Economic Analysis

U.S. 2020 Presidential Election: No easy cures

Filip Blazheski / Adrian Casillas / Kan Chen / Nathaniel Karp / Marcial Nava / Boyd Nash-Stacey
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The 2020 presidential election in November will be a referendum on the incumbent, a choice between doubling-down on the President's policies implemented during the last four years or a throwback toward a more centrist Democratic platform.

Historically, incumbents have an advantage when the economy is performing well, as most voters dislike uncertainty. However, swing voters in key states, which tend to have an outsized influence on U.S. elections, tend to be less ideological and thus vote based on their circumstances and outlook for the economy and the country. Therefore, as is the case with most elections, the result will be determined by voter turnout and the ability of the candidates to persuade the undecided.

The 2020 election is distinctive in two key aspects. First, political polarization stands at its highest level in modern history. Second, technological advances provide unprecedented tools to target voters at the individual level. The combination of both trends will have a high degree of influence on the outcome of this election. Furthermore, although a smooth and peaceful transition of power remains one of the most important trademarks of the U.S. political system, depending on how tight the results are, the 2020 election could also test the resiliency and strength of the institutions and highlight what needs to be fixed.

From an economic perspective, a divided government will not have enough space to make significant policy changes resulting in a continuation of the status quo in terms of growth whereas a unified government is more likely to implement a higher number of far-reaching legislative actions producing a significant uptick in growth and economic conditions. Still, regardless of the balance of power resulting from the election, the implications for the short-term are much clearer than for the long-term. Considering the pressing challenges that the nation is facing, the 2020 election could have significant repercussions and become a major turning point in history.

The voter is always right

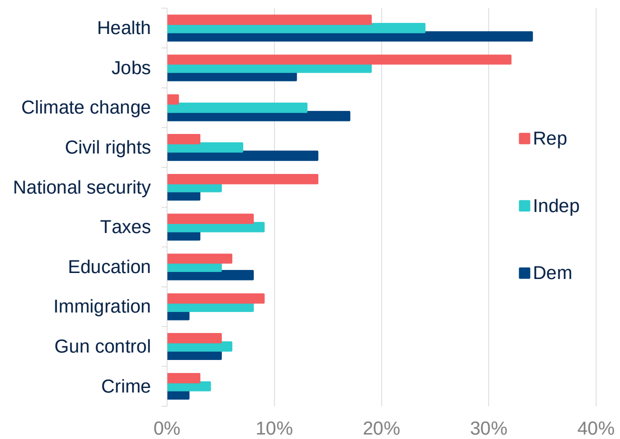
Not only will this election be a referendum on the current administration, it will also be a litmus test for how demographic and cultural differences on fundamental political values like the role of government, individual freedoms and socioeconomic and environmental challenges will determine how people vote. For example, although 87% of Americans believe science and technology will have a decisive role in solving the challenges of the future, the percentage of people that say that the government should do more to solve problems is 70% among Gen Z and 36% among Boomers.[1]

1: Source: Pew Research Institute

The main issues for voters include health care, national security, climate change, education, taxes, the budget deficit, terrorism, regulation, the criminal justice system, gun control, race relations, abortion, civil rights and civil liberties, gun violence, and income inequality.

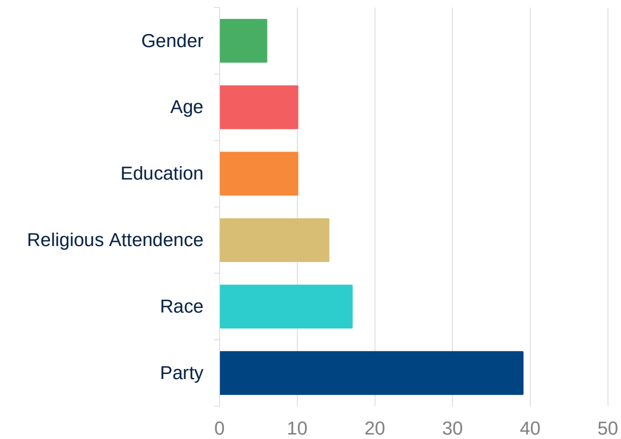
In some instances, voter concerns cross party lines while in others the gap in preferences is significant. For example, health care is the most important issue for Democrats and Independents, and ranks second for Republicans, after jobs and the economy, which is the second most important for Independents. In contrast, climate change ranks second for Democrats but second to last for Republicans. The same applies when it comes to the role of government in solving pressing problems. For example, the percentage of people that say that the government should do more to solve problems is 28% among Republicans and 85% among Democrats.[2]

Figure 1. **TOP ISSUES FOR VOTERS BY IDEOLOGY** (%)



Source: BBVA Research and The Economist/YouGov

Figure 2. **IDEOLOGICAL GAP ON 30 POLITICAL VALUES** (AVERAGE DIFFERENCE PP)



Source: BBVA Research and Pew Research

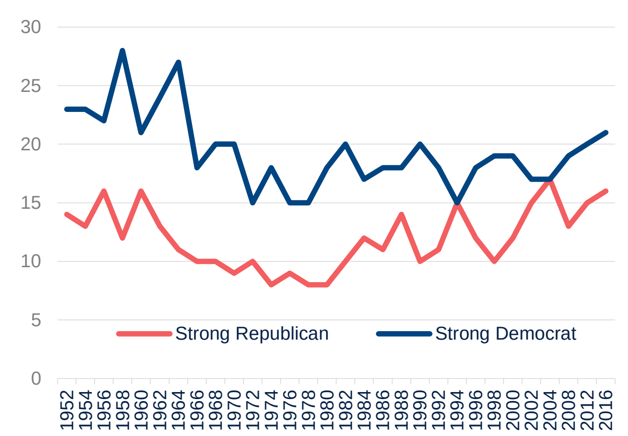
However, empirical evidence suggests that traditional political party differences have been dwarfed by identity politics amid surging partisan antipathy. Some experts argue that negative campaigning, confirmation bias, fake news, echo chambers, and filter bubbles have played a major role. According to J. Druckman, “Technology has facilitated citizens’ ability to seek out information sources they find agreeable and tune out others that prove dissonant.”[3]

Given that race, geography, religion, and other cultural and psychological differences also impact the split within parties, identity politics and demographic differences have reinforced each other, thereby widening the divide over the last decades. This allows elected officials to take more extreme positions that may not align with party voters, based on “we vs. them” rather than on content and personal values. This reduces the probability of reaching across the aisle and produces policies that may boost the chances of reelection at the expense of negative long-term consequences. According to E. Klein, political actors and institutions adopt polarized strategies to both respond and appeal to a more

2: Source: Pew Research Institute
3: Druckman, J. N. (2014) “Pathologies of Studying Public Opinion, Political Communication, and Democratic Responsiveness.” Political Communication, 31:3, 467-492

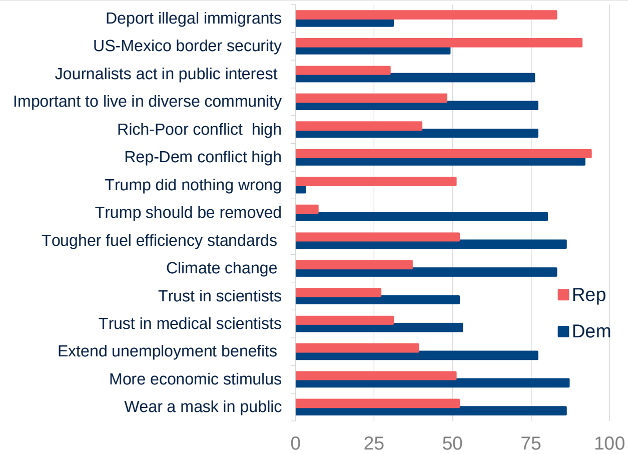
polarized audience, which further polarizes the audience and institutions, creating a feedback loop. In this system, bipartisanship becomes irrelevant, and everyone is fighting without getting the problems solved.[4]

Figure 3. **HISTORICAL PARTISANSHIP (SHARE OF POPULATION %)**



Source: BBVA Research and ANES

Figure 4. **DEMOCRAT AND REPUBLICAN ATTITUDES TOWARDS KEY ISSUES (%)**



Source: BBVA Research and Pew Research Institute

For example, in the 2016 election, the President successfully reignited a 200-year old debate of isolationism versus engagement. That is, closing the borders, doubling down on trade protectionism, looking to itself, and avoiding entanglements with the rest of the world vis-à-vis welcoming immigrants, enhancing free trade, and using the economic and military power to promote democratic ideals. For example, 65% of people see China either as an enemy or unfriendly vs. 17% that see it as an ally or friendly. In the case of Mexico, these percentages are 22% and 52%, respectively. Thus, the election will also be about how voters want to move this debate forward, either by re-engaging in world affairs or by doubling down on isolationism and nativism. Currently, the share of people that say that the U.S. should do more to solve global problems than less wealthy nations is 79% among Democrats and 49% among Republicans.[5]

Know Your Voter

The most recent polling data shows that Biden has a 9pp lead over the President while betting odds give Biden a 60% chance of winning in November. Therefore, if the election was held today, it is very likely that Biden would win. However, given the economic and political turbulence in the first half of 2020, anything might wedge itself between now and Election Day to either bolster or break the Democrat's advantage. In fact, after Biden became the *de facto* candidate for the Democrats, most pundits expected that Trump was going to be easily reelected. Now, however, Biden's high polling numbers are more likely to edge down than up. The President's chances could also improve if the

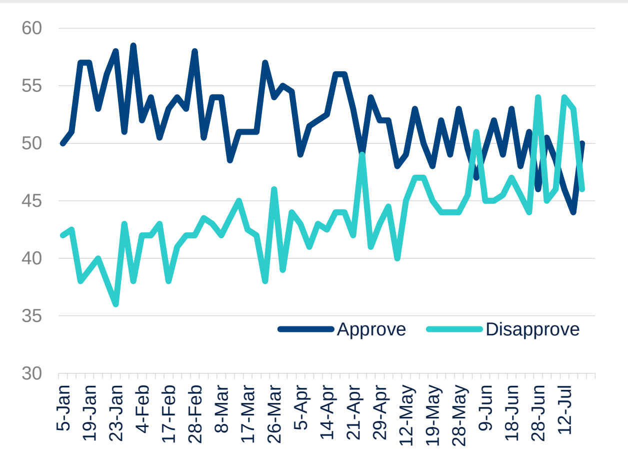
4: Klein, E. (2020). "Why We're Polarized". Simon & Schuster. NYC, NY.
5: Source: Pew Research Institute

Federal government resets the strategy to combat Covid-19 with successful results or if the economy recovers significantly faster than anticipated.

Moreover, the 2016 election showed that a combination of party apathy and unpopular candidates was a recipe for low voter turnout, which obscures insight from polls and general election consensus, which can be highly volatile in the months leading to the election. When looking at voter motivation and candidate favorability, it becomes clear that this election is a rerun of 2016 rather than any cycle from the prior two decades. The 2020 election will be decided by economic conditions, likeability, voter turnout, key swing states, and third-party share.

