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King of debt

Markets are betting that Donald Trump will keep abandoning his campaign promises

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Since the financial crisis, many left-leaning American commentators have yearned for more deficit spending to reflate the economy. Few would have predicted that a Republican administration would be the one to heed their calls. Yet financial markets seem to be betting that President-elect Donald Trump, backed by Republican majorities in the House and Senate, will go on a budgetary binge that ignites economic growth. Since the election the S&P 500 index of shares has jumped 3%, led by stocks like banks and retailers that soar and sink with the economic cycle.

Such expectations are not baseless. During the campaign Mr Trump called for tax cuts which, according to the Tax Policy Centre, a think-tank, would cost an eye-watering $7trn over a decade, raising the debt-to-GDP ratio by 26 percentage points (or, based on current projections, to 111% of GDP) by 2026. He promised new infrastructure spending worth $1trn, more money for defence and no cuts in spending on pensions and health care for the elderly (which is forecast to soar over the next decade). All else equal, such largesse should indeed give the economy some temporary vim. But there are three main reasons to doubt that a big boom will materialise.

The first is that Republicans in Congress are much less keen on loosening the purse-strings. Paul Ryan, Speaker of the House, has proposed tax cuts only half as big as Mr Trump's. Kevin Brady, chairman of the House Ways and Means Committee, said on November 16th that he expected any tax reform to pay for itself (even if that is partly by boosting growth). True, Mr Trump is likely to court Democratic votes for infrastructure spending. Still, market expectations "may be running ahead of political and legislative realities", says Alec Phillips of Goldman Sachs, a bank forecasting that Mr Trump will wind up with enough new spending to boost growth by a modest 0.3 percentage points for two years.

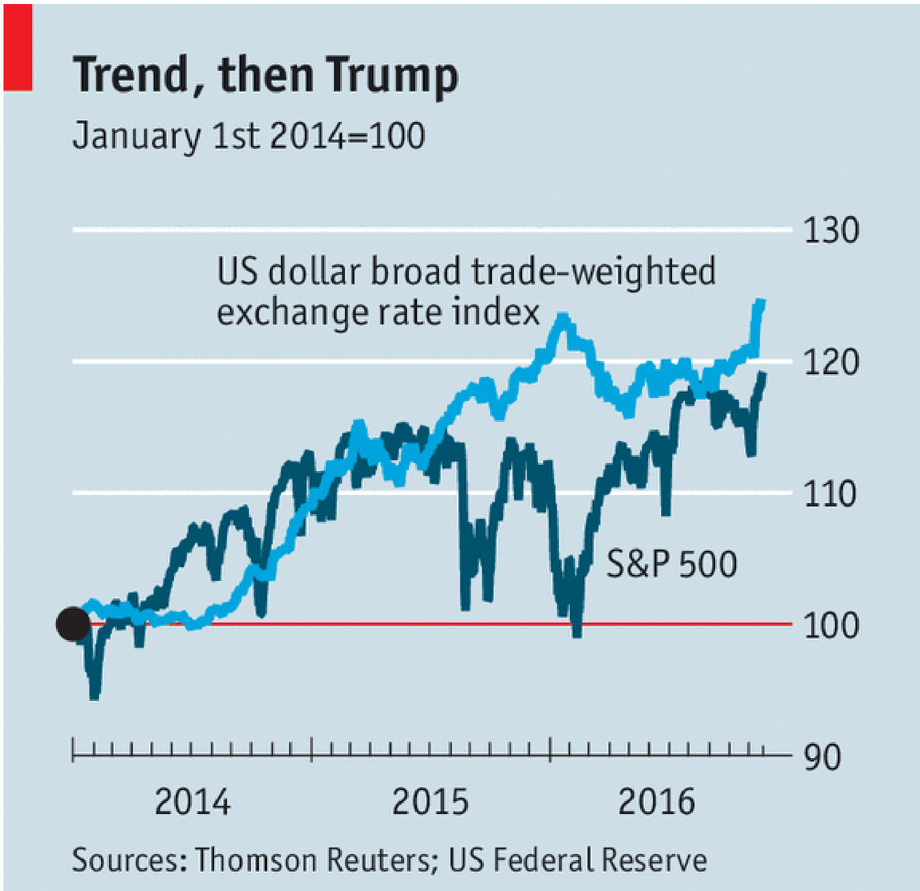
The second reason to be sceptical of a Trump boom is that a massive fiscal stimulus would be poorly timed. The chief argument for bigger deficits after the crisis was that unemployment was too high, and, with interest rates stuck near zero, there was little the Federal Reserve could do about it. But today, with unemployment below 5% and wage growth picking up, there is much less slack in the economy. And the Fed, which is worried about inflation round the corner, is expected to raise rates in December.

