5. Economic impact of Trump's policies

During the presidential election, the then-president-candidate Donald Trump proposed various plans aiming to boost the U.S. economy to a state of high economic growth, high labor participation rate, low unemployment, and reduced trade deficits. Specifically, those plans asked for increasing infrastructure spending and protectionist trade policies. As outsiders to Washington politics, President Trump and his economic counselors view the U.S. economy in a perspective that seems extremely different from other veteran policymakers. Therefore, the interpretation of his policy proposals is often subject to remarkable uncertainty and ambiguity.

In this section, our goal regarding the analysis of today's economic policies is two-fold. First, we try to use dynamic stochastic general-equilibrium (DSGE) models as a tool to analyze the implications of the policies under the Trump government. The tractability of DSGE models is a desirable feature that enables us to eliminate as much ambiguity as possible. Second, based on the estimates from the DSGE model, we attempt to shed light on the consequences of certain economic proposals and provide an anchor to further policy discussions. For this purpose, our benchmark model is the Federal Reserve's Estimated Dynamic Optimization (EDO) Model, which features the latest parameterization and desirable specifications on economic structures and exogenous shocks. In the rest of this section, we will utilize the EDO model and discuss two economic policies that are frequently brought up by the Trump administration.

Infrastructure spending

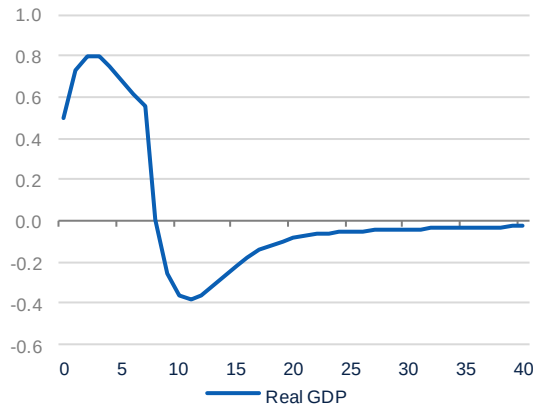
Using fiscal policy to stimulate the economy has a long history since Keynes's *General Theory* permanently changed the landscape of economics. However, mainstream opinions toward its effectiveness have swung significantly during the last six decades. In 1961, the Kennedy government managed to increase defense expenditure dramatically, and the subsequent strong economic growth convinced policymakers that discretionary fiscal policies combined with expansionary monetary policies were the key to a prosperous economy. However, upon repeated usage in the next two decades, this stimulative recipe, which is essentially an instrument to boost aggregate demand, reached its limit. A series of disastrous recessions with high inflation and unemployment in the 1970s put the discretionary fiscal policy under scrutiny (Lucas and Sargent, 1981). As thoughts on fiscal policies evolve, most macro economists tended to agree that "discretionary fiscal policy has not contributed to economic stability and may have actually been destabilizing at particular times in the past," and "monetary policy is the superior tool for macroeconomic stabilization."(Feldstein, 2002) In fact, Solow (2004) effectively summarized such change of political and intellectual landscape stating that "serious discussion of fiscal policy has almost disappeared."

The slow recovery from the Great Recession, however, urges economists and policymakers to explore more options to jumpstart the economy and reconsider the role of the fiscal policy. As the "Make America Great Again" slogan and a series of speeches reveal, President Trump and his economic advisors have looked into the past, and shown strong interests in discretionary fiscal policies such as expanding the defense budget and infrastructure investment. According to the "Rebuild America's Infrastructure" plan released by the White House,[1] the President "has dedicated $200 billion in his budget for infrastructure."