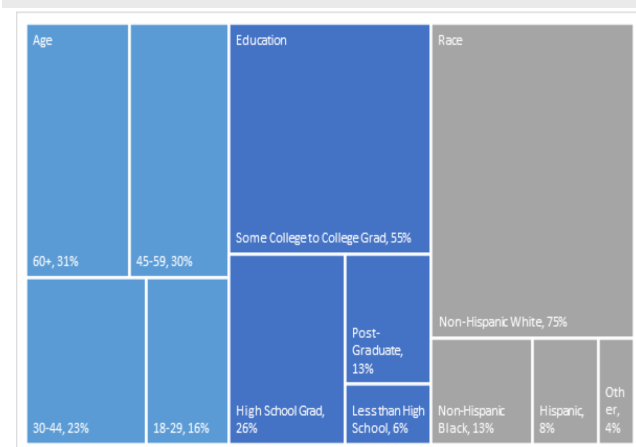
Economic conditions. As in every election, the vast majority of voters will make their decision based on their economic wellbeing and job prospects relative to the previous election. Despite the ongoing economic recession, perceptions on the economic wellbeing still favor President Trump. According to recent surveys, 44% of registered voters are better off than four years ago, while 38% were better off four years ago; among independents, there is an almost even split with 38% and 36%, respectively. The Covid19 crisis has certainly thrown a wrench in the President's appeal to voters. Among independents, 35% approve the President's handling of the Covid-19 outbreak while 56% disapprove it. Overall, some voters could react negatively to the combination of high unemployment at a time when equity prices are near record highs.

Figure 5. **APPROVAL OF TRUMP'S ECONOMY** (%)



Source: BBVA Research and RealClearPolitics

Figure 6. **SHARE OF ELECTORATE BY DEMOGRAPHICS** (%, Turnout x Eligible Voters)



Source: BBVA Research and USEP, Avg. 2008, 2012 & 2016

Likeability. Although both candidates are unpopular by historical standards, recent surveys suggest that Biden is not as disliked as Trump. Candidate favorability in the 2020 election cycle resembles trends from the President's first election when both Clinton and Trump consistently remained in negative territory while in campaign. Among those who disliked both candidates -the double haters- the vast majority voted for Trump in Michigan, Wisconsin, and Pennsylvania, where the election was decided. According to successive Pew Research polls, Trump and Biden voters mirror one another, with 76% of Trump supporters saying they view their ballot as a vote for Trump and 24% as a vote against Biden. In contrast, 33% of Biden voters viewed their ballot as support for Biden and 67% as a vote against

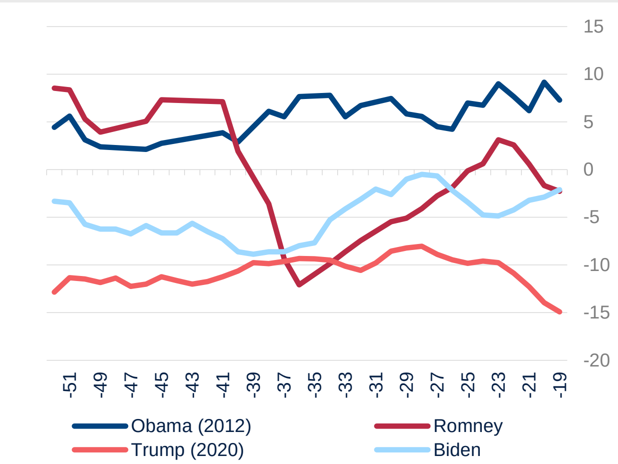
Trump. In 2016, 55% of self-designated Trump voters said their vote was against Clinton, and 50% of Clinton voters were voting against Trump.[6]

Turnout: The last general election was notable for the lowest voter turnout in two decades and for 2% of ballots abstaining from voting for president, which was more than twice that seen in 2012. Although the pandemic and social unrest could mobilize voters, we are unlikely to see a historic turnout. For example, minority and young voters played a considerable role in handing Obama his relatively large margin of victory in 2008, when Black turnout reached 70%, and young turnout was 50%. Meanwhile, in 2016, Trump won with a 6pp and 9pp margin among voters in the 50-64 and 65+ ranges, respectively. For the most part, this was an expression of dislike toward Clinton that may not repeat for Biden. In fact, recent polls show a tight margin among older voters.

Biden could also benefit from a better-than-expected turnout in commonly progressive demographic groups like young individuals, which may be high enough to match Trump's base - male, the elderly, and white non-college graduates. According to recent polls, Biden beats Trump among Whites, suggesting that he does not carry the same level of distrust among these groups as Clinton did. Biden also commands a comfortable margin among women, where the dislike for Trump is stronger.

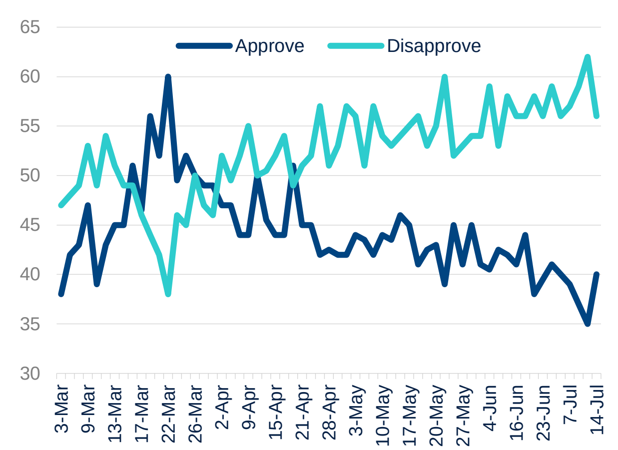
However, several trends could guarantee Trump's victory, like an increase in turnout and support from non-college-educated White voters. In 2016, the non-Hispanic White turnout was the highest since at least 1986. However, their share of the electorate continues to edge down from almost 86% in 1990 to less than 74% in 2018. A decrease in Black and non-Black Hispanic turnout would also help Trump. Hispanic turnout has never been above 50%, while Black turnout averages 50%. A low turnout by young voters would also help the incumbent candidate. While turnout for older voters in presidential elections is around 71%, it is only 44% for younger voters. Given the distribution of eligible voters, this implies that one vote from an older person is equivalent to two votes from a younger individual.

Figure 7. **INCUMBENT NET FAVORABILITY** (PP, WEEKS UNTIL ELECTION)



Source: BBVA Research and RealClearPolitics

Figure 8 **APPROVAL OF TRUMP'S HANDLING OF COVID** (%)



Source: BBVA Research and RealClearPolitics

6: Source: Pew Research Institute

Swing States. The result of the election will likely come down to six battleground states -Wisconsin, Michigan, Pennsylvania, North Carolina, Florida, Arizona- where key demographics, the magnitude of the COVID-19 crisis, and local-level economic conditions will play a major role in how voters make their decision. Recent polls suggest that Biden is leading Trump by a margin of five to eight points, comfortably outside the margin of error in Wisconsin, Florida, Michigan, and Pennsylvania, whereas he is leading Trump by less than three points in North Carolina and Arizona. Meanwhile, Trump is leading by a narrow margin in Texas and Georgia which are not traditionally considered swing states, but that could be in play if the candidates decide to spend enough time and resources in them.

Third Party. Trump's victory in 2016, with only 46% of the vote, would not have occurred without third-party and write-in candidates receiving 5% vote-share, which benefited from high levels of dislike for the two main candidates. It is likely that around 2% will return to one of the two main parties, and about 60% will go to the Democrats. This could increase Biden's chances of victory in key places considering that in the last election, third-party options obtained more votes than the difference between the two candidates in states with tight races.

In sum, economic conditions, the pandemic, and voter turnouts of key demographic groups in swing states will decide this election. Although Biden currently enjoys more favorable conditions than Trump, idiosyncratic issues at the local level could influence the candidate's standing in swing states. In other words, even the best polls could miss major shifts in voter sentiment and preferences that will only be apparent on Election Day. Thus, to some extent, the election remains contested.

Rules of the Game

Passing major partisan and controversial legislation is a complicated process without a unified government. Since Senate procedural rules require 60 votes to advance legislation without facing what is commonly called the "filibuster" or endless debate to delay or avoid a vote, the hurdle for passing legislation is high. Since the 1960s, when Democrats held the presidency and a 60-vote filibuster-proof majority in the Senate, there have only been two Congresses when this has occurred (77-79 and 09-11[7]).

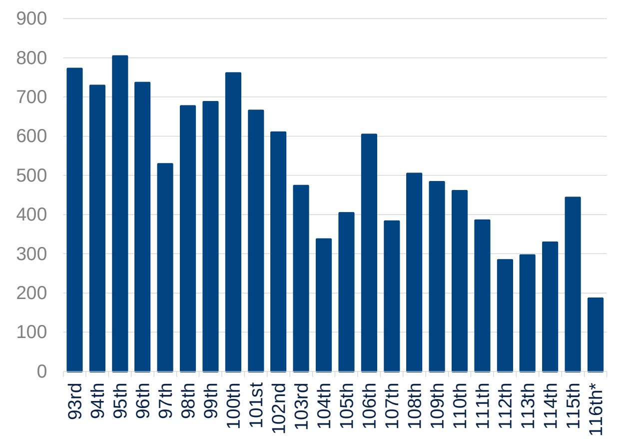
Alternatively, the majority can resort to the "budget reconciliation process", which can be done relatively quickly and only requires a simple majority in the Senate. Nonetheless, there are important limitations. Reconciliation can only be brought up a maximum of three times per year per budget resolution, it cannot be used to increase deficits beyond the budget window (currently at 10 years), and it can be blocked if the provisions are extraneous to the purpose of implementing budget changes.

Since 1980, Congress has passed 25 reconciliation bills, of which 21 have been enacted and 4 vetoed by the president. These include four signed by President B. Clinton, which mainly dealt with tax and spending measures but also made significant changes to the welfare system. Republicans used it twice to cut taxes in 2001 and 2003. In 2010, Democrats adjusted the Affordable Care Act (ACA) through reconciliation, and in 2017, Republicans passed the tax reform under the same process. Some experts argue that the reconciliation process has promoted gridlock, discouraged bipartisan lawmaking, and made deficit reductions more difficult. Since 1917, cloture has been invoked

7: In the 111th Congress, Democrats had supermajority in the Senate between July 7 and August 25, 2009 and between September 25, 2009 and February 4, 2010.

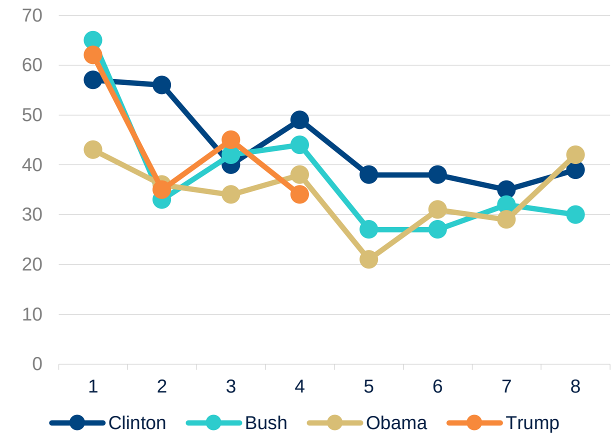
1,056 times, of which 58% has occurred in the last 6 years. In addition, the number of laws enacted by Congress has diminished over time, although the number of pages has gone up.

