularly if we ended up with a better balance between monetary and fiscal policy.

Protectionist threat

While Trump's fiscal stimulus is not as dangerous as it seems, his efforts to close the trade deficit with protectionist measures are harder to defend. The President recently announced sizeable import tariffs on steel and aluminium. While these apply to only a small share of US imports (less than 2% of total goods imports) there is a risk they spark a wider trade war, particularly if the EU and China retaliated. Widespread protectionism would not only to disrupt global supply chains, but could also cause a deterioration in the global growth-inflation tradeoff.

While trade wars are an unlikely prospect, investors will need to monitor this situation. The tariffs also highlight an important contradiction at the heart of Trump's macro policies. The US president wants a stronger economy but is unwilling to tolerate a larger trade deficit. This will be extremely difficult to achieve, particularly if the economy is close to full employment. As Paul Krugman points out, if the trade deficit is 3% of GDP, Trump would need to reallocate 3%pts of output towards domestic production. The administration's best hope is a supply response – Trump needs a successful 'high pressure' economy. But trade wars that harm potential GDP would clearly make this harder to achieve.

Bottom line

The US government has passed a significant fiscal stimulus, worth around 2% of GDP over two years. This move has alarmed some investors who worry, with the economy close to full employment, these policies will invite an inflationary surge that could prompt the Federal Reserve to kill the US expansion. Others worry that the re-emergence of the 'twin deficits' will undermine investor confidence in the dollar, which might also have inflationary consequences. The Trump stimulus is essentially an experiment in 'high-pressure' economics. The policy could work if it is successful in boosting supply potential, an idea that dates back to the 1950s. Given the way the economy has performed over the last decade, this is not an impossible task and a repeat of the wage-price spirals of the 1970s seems unlikely. But only in the absence of self-defeating trade wars!

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