1: https://www.whitehouse.gov/blog/2017/06/08/president-trumps-plan-rebuild-americas-infrastructure

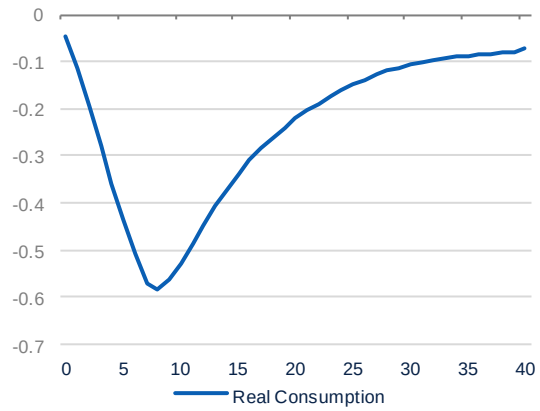
Although fiscal policy is still being negotiated, the proposed magnitude of the infrastructure plan should not be considered as completely irrelevant. Even if $200bn in investment may seem overly aggressive, it can still help us to estimate the largest possible economic impact from the fiscal stimulus. Therefore, in this section, we assume that the President convinces lawmakers and Congress approves a budget with $200bn dedicated to infrastructure. We further assume that the extra expenditure will be spent in eight quarters at steady growth rates. Figures 5.1 – 5.4 show the effects of such fiscal stimulus according to the EDO model.

Figure 5.1 Impulse responses: government expenditure shock (%)



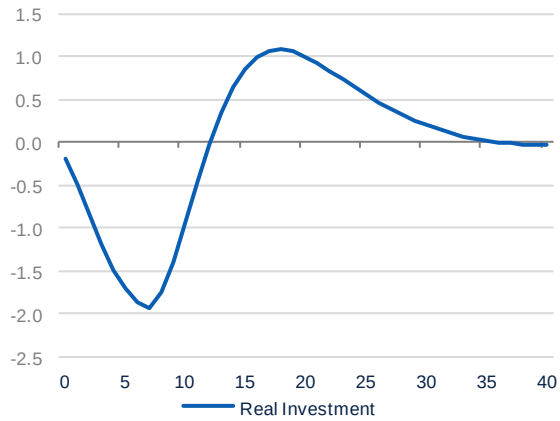
Source: BBVA Research

Figure 5.2 Impulse responses: government expenditure shock (%)



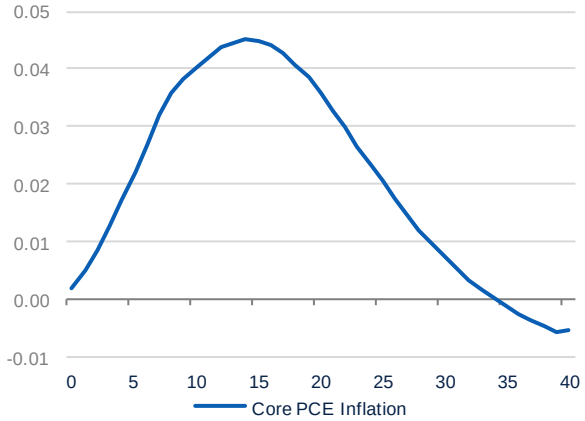
Source: BBVA Research

Figure 5.3 Impulse responses: government expenditure shock (%)



Source: BBVA Research

Figure 5.4 Impulse responses: government expenditure shock (%)



Source: BBVA Research

As we can see from the figures, the $200bn infrastructure investment can boost real GDP growth by 0.8% at the peak. However, the positive effect will quickly converge to zero when the fiscal stimulus program ends at the eighth quarter. The temporary effect is consistent with the experience from the 1960's in which fiscal stimulus only has a short-term effect and should not be used as a cure for structural problems. Moreover, the EDO model also helps to estimate the "crowd out" effect on private consumption and investment. The negative impact on their short-term growth rates is significant. Additionally, the estimated effect on inflation is also consistent with existing literature. As Dupor and Li (2015) summarize, the fiscal stimulus will have little impact on the price level.

Protectionist trade policies

International trade has been one of the key issues in President Trump's political agenda. In our previous discussions, we have examined the effect of Trump's speeches[2] and stylized facts of the trade balance.[3] In this section, we try to shed light on potential trade policies and how they would influence the economy.