Figure 9. **LAWS ENACTED BY CONGRESSIONAL TERM** (NUMBER)



*Normalized to reflect full congressional session
Source: BBVA Research and Govtrack

Figure 10. **EXECUTIVE ORDERS BY YEAR IN OFFICE** (NUMBER)



Source: BBVA Research and Federal Register

The Constitution gives the president the power to appoint federal judges, ambassadors, and other "principal officers" subject to Senate confirmation. The president can also veto legislation, grant pardons, sign treaties -with advice and consent from the Senate-, and declare war. In the absence of Congressional support, the President can issue executive actions (memoranda, proclamations and orders), which are meant to help enforce the laws but that have been used in a broad fashion well beyond the sole responsibility and obligation of making sure that the laws are faithfully executed. Since independence, all but one president have used executive actions to advance their policies some of which have had a significant impact shaping American history like freeing slaves, suspending habeas corpus, nationalizing the steel industry, confiscating gold, desegregating the armed forces, creating FEMA, protecting water and land resources, expanding and limiting immigration, imposing trade tariffs and withdrawing from international agreements. In some cases, Congress can take action to block them. In others, executive orders can be contested in court or reversed by the next administration.

In sum, the possibility of the next administration to implement partisan and far-reaching legislation will be limited without a unified government and a supermajority in the Senate. Still, the next president will be able to issue executive actions to advance political objectives with potentially significant implications, although these could come with an expiration date.

No Middle Ground

Biden

Although Biden has embraced some key ideas that four years ago seemed too progressive like paid family sick leave, lowering the eligibility age for Medicare and extending student debt relief, his main proposals can be characterized as a continuation of the Obama administration policies. On economic and tax policy issues, Biden supports a $1.3tn infrastructure package, increasing the federal minimum wage to $15, raising the income tax rate, social security taxes, the capital gains tax and corporate tax rates, as well as reducing deductions for top income earners. On healthcare, Biden opposes Medicare-for-all and prefers to build on the ACA's foundation, offering a public option and lowering prescription drug costs. On the environment and energy, Biden's goal is to achieve a 100% clean energy economy and reach net-zero emissions no later than 2050. To that end, he proposes $5tn investment ($1.7tn public and $3.2tn private/state & local) over ten years, a carbon tax, ending new oil leases in federal lands and offshore drilling, and developing new nuclear technologies. On the tech sector and privacy protection laws, Biden has signaled that more investigation is needed. His stance on foreign trade reflects support for deals with binding standards for labor, human rights, and the environment, fewer concerns on China, unwillingness to use tariffs to pressure other countries, joining CPTPP with some adjustments, and backing up the USMCA. On immigration, Biden supports an open and welcoming system, DACA, eliminating recent restrictions and a path to citizenship for undocumented workers.

Trump

Although the administration has not explicitly laid out what the plans are for the next four years, it seems that the focus will be on healthcare, taxes, infrastructure, immigration, and trade. On taxes, the president has indicated that the administration is considering a tax reform 2.0 focused on tax breaks for the middle class and making permanent some provisions that are due to expire. In part, this reflects that the benefits from the 2017 tax reform were mainly concentrated among high-income earners and corporations. Now the administration has indicated a strong willingness to cover a broader segment of the population. In addition, there would be spending cuts although probably not substantial since entitlement programs are not part of the list.

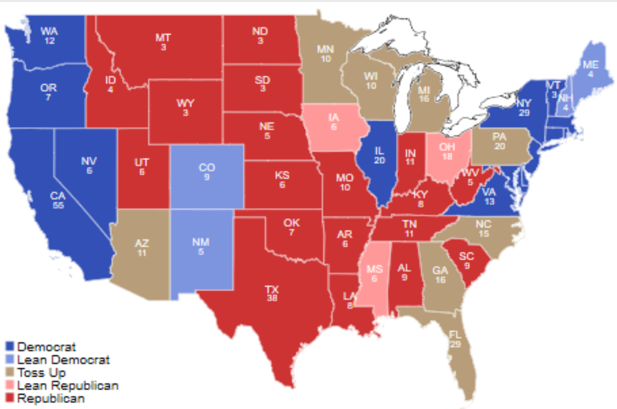
On infrastructure, the President supports a $2tn package to improve precarious roads, bridges and ports. The plan to reshape immigration implies moving away from a system mainly based on family reunification to one based on education and job skills, as in other developed countries. On trade, the administration is likely to continue disrupting the global trading system through tariffs and other protectionist measures. On healthcare, the President supports eliminating the ACA while boosting quality and reducing costs through increased competition from insurance providers. House Republicans recently released a proposal similar to the one in 2017, where existing Medicaid and individual market subsidies would be repackaged into state block grants where fifty new health insurance reform plans would be created and administered. In fact, the GOP recently announced that they will maintain the 2016 platform for the next four years.

Put up your dukes

Current polling suggests that if the election was held today, there is a high probability that the Democrats would control Congress and the White House. However, there are still other possibilities given how much time is left until Election Day. In 2016, for example, Trump won the presidency with 46% of the vote and slim majorities in some key states that gave him the Electoral College.

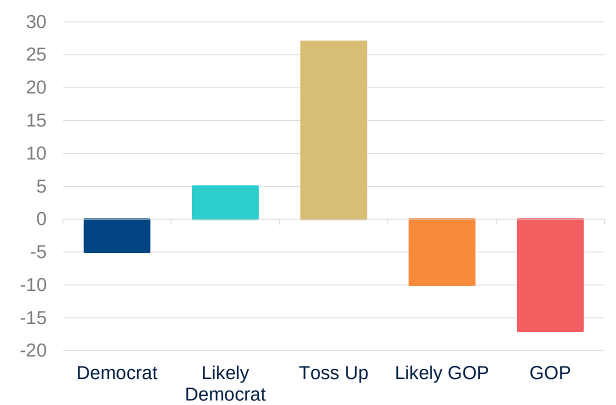
According to our state-level Electoral College model, which is based on institutional and constituent ideological trends, voter turnout and regional economic conditions, Democrats are likely to win 220 Electoral Votes (EV) while the GOP is now only likely to win 188 EV, with 127 EV votes up for grabs. This is in contrast to the pre-Covid-19 projections, in which the GOP was projected to win 215 EV, with 100 EV up for grabs. Meanwhile, our incumbent model, which considers economic growth and net approval, suggests that under current conditions Democrats would easily win more than 300 EV. For Democrats to lose, net approval for Trump would have to turn positive and reach close to 10 percentage points. Third party models confirm this result. For example, the Cook Report gives Democrats 279 EV while Sabatos Crystal Ball, Inside Elections and Politico give the Democrats 268 EV and around 66 EV are toss-ups. According to betting houses and state polling models, Democrats obtain 334 and 301 EV, respectively.

Figure 11. **BBVA ELECTION MODEL PREDICTIONS** (ELECTORAL DELEGATES)



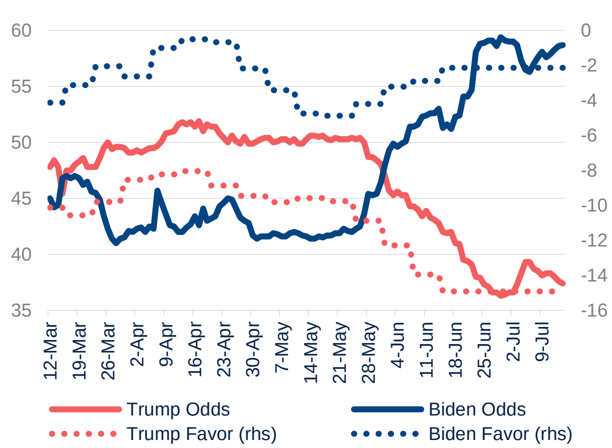
Source: BBVA Research

Figure 12. **PRE AND POST PANDEMIC SHIFT IN ELECTION PROJECTIONS** (CHANGE IN ELECTORAL DELEGATES)



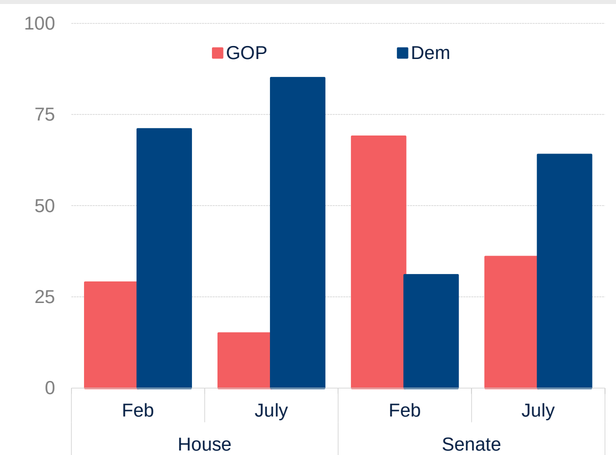
Source: BBVA Research

Figure 13. **PRESIDENTIAL BETTING ODDS & NET FAVORABILITY** (% & PP)



Source: BBVA Research and RealClearPolitics

Figure 14. **HOUSE AND SENATE ELECTION ODDS** (%)



Source: BBVA Research and PredictIt

Blue Wave

Our blue wave scenario assumes that Democrats take control of the White House, the Senate, and the House. However, even if Democrats win all the close races in the Senate, they will remain short of the 60 votes needed to break the filibuster.[8] This implies that they would still have to use budget reconciliation to move forward some key tax and spending policies, as it is very unlikely that even some GOP senators would be willing to reach across party lines. In any case, Democrats would have ample space to push forward their progressive agenda and shift the direction of the country through Supreme Court nominations, judicial appointments, reshuffling heads of various government agencies, rebooting foreign policy objectives and changing the scope of regulatory policy.

Purple Rain

Our purple rain scenario assumes that Biden wins the presidency and Democrats regain control of the House but the GOP keeps the Senate. Given Biden's centrists views, less antagonistic approach and vast experience inside the Beltway, this scenario represents an opportunity for bipartisanship politics. A partial victory for Democrats will be interpreted as an endorsement to move away from the policies during the last four years. However, Republicans in the Senate will have to choose between full-front opposition and wait until the midterm elections or compromise and move forward in those few areas where there is common ground like infrastructure and the opioid epidemic. Opting for the former implies opening investigations, blocking appointments, and choking international agreements. Choosing the latter could limit polarization and bring about a healthier and functional Senate. Past experience is not useful in this case since a Democrat led White House and House with a Republican Senate has never happened. Yet, the fact that the Senate tends to be more stable and less radical than the House raises some hopes for bipartisanship if this scenario were to occur.