A soaring deficit could make the central bank more hawkish. Quizzed about stimulus before a congressional committee on November 17th, Janet Yellen, the Fed's chairman, questioned whether the economy needed much more spending. It is within the power of Ms Yellen and her colleagues to flatten Mr Trump's stimulus by tightening monetary policy faster.

Markets seem to be expecting higher interest rates, rather than an inflationary boom. The yield on ten-year government debt now hovers around 2.4%, up almost 0.5 percentage points from election day. But inflation expectations, measured as the gap between yields on inflation-indexed bonds and the normal sort, are up only half as much. That suggests an expectation of higher rates, as well as higher prices, is pushing yields up. In the week to November 16th the dollar, which tends to rise with interest rates, rose 2.3% in trade-weighted terms—its biggest weekly gain since October 2008. Compared with this, the rise in the stockmarket since the election has been unexceptional: on five other occasions during 2016 the S&P 500 has recorded a larger gain over two weeks. Stocks that do poorly when interest rates rise, such as utilities, have suffered since the election.

The third reason for circumspection is uncertainty over the details of Mr Trump's infrastructure spending. "With negative interest rates throughout the world, it's the greatest opportunity to rebuild everything…we're just going to throw it up against the wall and see if it sticks," said Steve Bannon, Mr Trump's incoming senior adviser, to the *Hollywood Reporter*on November 18th. But this carefree, spendthrift attitude does not chime with Mr Trump's plan, which was penned by Wilbur Ross and Peter Navarro, two of his economic advisers, and released shortly before the election.

Based on that document, of the $1trn in planned spending, perhaps $140bn comes from the government (which, despite Mr Trump's bluster, is less than the combined $500bn Hillary Clinton wanted Congress to spend or lend to developers). The administration would not direct that money itself. Instead, the government would give firms who invest in private infrastructure projects a tax break worth 82 cents for every dollar of equity they stump up.