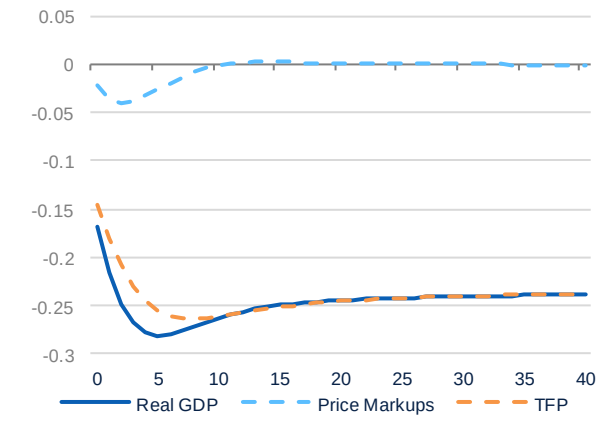
Although the Trump government has had talks with leaders of other countries on trade issues, under the current rules on trade negotiations, the change of trade policies would require the collaboration of different bodies of the government. Given the highly complicated input-output structure of the U.S. economy and its sheer importance in the global economy, any trade reform would require a lengthy process of deliberation and negotiation. For example, the House Republicans' border-adjustment tax (BAT) plan has been widely criticized for generating "unintended consequences" and thus is not expected to pass the legislation.

On the other hand, even though the BAT plan could be axed, the President can still use other ways to impose trade barriers that increase the costs of foreign goods and protect domestic manufacturers. For example, the investigation on imported steels is widely expected to results in higher import tariffs. As the government also plans to investigate other imports such as sugar and lumber, higher costs of international trade seem inevitable for the U.S.

The rising cost of international trade will have adverse effects on the economy. First, trade barriers will introduce market frictions and thus increase price markups of affected goods. Second, higher costs of international trade will also cause structural changes in the globally integrated supply chain, which reduce productivity. Given the highly complex input-output structure of the U.S. economy, we assume that more trade barriers will increase the markups of capital goods and consumption goods by one tenth of their standard deviation, and decrease the economy-wide productivity by one tenth of their standard deviation. The results are in Figures 5.5 to 5.8.

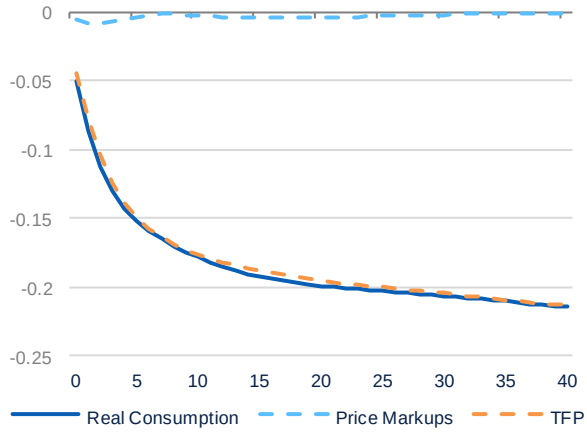
2: https://www.bbvaresearch.com/en/publicaciones/u-s-big-data-analysis-trump-effect-on-trade-narratives/
3: https://www.bbvaresearch.com/en/publicaciones/u-s-the-trade-deficit-dont-fear-the-beast/

Figure 5.5 Impulse responses: trade policy shock (%)



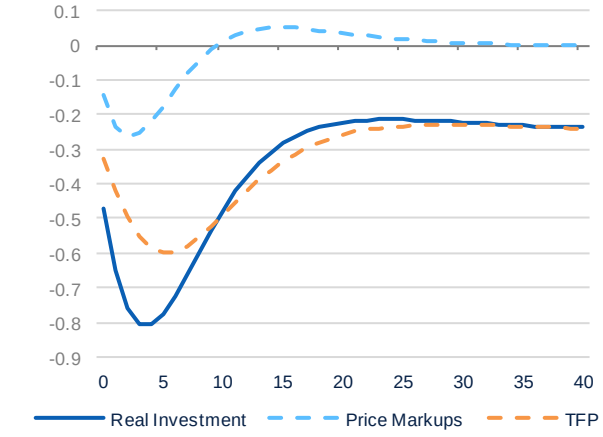
Source: BBVA Research

Figure 5.6 Impulse responses: trade policy shock (%)