Red Tide

Our red tide scenario assumes that the GOP maintains control of the Senate and the White House and regains the House. In the Senate, the GOP wins all contested races and thus increases its margin by two votes; however, this is still below what is needed to break the filibuster. Therefore, most of the tax and spending policies would have to be implemented through budget reconciliation; other matters would have to go through executive actions. If this plays out, the red tide scenario will occur during the second term of the Trump presidency, which is historically associated with a more challenging political environment. This could exacerbate the President's desire to cement his legacy through continuing the disruption to the global order and double-down on some of the more controversial promises given that the costs of alienating important swing voters would become irrelevant when there is no potential for re-election.

Pretty in Pink

Our pretty in pink scenario assumes that the GOP maintains control of the White House and the Senate, but Democrats cling to the House. Considering the more diverse and hostile nature of the House relative to the Senate, this scenario assumes a lower probability of bipartisanship and thus increasing brinkmanship. In fact, it could even

8: In 2020, there are 23 GOP and 12 Democratic seats up for election result in further investigations by the House and a potential second impeachment process. However, we also expect both parties to cooperate in basic areas and the federal budget. To the extent that both sides are able to moderate their positions, there might be some chance of passing legislation on infrastructure and immigration. If both sides remain adamant to make concessions, governance will be a complicated process that would imply more reliance on executive actions, legal challenges and Supreme Court rulings.

From a political perspective, the upcoming election could be seen as a test of the country's institutional framework as has happened in the past and, which despite major failures, has managed to survive the test of time.

A rolling stone gathers no moss

From an economic perspective, we developed three major scenarios that capture both the potential results of the election and the impact of the health crisis: **polarized, carte blanche and pandemic**. In all three cases, regardless of who wins the election, the next administration would have to devote a vast amount of time and resources to cope with three key challenges: the health crisis, economic fallout and social unrest. In the polarized and carte blanche scenarios, we assume that the health crisis is properly managed and is under control through effective treatment and mass-distribution of a vaccine as early as 1H21. Similarly, we assume that economic normalization, which started at the end of 2Q20, continues building momentum, but the level of GDP remains below pre-crisis levels at least until 2022. In addition, social unrest will continue but tensions recede over time.

In contrast, the pandemic scenario assumes a new rise in infections, which leads to persistent voluntary social distancing and additional lockdowns. Moreover, a nontrivial share of the economy would take a prolonged period to return to normal while a smaller share will be permanently damaged. Finally, social unrest is expected to intensify, with negative effects on confidence and expectations.

Although most voters believe that political outcomes have a significant influence on economic performance, the difference across major economic indicators, depending on which party is running the show, is relatively small and statistically insignificant. This reflects both the effectiveness of the system cemented on solid fundamentals[9] and the limitations for one individual or group of interest to make critical and permanent changes if these are not consistent with these core principles or supported by the majority. In other words, the results of the election could benefit one sector or group of individuals more than others, but at the aggregate level the differences on economic growth, unemployment, inflation, interest rates, equity prices, lending, and other indicators is small.

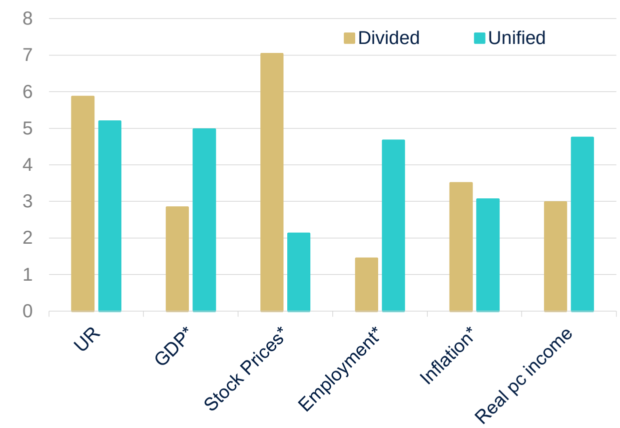
In terms of how many branches of government are controlled by one party and the economic outcomes, in the post-WWII era, there have been two periods (1960-1969 and 1977-1978) when one party controlled the White House and Congress with a filibuster-proof majority, both of which were led by the Democrats. While stock prices were significantly lower during these unified governments, GDP, employment and real per capita income growth were much higher than with divided governments, whereas inflation was similar. Moreover, consumer and small business confidence was higher, possibly signaling that unity and progress, regardless of party affiliation, is a positive. As expected, despite similar inflation, nominal long-term interest rates were slightly higher in the divided-government periods, probably

9: Some examples include a market-oriented economy, flexible labor markets, taxation that incentivizes work, entrepreneurial culture, top research universities, pro-growth regulatory environment, a highly developed financial system, separation of powers, rule of Law, property rights protection, and limited government intervention.

reflecting higher uncertainty and risk perception. However, this difference was small, with the 10-year treasury yields averaging 5.8% in periods with a divided government and 5.2% in the unified setting.

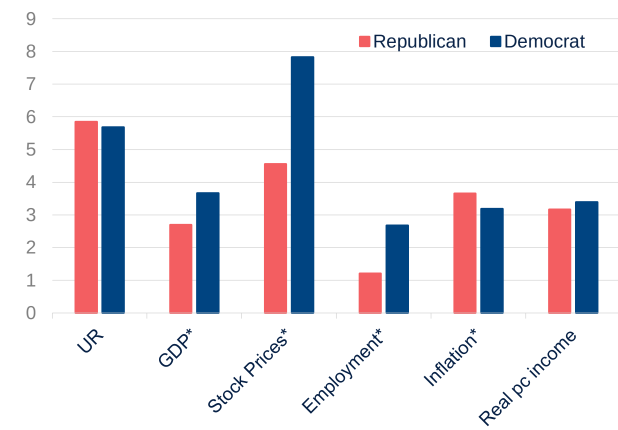
In the same period, when looking at variations in terms of financial and economic outcomes based on which party controls the White House, the differences are small, but favor the Democrats. Employment growth has been higher and the unemployment rate lower during Democratic presidencies. They have also achieved slightly higher GDP growth and real per capita incomes, but lagged in terms of small business confidence and did only modestly better in terms of consumer confidence. Interestingly, equity prices gains were 3.3pp higher during Democratic presidencies with 10-year yields on U.S. Treasuries more than 1pp lower.

Figure 15. **ECONOMIC AND FINANCIAL OUTCOMES, UNIFIED VS. DIVIDED** (%)



Note: *Year-over-year growth
Source: BBVA Research

Figure 16. **ECONOMIC AND FINANCIAL OUTCOMES, DEMOCRAT VS. REPUBLICAN PRESIDENT** (%)



Note: *Year-over-year growth
Source: BBVA Research

Polarized

In the polarized scenario, we assume that one party either loses control of one legislative branch or has full control of Congress and the White House, but the margin of victory in the Senate falls short from the 60 votes needed to break the filibuster. We assign a 70% likelihood and thus it can be considered a baseline scenario. As explained above, the next administration will devote the first months to addressing any remaining challenges associated with the health crisis such as distributing the vaccine, ensuring sufficient medical supplies and equipment, providing broad access to testing and therapeutics and supporting efforts to contact trace. In addition, the administration will have to deal with the economic crisis by ensuring firms, individuals and state and local governments receive adequate economic support while also achieving a comprehensive and safe reopening. Moreover, the new government will have to manage social tensions and the psychological and emotional effects of the pandemic.

This scenario assumes that the next administration will be able to advance some key policy proposals with limited or no support from the opposition, either through budget reconciliation or through executive actions. Thus, the next administration will be able to boost growth through more government spending, tax cuts or a combination of both. This implies a reallocation of resources that may favor certain industries or regions more than others. For example, Democrats may focus on a more progressive tax system and increasing spending on health care and education while Republicans may target tax cuts and deregulation. However, regardless of which party wins the election and the number and nature of legislative actions, the short-term impact on economic performance will be limited.

In terms of growth, we assume the pandemic will heavily influence growth in the first year both in terms of the statistical base effect of coming from the lows of 2020 and in terms of the timing of the vaccine, which could be available in 1H21 at the earliest. As a result, GDP growth is above potential for the first half of the term, but converges to around 2% thereafter. Despite the high growth rates in the first half of the term, the economy fails to return to pre-pandemic levels until 2022, following an L-shape or “Swoosh” recovery path that never returns to its pre-pandemic trend.

In this scenario, the unemployment rate remains stubbornly high, consistent with a jobless recovery and labor market hysteresis.[10] By the end of the term, the unemployment rate hovers around 5.2% with core PCE remaining below the Fed’s target of 2%, implying a cautious stance that does not begin to remove accommodation until 2023. With low short-term interest rates, muted inflationary pressures and elevated risk perception, long-term yields remain low and only begin to edge up in the latter half of the next president’s term, reaching 2.3% in 2024.

Carte Blanche

In the carte blanche scenario, we assume that one party has full control of Congress, the White House and, either a supermajority in the Senate or enough support from some members of the opposition to advance legislation through the normal course of business. Considering historical evidence, recent polling data, how ineffective Congress has been in recent years, and rising levels of polarization, we assign a 10% probability to this scenario.

Although there are no differences between this scenario and the previous one regarding the time to develop a vaccine, pressures from social unrest or the magnitude of economic strains impacting certain industries, by construction this scenario assumes that the winning party will be able to get more done than in the polarized scenario. This implies lower policy uncertainty and risk perception, which result in higher levels of investment and lending. This in turn boosts employment and consumption, pushing short-term economic performance above trend.

However, the aggregate impact remains similar regardless of which party controls the government. For example, increased spending on energy infrastructure will boost growth in the short-term regardless if this is done through renewables or fossil fuels. An immigration reform would also boost labor force participation regardless if this is done through the legalization of undocumented workers or through a skilled-based system. Likewise, boosting after-tax income and thus private spending in the short-term could be achieved through more progressive taxation and redistributive policies or through tax cuts.

Although economic conditions remain stable even in a divided scenario, a unified government will have a greater chance of addressing major short-term challenges including the pandemic, high unemployment and business sector disruptions, suggesting that the economic outcome in this scenario would be significantly better. Therefore, in this

10: In the economic literature, the term hysteresis usually denotes the notion that recessions have permanent negative effects on the supply-side of the economy.

scenario we assume GDP growth reaches 5% in 2021 through fiscal expansion and infrastructure investment. After that, growth rates remain well above trend, converging with growth rate of 3% in 2023, supported by higher investment, labor force growth and public-private R&D, as well as a productivity boost. As a result, GDP surpasses the pre-pandemic trend in 2023.

By the end of the term, we expect the unemployment rate to dip below 3%, which is below those observed prior to the pandemic. The rapid acceleration of aggregate demand, tight labor markets and improving inflation expectations would drive inflation above the Federal Reserve (Fed) 2% target. In fact, the level of inflation converges with the pre-pandemic path towards the end of the term, satisfying the Fed's desire for some overshooting of the symmetric target, which they have failed to accomplish for over a decade. As a result, the Fed begins to remove accommodation as early as 2022, but remains cautious given the recent experiences with acting too quickly, slowly raising rates thereafter. As a result of an improved outlook for inflation, a more hawkish Fed and modest normalization in the term premium, we expect 10-year Treasury yields could reach 3.75% by 2024.

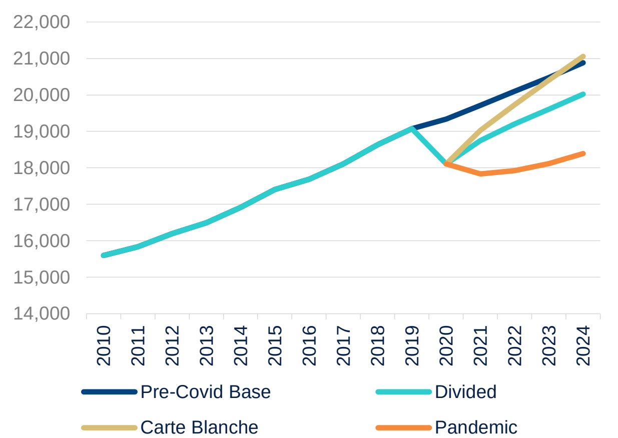
Pandemic

Our pandemic scenario implies depressed business and consumer expectations, elevated risk perception and lower levels of consumption, investment and employment than in either of the previous two scenarios. That is, the short-term outlook will be mainly determined by increased health care pressures stemming from the pandemic, low levels of economic activity in certain industries and high social tensions. We assign a 20% probability to this scenario. From a political perspective, the next administration will not be able to pass meaningful policies and could even make significant mistakes that would exacerbate the downside risks from the pandemic and the economic fallout. At the individual and industry level, the redistributive effects would not change materially from what has happened so far. In other words, the people and industries that have been severely affected will continue to suffer more than others, and the next administration policies would be preoccupied with playing catch-up rather than addressing structural challenges. As a result, economic performance would fall below trend, and the long-term consequences could be significant.

If the government is unable to control the spread of COVID-19 and there is no vaccine available for some time, who wins the election will not have a major influence on economic conditions over the next four years, as the administration will have to focus their attention on fighting off a double-dip or depression rather than addressing key structural challenges. As a result, we expect growth would remain negative in 2021 with an unemployment rate surging to around 13%. Persistent dislocations from the virus and a reshuffling of capital leads to major productivity losses, erosion of labor force skills and attachment, and demand-side stagnation with little remaining fiscal capacity. As such, unemployment remains above 8% throughout the term with inflation averaging 0.9% for the four years.

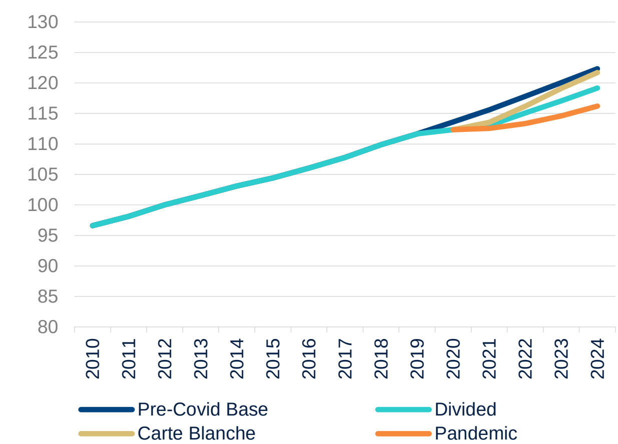
Under these conditions, monetary policy remains extremely accommodative. Without the ability or willingness to expand fiscal policy sufficiently and with rates already at the effective lower bound, we anticipate that the Fed commits to unlimited Large Scale Asset Purchases, Yield Curve Targeting and other unconventional tools. Given the lack of appetite from the current Fed to commit to negative interest rates, we do not think this will happen although we cannot rule it out completely. Instead, the Fed will ready the "big bazooka" by expanding the scope and magnitude of private and public sector security purchases. In light of the extremely weak inflation environment and tepid growth conditions, long-term yields reach all-time lows of around 0.1% by the end of 2024.

Figure 17. **REAL GDP** ($TN)



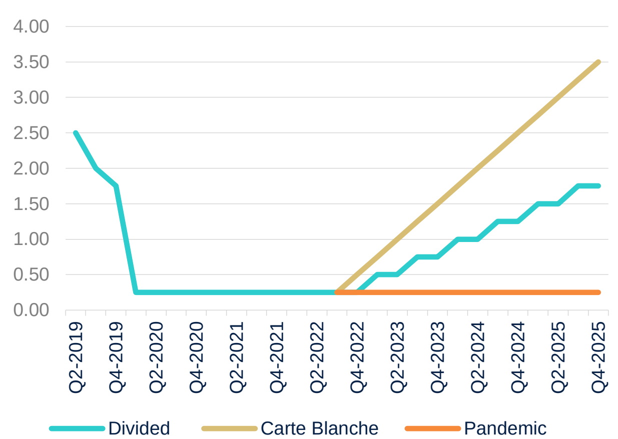
Source: BBVA Research

Figure 18. **CORE PCE PRICE INDEX** (2012=100)



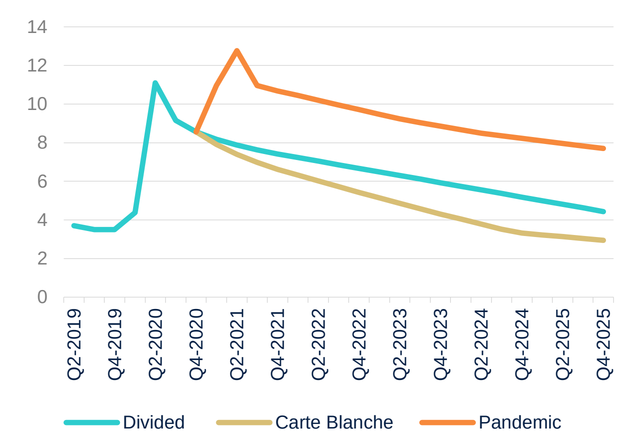
Source: BBVA Research

Figure 19. **FEDERAL FUNDS RATE, UPPER BOUND** (%)



Source: BBVA Research

Figure 20. **UNEMPLOYMENT RATE** (%)



Source: BBVA Research

What you see is what you get

From an industry perspective, the list of winners and losers differ significantly due to the candidates' opposing views on key issues such as healthcare, taxes, climate change, infrastructure, immigration, worker's compensation, foreign trade and regulation. However, evidence from the current and last administration suggests that for some industries, structural trends and technological change can outweigh the impact of public policy, and that strong economic performance tends to benefit all sectors. For instance, back in December 2016, pundits never imagined that Tesla's market cap would exceed ExxonMobil's.

Industries under Biden

Healthcare could benefit from a Democratic government. Mr. Biden would seek to reinforce the ACA to increase the number of people covered by health insurance. This could increase the demand for healthcare goods and services. Hospitals, ambulatory services and physician's practices could experience significant growth.

Biden's "Clean Energy Revolution" represents one of his top priorities, which seeks to achieve "a 100% clean energy economy and net-zero emissions no later than 2050". This would be positive for electric vehicles and renewable energy. In the auto industry, manufacturers that have invested in electrification are likely to benefit from policies aimed at reducing CO2 emissions. A Biden administration will likely encourage the adoption of electric vehicles and provide incentives to the expansion of the national charging network.

Renewables are likely to regain momentum as some of the incentives they enjoyed during the Obama presidency could be reinstated and most likely expanded by a Biden administration. Regulatory actions and tax incentives would benefit manufacturers of solar panels, optimizers and inverters, battery storage, wind turbines manufacturers, energy generation, and utility-scale renewables.

Construction could also boom if the clean energy and infrastructure plans materializes, supported by the idea of sourcing construction materials from domestic companies for federally funded projects, retrofitting existing buildings, expanding and modernizing public transit networks, modernizing the electric grid, repairing bridges and highways, and deploying a national electric-vehicle charging network.

A Biden administration will seek to revitalize passenger and freight railroads by improving existing infrastructure and investing in new projects, while supporting low-carbon aviation and shipping technology. Another big winner could be the cannabis industry. Although Biden is not in favor of legalizing marijuana, his administration could downgrade it from Schedule 1 narcotic, decriminalize its use, stop enforcing federal laws on states that have legalized it and support the SAFE Act. This would give a boost to the cannabis industry in the states that have legalized the drug, as well as suppliers, the financial sector and other service providers.

In addition, Biden's pro-immigration and legalization plans could allow millions of undocumented workers to increase their wages and improve access financial services, housing and other high-ticket items, as well as state and local services. This would boost aggregate demand and benefit a wide range of industries.

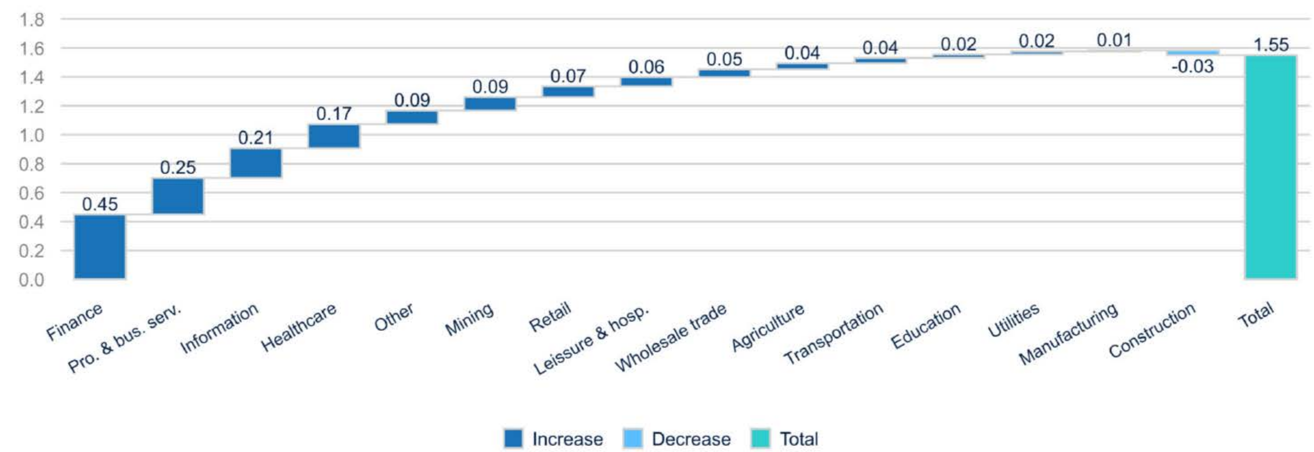
On the downside, a Biden administration would be challenging for the oil and gas industry due to potentially tougher environmental rules, and the protection of federal lands and waters. Although natural gas will maintain its position as a bridge fuel for several more years, stricter regulations, support for clean energy and storage technologies could accelerate the transition towards a carbon free energy economy, lowering the attractiveness of natural gas.