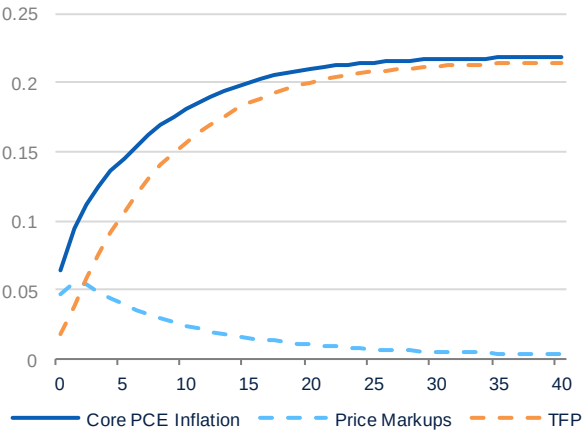
Source: BBVA Research

Figure 5.7 Impulse responses: trade policy shock (%)



Source: BBVA Research

Figure 5.8 Impulse responses: trade policy shock (%)



Source: BBVA Research

Based on estimates from EDO, protectionist trade policies will increase the price markups in the economy, and their effect will be transitory and mostly disappear after two years. On the other hand, the loss of productivity caused by trade barriers will have a dominant and permanent effect on economic variables. This estimate is consistent with the theoretical and empirical literature on openness and productivity growth. That is, when trade barriers increase, the productivity will fall either because the less competitive firms can remain in the market (Melitz, 2003), or because cheaper imported intermediate goods would become unavailable for domestic firms (Goldberg et al., 2010). Since productivity growth is incremental, the negative productivity shock will permanently damage the economy.

The mediocre economic growth since the end of the recession has been challenging economists and policymakers in both theory and practice. As many economists have suggested, headwinds are more likely to be secular than temporary. Moreover, the key to achieving the goal of 3% growth is to provide a strong boost to productivity, and such increase would require a policy package that aggressively incentivizes private investment (Cogan et al., 2017). According to our estimation, the implementation of the president's agenda will have mixed effects on the economy. Increasing infrastructure spending by itself can only provide short-run stimulus at the cost of crowding out private investment. On the other hand, a well-thought-out plan that includes higher infrastructure spending could boost long-term productivity, and generate larger benefits than what our model predicts. Furthermore, although renegotiating out-of-date trade agreements can eliminate frictions and make the market more competitive, using protectionist policies as leverage would risk weakening productivity growth and inflicting permanent damages to the economy.

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This report has been produced by the U.S. Unit

Chief U.S. Economist
Nathaniel Karp
nathaniel.karp@bbva.com
+1 713 881 0663

Filip Blazheski
filip.blazheski@bbva.com

Kan Chen
kan.chen@bbva.com

Boyd Nash-Stacey
boyd.stacey@bbva.com

Marcial Nava
marcial.nava@bbva.com

Shushanik Papanyan
shushanik.papanyan@bbva.com

CONTACT DETAILS:
BBVA Research USA
2200 Post Oak Blvd.
Houston, TX 77025
United States.

Email: bbvaresearch_usa@bbva.com
www.bbvaresearch.com
www.bbvacompass.com/compass/research/
twitter.com/BBVAResearchUSA
bbvaresearchusa.podbean.com

BBVA Research

Group Chief Economist
Jorge Sicilia Serrano

United States of America
Nathaniel Karp
Nathaniel.Karp@bbva.com

Spain & Portugal
Miguel Cardoso
miguel.cardoso@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Turkey, China & Geopolitics
Álvaro Ortiz
alvaro.ortiz@bbva.com

Turkey
Álvaro Ortiz
alvaro.ortiz@bbva.com

China
Le Xia
le.xia@bbva.com

South America
Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Julio Pineda
juliocesar.pineda@bbva.com

Macroeconomic Analysis
Rafael Doménech
r.domenech@bbva.com

Global Macroeconomic Scenarios
Miguel Jiménez
mjimenezg@bbva.com

Global Financial Markets
Sonsoles Castillo
s.castillo@bbva.com

Global Modelling & Long Term Analysis
Julián Cubero
juan.cubero@bbva.com

Innovation & Processes
Oscar de las Peñas
oscar.delaspenas@bbva.com

Financial Systems & Regulation
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Countries Coordination
Olga Cerqueira
olga.gouveia@bbva.com

Digital Regulation
Álvaro Martín
alvaro.martin@bbva.com

Regulation
María Abascal
maria.abascal@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com