In the short run, an increase in the federal minimum hourly wage to $15 would lower business income and investment, particularly for small businesses in industries such as food away from home, accommodation, personal and laundry services and retail trade, where between 1.8% and 11% of workers are paid at or below the federal minimum wage. In the health insurance industry, the potential benefits of expanded healthcare coverage under Obamacare 2.0 could be offset by the “public option” proposed as part of Obamacare 2.0.

Big Tech could also lose from a Biden administration if this seeks to increase the accountability of social media companies and break monopolistic competition in the sector. Big Tech could also be impacted by policies to increase tax revenues. Moreover, tech companies in the shared economy space could also suffer from an administration that will seek to strengthen labor protection laws. Pharma companies will also lose from a Biden’s administration attempts to prevent companies from imposing prohibitive prices to certain drugs.

By incorporating millions of workers into the formal economy, a Biden’s immigration reform would increase wage pressures in industries that employ a large share of undocumented workers such as agriculture, construction, services to buildings, leisure and hospitality, and landscaping, dry cleaning and animal slaughtering services, among others. It would also add budgetary pressures on state and local finances. Moreover, not all the participants in the healthcare sector would benefit from Biden’s plan, particularly those that rely on high markups and limited competition.

Figure 21. **CONTRIBUTION TO REAL GDP GROWTH BY INDUSTRY*** (2008-2016)



*Compounded annual growth rate. Source: BBVA Research and Haver Analytics

Industries under Trump

A second Trump term will maintain its low tax agenda, which in general has had a positive impact on the business sector. For example, the impact of the 2017 tax reform on the effective tax rate on investment was a significant decline for equipment and public utility structures, substantial for nonresidential structures and mild for intangibles. However, it seems that a potential tax reform 2.0 would have limited space to further cut business tax rates. Still, lower taxes for individuals that increase after-tax income would boost overall consumption. Lowering the 22% tax bracket to 15%, extending estate tax provisions under the TCJA, and indexing capital gains to inflation would benefit taxpayers in the top 10%, which could boost consumption and investment for luxury goods and services industries. Industries such as autos, computers and electronics, and appliances manufacturing will benefit from lower taxes on the middle class.

Similarly, a low corporate tax regime will continue to benefit the IT sector, particularly the biggest companies. These companies may face a lower risk of being subjected to anti-trust regulations under a second Trump term. Cutting capital gains taxes and expanding tax-free investment accounts would benefit the securities and brokerages industry.

On deregulation, the Trump administration has taken a wide range of measures. Some are still in the rulemaking process while others have been repealed or delayed. Considering only those that are effective, 24% have been on the environment, 14% on the health sector, 12% on transportation and 9% on the financial industry. If these trends continue, the energy sector (coal and oil & gas) would be the most benefited from a second Trump term. A Trump administration is expected to further facilitate drilling and exploration, as well as the construction of pipelines and export infrastructure. Likewise, defense and aerospace industries will be better off under a Trump administration that will seek to allocate resources to the recently created United States Space Force, and to expand the country's defense capabilities, including cybersecurity.

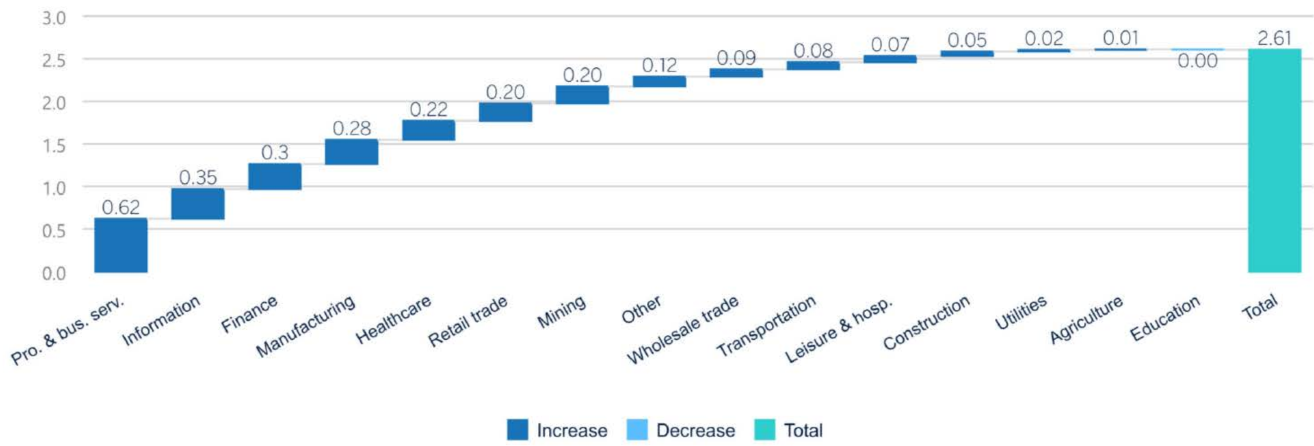
In the realm of healthcare, private insurance companies would not have to worry about government intervention in the marketplace. A promoter of school choice, a second Trump administration will push forward the "vouchers" model, which could incentivize investments in private schools. Companies in charge of private detention centers will also continue benefiting from policies towards asylum seekers and undocumented immigrants.

However, four more years of a Republican administration will not be ideal for some industries. This is the case of renewable energy, which will find it difficult to expand under an administration that prioritizes fossil fuels over climate change. Investments in the electrification of transportation and energy storage could be discouraged by the weakening of fuel economy standards.

Companies that outsource a significant portion of their value chains outside North America may continue suffering from protectionist measures. In particular, tensions with China will add uncertainty to the future of companies that conduct businesses with Chinese firms or have presence in that market. Policies that restrict the number of student visas and the immigration of high-skilled individuals would prove detrimental to industries that employ foreign high-skilled workers such as IT and consulting services, as well as universities and higher education services. Meanwhile, restrictions on low-skilled immigrants and mass deportations would add pressures on industries more dependent on lower-skilled workers like agriculture, food processing and construction, while further efforts to dismantle the ACA would deprive the healthcare sector from potentially more patients.

For many other industries, the outlook remains positive regardless of who wins the election. For example, the new United States-Mexico-Canada (USMCA) trade agreement will benefit industries that have integrated their value chains across North America like motor vehicle manufacturing and parts. The treaties upgraded local content rules will have a positive impact on primary metals manufacturing. Other industries that could gain from the new trade agreement are agriculture, dairy, pharmaceuticals, tech and railroads.

Figure 22. **CONTRIBUTION TO REAL GDP GROWTH BY INDUSTRY*** (2017-2019)



*Compounded annual growth rate. Source: BBVA Research and Haver Analytics

Banking: Keep your chin up

The financial industry has not been the primary focus of the Democratic and Republican parties during the 2020 elections campaign, despite the industry featuring more prominently in the Democratic Party primaries. This stands in stark contrast to the campaigns in the run-up to the 2008, 2012 and 2016 elections. The relative absence of focus on banking is understandable since the most pressing issue in 2008 was the Government support to banks in the wake of the financial crisis, while in 2012 and 2016, post-crisis regulation had just been enacted or was still in the making. For example, both GOP candidates Romney in 2012 and Trump in 2016 supported the repeal of the Dodd-Frank Act. The fact that the bulk of this Act remains in force, despite some deregulatory actions, reflects the limited ability of any incoming administration to enact radical legislative changes.

While Biden's list of policy proposals does not include a specific one for the financial industry, some of the plans outlined thus far could have a material albeit indirect effect on banks and other financial intermediaries. Primarily, the Biden administration is likely to reinstate a number of regulations removed during the Trump administration, which could increase compliance costs. His administration is also likely to tighten enforcement of measures that prevent discriminatory lending practices and could seek to strengthen and expand the Community Reinvestment Act (CRA) and the Consumer Financial Protection Bureau (CFPB).

Furthermore, the Biden campaign has also endorsed a bankruptcy reform program proposed by Elizabeth Warren that, if implemented, should make it easier for consumers to obtain debt relief and shift the burden away from creditors towards lenders to some extent. Bankruptcy laws changed in 2005 with strong support from the banking industry and Biden. The impact of any changes to bankruptcy regulation depends on how much the proposal is going to change through the legislative process. If passed, the changes are likely to lead to adjustments in lending practices.

In addition, a Biden administration is likely to maintain and possibly even expand the safeguards that separate retail-banking institutions from riskier investment operations. Last but not least, Biden's proposals include "postal banking", which based on the experience from other countries, should not be a major challenge for banks due to its limited scope, although it could benefit some consumers that might need a greater choice of small-scale financial services.

That being said, some of Biden's plans could also be supportive of banks. The single largest potential impact lies in the proposed infrastructure program, although this could take some time before it is fully implemented. Other programs include helping families buy their first home through tax credits and supporting small businesses. Lenders, particularly smaller ones, would benefit from the creation of a Small Business Fund, the proposed doubling of funding for the State Small Business Credit Initiative, as well as the proposed investments in revitalizing rural America.

Last but not least, policies to improve the social safety net could lead to higher lending activity to lower income households, due to increased borrowing capacity after a boost to take-home income, improved credit quality of consumer portfolios, and lower credit losses for private institutions. However, depending on how the initiatives are funded and the resulting level of risk exposure, this could lead to higher financial burdens for both taxpayers and businesses.

The greatest potential benefits from a Republican victory in 2020 for the financial industry would be another round of tax cuts and further deregulation. In addition to corporate tax cuts directly increasing after-tax profits for banks, lower personal income taxes can also increase take-home pay for the middle-class households and SMEs, possibly supporting higher loan demand.

While Trump's re-election campaign has not advanced a specific set of policy proposals for the financial industry, his second term administration will likely continue on the path of gradual deregulation. This would occur primarily through the roll back of some of the limitations imposed by the Dodd-Frank Act, which would further lower compliance and transaction costs. Republicans have also expressed interest in abolishing the CFPB, which many see as unconstitutional, harmful for consumers and free from Congressional oversight. Some changes to CRA implementation are also possible. Republicans have also proposed to increase infrastructure investment, which would be a positive development for lenders, as it would support increased borrowing by companies directly or indirectly involved in the program.

Nonetheless, a number of Trump policies could have negative effects on the industry. Less effective regulation in the past has led to greater financial instability, causing significant damage to the industry over the long run. In addition, any policies that could lead to increased income and wealth inequality could also mean greater societal instability and lower potential growth, which would limit sustainable credit expansion and increase credit risk, in turn further dampening the economy's output potential. For example, some studies suggest that the benefits from boosting tax-free investment vehicles at the expense of tax revenues accrue mostly to the wealthy and do not increase middle-class net savings, exacerbating a trend that would have been already underway.

As the current crisis is not rooted in the financial sector and banks have played a very constructive role over the last year, financial institutions are no longer in the crosshairs of politicians, who instead are sparring in other policy areas such as employment protection, immigration, education, healthcare and governance. The overall outlook for the banking industry remains positive, supported by the expansion of the digital economy and innovation. While financial institutions are not likely to face major shifts in their business outlook based on the outcome of the election, in the short run, a Democratic administration could result in some increase in compliance costs and taxes and a Republican one in the opposite. The likelihood of implementing any proposed policy depends on the political landscape after the elections, discussed in the different scenarios earlier. Regardless, any political outcome can result in opportunities to increase banks' business for organizations that are able to adapt quickly.

East, west, home's best

Diversified state economies will do well regardless of who wins the election. This is particularly true for California and Texas, which experienced above average growth during the eight years of Biden's vice presidency and the first three years of the Trump administration. California and Texas are the two largest state economies, and have healthy economies characterized by solid population growth and the presence of a wide variety of high value added industries. Smaller state economies with strong fundamentals like Colorado, Utah, and Washington also expanded above the national average during both administrations. For most of the states, success will depend on how well their industry base and competitive advantages match the candidates' agenda.

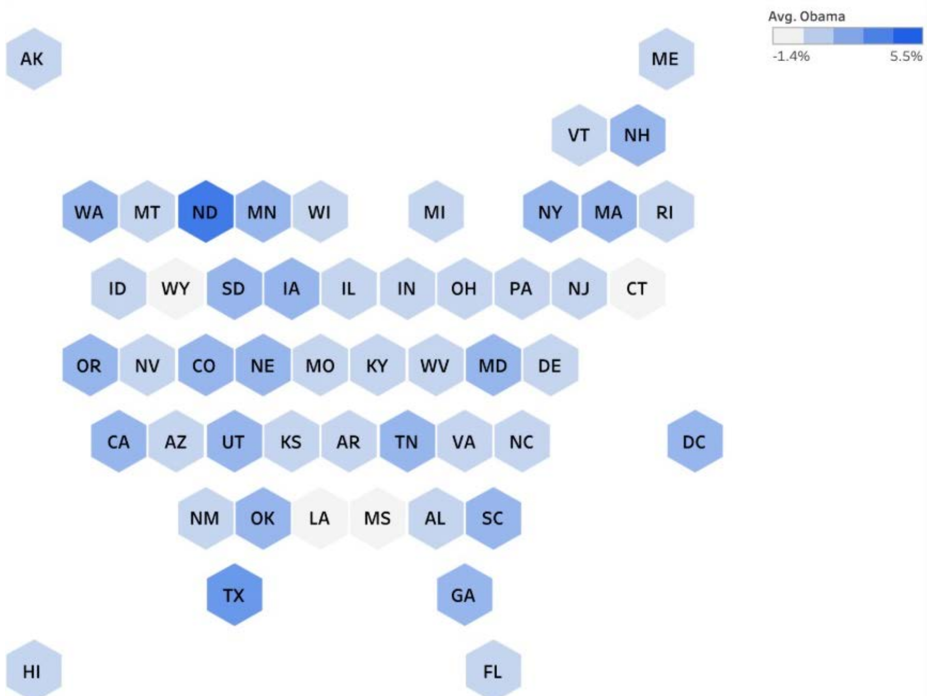
For instance, Biden's stance on immigration could provide more certainty to state economies that rely heavily on immigrant labor force, both skilled and unskilled, like California, Texas, New York and Florida. Moreover, a Biden presidency would be good for states that have pursued an environmental agenda despite the current administration's crusade against environmental regulations. A Democratic government committed to fight climate change could eliminate market distortions caused by different policies and goals across states, facilitating green investments, and the development of a national carbon market. On the contrary, a Democratic presidency may not be the best option for states that have a large concentration of fossil fuel industries like Louisiana, Alaska, Wyoming or North Dakota that lack a strong presence of other high-value industries.

In the short-run, a Biden administration may not be the best option for states with a significant concentration of industries that pay minimum wage like food processing or leisure and hospitality. Many of the states with the largest proportion of hourly earning workers are in the south: Kentucky, Mississippi, Tennessee, South Carolina, Louisiana, and Virginia. However, a higher minimum wage could boost spending among workers, which would have a positive effect on economic activity. In the long run, according to the CBO, it would bring 1.3M people out of poverty. The net impact of minimum wage legislation on state economies will depend on how businesses adapt to higher labor costs and how higher wages spill over into the local economy. Overall, low-income residents in Southern states are more likely to win from a Biden administration that focuses on social disparities, minimum wage, and access to healthcare.

Biden's support for higher taxes on the wealthy could have a negative impact on states with the richest households like Massachusetts, New York, Connecticut, Washington and California. However, a more progressive tax policy may prove good for states with the poorest households like West Virginia and New Mexico.

Biden's proposals to expand access to healthcare will have a positive impact on states with the largest healthcare ecosystems like Maryland, Pennsylvania or Arizona as well as states with the largest populations of uninsured. On the contrary, states with higher concentration of pharmaceutical firms like Massachusetts, New Jersey or North Carolina could experience the negative impact of stricter regulations.

Figure 23. **AVERAGE REAL GDP GROWTH BY STATE** (2008-2016)



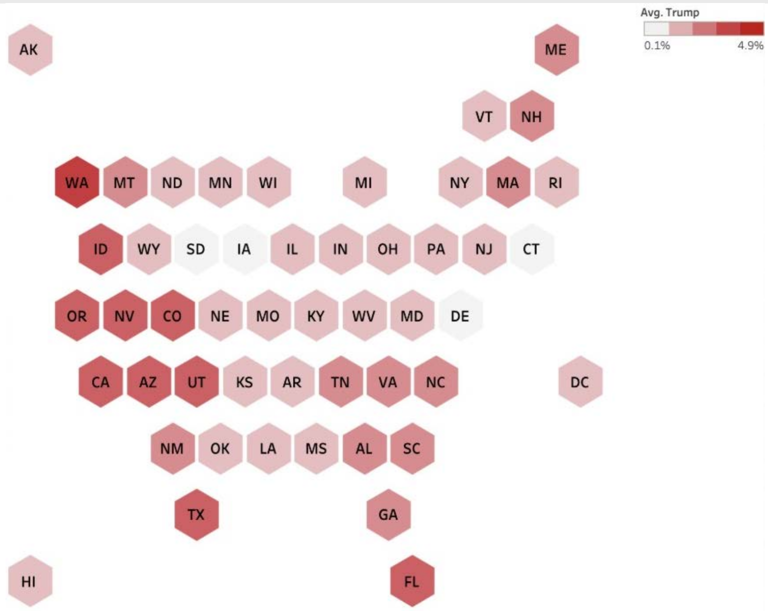
Source: BBVA Research and Haver Analytics

A Trump administration will be positive for states that host defense and aerospace clusters like Alabama, Arizona, California, Connecticut, Kansas, Massachusetts, New York, Ohio, Oklahoma Texas, and Washington. Meanwhile, financial deregulation will be good for New York, Illinois and Florida financial service clusters. North Carolina, Massachusetts, Texas and California IT clusters will continue enjoying the benefits of Trump's corporate tax regime and an apparent lack of interest in breaking monopolistic behavior in the sector. A Trump administration will also be good for energy states, most notably those focused on oil and gas extraction like Alaska, Louisiana, Pennsylvania, North Dakota and Texas.

Four more years of protectionism and trade uncertainty will continue to have a net negative impact across all states, particularly those with a large share of exports to GDP, and while there might be some benefits for certain industries, the losses in agriculture and services far outweigh the gains in manufacturing. For example, key steel and aluminum producers like Georgia, Indiana, Alabama, Ohio, Pennsylvania and Michigan could benefit from import tariffs. However, states like Illinois, Wisconsin, Iowa, Minnesota, Missouri, Nebraska and Indiana have suffered great job losses from the U.S.-China trade war. These states could regain some jobs if the U.S.-China trade deal proceeds as planned and boosts exports of agricultural and industrial products. The trade deal will also benefit other states with a strong export base of semiconductors like Oregon. In addition, states with a large concentration of motor vehicle manufacturing like Michigan, Kentucky, Tennessee, Mississippi, Indiana and Alabama may do better under the new USMCA. However, these policies will not be enough to offset lost global competitiveness and cause a massive reshoring of businesses and jobs.

Meanwhile, states with the largest foreign-born populations like California, Texas, Arizona, Nevada, New Jersey, Florida, and Illinois would be negatively impacted by further restrictions on immigration of both skilled and unskilled individuals. On the healthcare front, states with the largest populations of uninsured individuals like Texas, Oklahoma and Idaho will continue to face significant social and economic costs.

Figure 24. **AVERAGE REAL GDP GROWTH BY STATE** (2017-2019)



Source: BBVA Research and Haver Analytics

The fate of state economies is not only determined by their current industry base or competitive advantages, but also by how well they position themselves to gain no matter the results of the federal election. This implies allocating resources into industries and policies that will yield the biggest benefits in the long-term.

There's No Such Thing as a Free Lunch

In the long-run, we assume three distinct scenarios: **exceptionalism, muddle through, and fracture.** The three scenarios differentiate from each other, depending on how voters and policymakers decide to tackle the major socio-economic challenges that our nation faces today.

The exceptionalism scenario assumes that politicians make a significant number of correct decisions to boost potential GDP and economic well-being. Historically, many economic milestones would not have occurred without some form of government participation, from the construction of Ellis Island, the Hoover Dam and the Panama Canal, to the Interstate Highway System and the Defense Advanced Research Projects Agency, or the GI Bill, the Apollo Space Program and the Elementary and Secondary Education Act. In many instances, even modest investments in people and infrastructure have boosted innovation and produced tremendous gains for the private sector. This is clear evidence of what can be accomplished, but also of the difficulty in moving forward in a bipartisan manner.

The muddle-through scenario assumes that polarization remains elevated and results in limited space for bipartisan policies. While policymakers could take necessary steps, these will be limited in size and scope. Moreover, there is no guarantee that the most critical challenges will be prioritized, implying that Congress would, more often than not, continue kicking the can.

The fracture scenario assumes that polarization intensifies, and the country fails to tackle these challenges either by not doing enough or by making incorrect policy choices. Perhaps the most important example in history is the Great Depression, when the government made a series of policy mistakes that turned an economic crisis into one, if not the worst, contraction in U.S. history. Tight monetary conditions, tax hikes, trade restrictions and excessive and inefficient regulations, lowered financial depth and increased production costs. On the political front, history also reveals periods of corruption, when presidents made questionable decisions with both Congress and the Supreme Court failing to take action, or when powerful presidents decided to test the limit of their power by advancing detrimental actions.

The probability of an outright exceptionalism scenario is low. Throughout history, reaching an exceptionalism scenario usually requires first to transit through a fractured scenario. However, major policy breakthroughs have been accompanied by missteps that have lowered the potential positive impact, like the New Deal after the Great Depression. That is, only after a significant deterioration in economic conditions and mounting social pressures, voters grant enough power to one party so they can pass meaningful legislation to overcome these challenges, even if the set of policies end up having unintended or unexpected consequences.

Among the many long-term challenges, we can highlight those related to sustainability, infrastructure, automation, digitization, polarization, education, healthcare, housing, inequality, racism, immigration, public R&D, and fiscal stability. Many of these challenges have either emanated from policy mistakes while others are exogenous. Some are new while others have developed over decades. Regardless of the origin or duration, it would seem that a complete overhaul is needed. However, there is no silver bullet to solve these challenges swiftly and efficiently. In addition, there are multiple interlinkages among these challenges implying that positive or negative results in one area could lead to similar outcomes in others.

For example, one key factor that drives labor force growth is immigration, which has a profound impact on economic performance. However, while most studies show a positive correlation between immigration of high-skill workers and economic development, the view on low-skilled immigration is mixed. High-skill immigrants bring in a high level of human capital and increase productivity, which benefits all participants in the labor market. High-skill immigrants also have a positive effect on fiscal revenues. Meanwhile, overall immigration can depress wages and opportunities for native-born, low-skill workers.[11] Thus, encouraging immigration could have positive effects on innovation and entrepreneurship, and coupled with an aging population, it could moderate the fiscal pressures stemming from social security and Medicare.

In addition, healthcare reforms are an urgent issue for the next president. An inefficient healthcare system produces a high deadweight loss, which is burdensome to economic growth.[12] While Democrats and Republicans approach this issue from radically different ways, improving healthcare outcomes, expanding coverage and reducing costs, will

11: Borjas, G. J. (2019). “Immigration and Economic Growth.” NBER Working Paper, (w25836).
12: Blazheski, F., & Karp, N. (2018). “Got symptoms? High U.S. healthcare spending and its long-term impact on economic growth.” U.S. Economic Watch, 10-20.

significantly increase the labor supply and productivity while reducing costs for business and inequality. Moreover, it would also support fiscal stability.

Although both parties have a common understanding of the diagnostics related to some challenges, the policy proposals are not compatible and, more often than not, are guided by ideology rather than economic theory. For example, boosting public investment in infrastructure and public R&D could have significant positive effects on productivity, competitiveness, and innovation. Both sides agree that more investment is needed to renew and modernize existing infrastructure, which continues to deteriorate and reduce competitiveness. However, policymakers have failed to agree on how to pay for it, either through additional taxes or by cutting spending for other items. If policymakers fail to allocate government investments properly, the outdated and deteriorating infrastructure will further drag the U.S. economy to a lower potential growth rate.

A similar example exists regarding education performance, where significant differences depending on household income, race, and geographic location. Democrats support more government spending, even though the U.S. spends more resources than most other countries on a per-capita basis. Republicans favor school choice, voucher, and charter programs and a decentralized system, despite conflicting evidence on performance outcomes between charter and public schools. This challenge is particularly crucial because education is closely related to automation and labor market dislocation, which in turn have influenced inequality and polarization.

On global trade, both sides have expressed deep concerns on the rules-of-the-game, cheating, enforcement and unfairness of the global trading system that has encouraged offshoring and outsourcing, and caused the loss of millions of domestic jobs and hundreds of businesses, widened inequality and regional disparities. However, both sides have a different approach regarding the solution. Republicans favor renegotiating bilateral agreements, tough sanctions and overhauling the current system. Democrats favor more workforce training, reducing trade barriers, setting global trade standards, and more significant input from labor and environmental stakeholders.

In other cases, both sides have a drastically different perspective on the magnitude of the problem and the potential solutions. For example, Democrats believe that climate change represents an existential threat and proposes raising taxes to fund trillions of dollars on green alternatives and imposing restrictions on emissions and other pollutants. On the other hand, Republicans do not see climate change as a risk, oppose raising taxes, and prefer continuing to subsidize the fossil fuel industry and eliminate what they consider as costly and ineffective environmental regulations.

Overall, we remain skeptical about the ability of either party to make significant progress. A stronger push for progressive actions on education, housing, labor, and the environment, as Democrats propose, could have substantial positive effects. Healthcare reform could reduce health-related bankruptcies and improve job mobility while an immigration reform would boost labor supply, financial inclusion, and enhance human capital formation. New energy technologies and modernizing existing physical and digital infrastructure could catapult innovation and productivity growth. A higher minimum wage and after-tax income for lower-income households could boost consumption and the incentives to work. Moreover, a decline in trade uncertainty will also boost growth. However, more significant government intervention would also generate other types of problems with potentially even higher costs than the proposed policies, thereby diminishing economic wellbeing and potential GDP.

In terms of fiscal policy, full implementation of Biden's tax plan would increase revenues by $3tn to $4tn over ten years, with most of the impact falling on top-income earners and corporations. Low- and middle-income earners would still be negatively impacted, albeit modestly, on after-tax income since a share of higher corporate tax rates is borne by labor.

General equilibrium models assume that higher revenues reduce fiscal deficits, thereby boosting investment and capital accumulation, although higher tax rates also discourage work and savings.[13] If most additional revenues are spent, this eliminates the positive effects of reducing the deficit while maintaining the negative ones from higher taxes. However, these are offset by the positive impact of higher spending on growth. Assuming the tax burden falls on a small group of high-income earners and revenues are spent on high-multiplier options, the net impact will be positive. In the long run, the net effects could increase GDP significantly.

In contrast, Republicans promise to further deregulate and promote a pro-business environment. According to Coffey,[14] annual GDP growth is 0.8% lower due to the cumulative effects of regulation. Moreover, the share of workers licensed at the state level has increased more than five-fold since the 1950s.[15] Eliminating these barriers would increase employment opportunities and wages for non-licensed workers, boost mobility across states, and reduce costs for consumers. In addition, while the GOP favors skilled-based immigration reform, the impact from reforming the system would be small at the aggregate level, according to the Penn-Wharton immigration model. However, focusing on attracting the most talented and entrepreneurial-minded individuals would boost productivity and lead to increased business formation, which is a crucial driver of employment growth. Modernizing necessary infrastructure and lowering tax rates would also boost private investment, productivity, innovation, competitiveness, and labor force growth. These policies could significantly boost GDP over the long run.

Although the GOP also champions fiscal responsibility, in the absence of major policy changes, between 2021 and 2030, the cumulative budget deficit will reach $14.1tn, and average 5.5% of GDP, more than twice the historical average. Public debt is expected to surpass $34tn by 2030, representing more than 110% of GDP, the highest level in history. According to traditional models, running large deficits reduces private investment and income while increasing interest rates, reducing potential GDP. In addition, although the data during the last four years does not support the doomsday scenarios from foreign trade disruptions that analysts expected when the then GOP presidential candidate was calling for a major revamping of U.S. trade relations, in the long-run, the realignment of trade and global supply chains could result in higher production costs and revenue losses. If reshoring is accompanied by more automation and labor dislocation rather than more job creation, there could be significant long-term effects on income inequality, polarization, and social unrest.

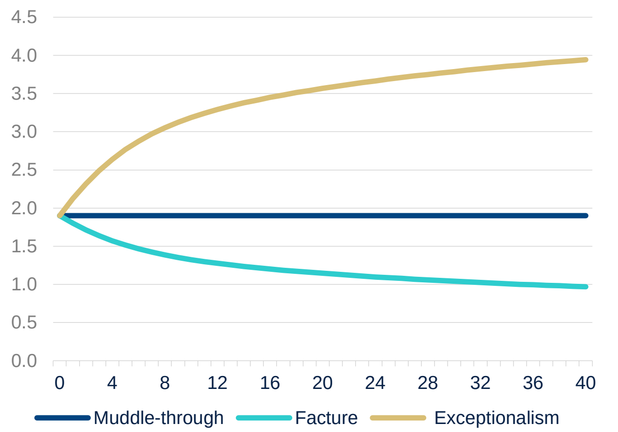
From an economic perspective, we assign an 80% probability to the muddle-through scenario, which would result in GDP growth remaining near current estimates of potential growth of around 2%. To assess the potential economic effects under the two alternative scenarios we use a dynamic stochastic general equilibrium (DSGE) model. The exceptionalism scenario with a 10% probability would have a significant positive impact on productivity, investment, and employment. Our model results confirm that potential GDP would be higher and growth would average around 4%. Higher wages and rising demand for goods and services will drive up the inflation rate by 0.4% in ten years. Since the inflation rate comfortably stays above the Fed’s 2% target, we would also expect higher nominal interest rates amid mild economic fluctuations.

In contrast, the fracture scenario with a 10% likelihood would imply ongoing deterioration of the institutional framework, with severe consequences on competitiveness, thereby reducing potential output and growth, which would average

13: See for example, Penn Wharton Budget Model and the Tax Foundation General Equilibrium Tax Model
14: Bentley, Coffey, et al. (2016). “The Cumulative Costs of Regulation.” Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA.
15: Jason, Furman. (2015). “Occupation Licensing and Economic Rents.” The Brookings Institution.

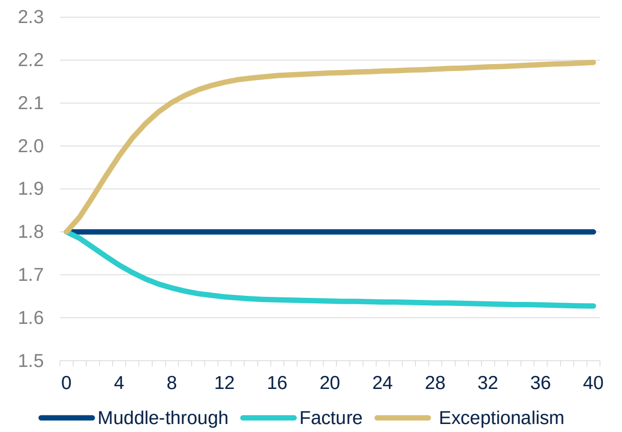
around 1% amid elevated volatility. In addition, inflation will hover around 1.6%, forcing yields on treasury bonds lower and reducing the effectiveness of monetary policies.

Figure 25. **GDP GROWTH RATE IN 10 YEARS UNDER THREE SCENARIOS** (%, quarters)



Source: BBVA Research

Figure 26. **INFLATION IN 10 YEARS UNDER THREE SCENARIOS** (%, quarters)



Source: BBVA Research

While the urgency to act remains high and the benefits of striving for exceptionalism are clear, the high degree of polarization and growing ideological gap could push the U.S. on a fractured path. While perceptions remain rooted in the idea that the current environment is exceptionally dire, there have been periods in U.S. history that have experienced more fractious and desperate times in terms of social and political unrest and economic malaise.

For example, 74 years after the Constitution's signing, the U.S. fought the Civil War, which was the bloodiest conflict in its history, with more than 2% of the population (~620K individuals) losing their lives. During the Great Depression, GDP growth was negative for four consecutive years with a cumulative drop of 27%, while the unemployment rate reached 25.6%, driving millions of people into poverty at a time when the safety net was practically nonexistent. Moreover, the U.S. is less than a century removed from a period of institutionalized segregation that lasted almost a century.

Ultimately, the convergence of the pandemic and the social unrest has produced one of the more uncertain periods in modern U.S. history. The question is which path the U.S. will take: an inclusive and strategic vision towards exceptionalism, or one that falls victim to procrastination and polarization conducive to stagnation.