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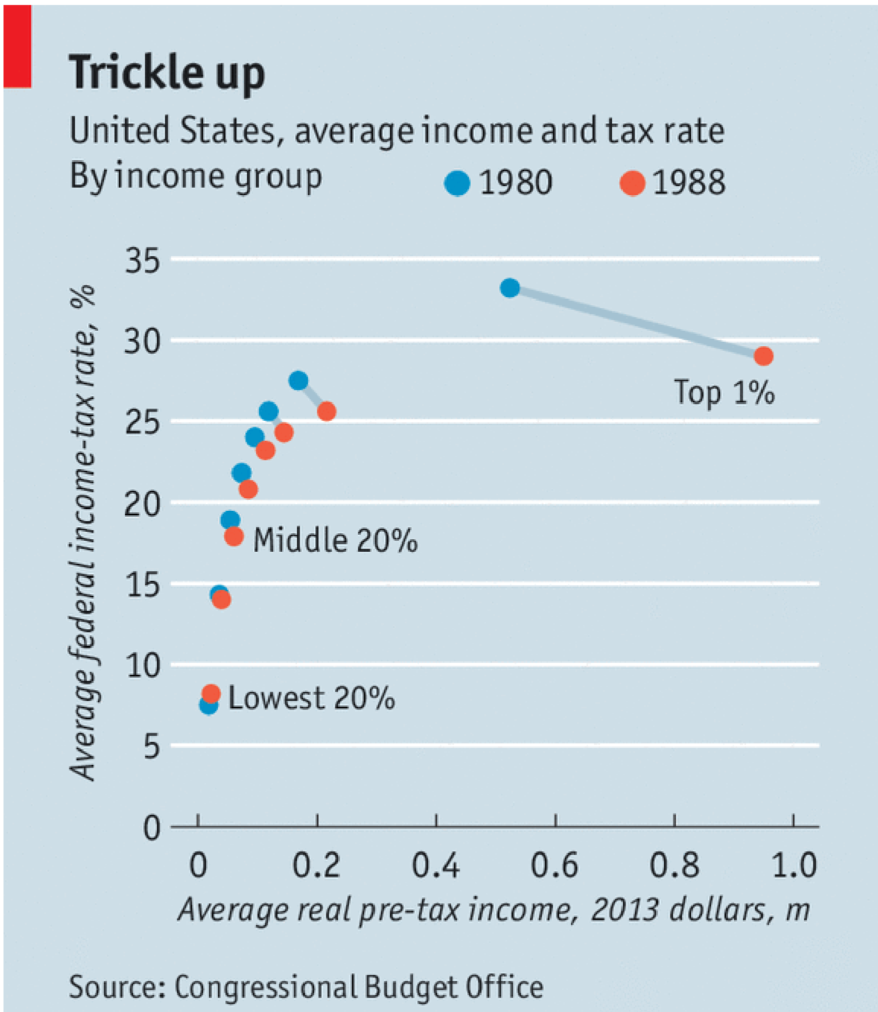
It is not clear how much juice this private-sector money would add to the economy. Critics say that investors might just shift money towards subsidised projects, rather than spend afresh. Problematically, the plan could only fund profitmaking infrastructure projects, like toll bridges. Laws banning the government from retrospectively adding tolls to existing roads—which would be very unpopular even it were always legal—mean such a set up would not help much with the country's backlog of maintenance. The scheme is more likely to subsidise "pointless" new projects, according to Randal O'Toole of the Cato Institute, a libertarian think-tank.

Return of the supply-siders

Boosting spending is not the only route to growth. Republicans have often called for tax cuts not as a fiscal stimulus, but as a way to encourage work and investment in the long run. Might Mr Trump's boom come from greasing the wheels of the economy, rather than juicing its engine?

There is certainly room for some gains on this front. Mr Trump wants to slash the corporation tax rate from 35%, the highest rate in the OECD, a club of mostly-rich countries, to 15% (Mr Ryan has proposed a rate of 20%). That should encourage investment. Mr Trump's deregulatory agenda—he promised on November 21st that for every new regulation written, he would roll back two—should do the same, whatever its other costs.

The problem is that two key planks of Mr Trump's campaign, protectionism and an immigration crackdown, would pull in the other direction. Dan DiMicco, Mr Trump's trade adviser who now leads the transition team for the Office of the United States Trade Representative, told *The Economist* before the election that "the era of trade deficits is over". But funding bigger government deficits will require inflows of capital from abroad, the flipside of which is larger, not smaller, trade deficits. If protectionism stops foreigners stumping up the cash for Mr Trump's spending binge, American savers will have to. That will reduce the funds available for private-sector investment, hampering growth.



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Cutting taxes might create enough growth to allow Mr Trump to quietly moderate his protectionism, or at least to offset it. In the 1980s Ronald Reagan sent deficits ballooning by cutting taxes for the rich, and oversaw fast growth in spite of modest protectionism. A second "Reagan revolution" would certainly please many Republicans. But the top rate of federal income tax today is 39.6%, compared with 70% in 1980. History also suggests this recipe would do little for the fortunes of those blue-collar workers whom Mr Trump pledged to shield from foreign competition. Gains in real income between 1980 and 1988 were heavily skewed towards the richest (see chart). Middle-earners, whose average tax rate fell by a percentage point, saw real pre-tax income gains of just 0.6% a year. By contrast, the top 1% of earners saw their average tax rate fall by four percentage points while their pre-tax real incomes surged by 7.7% a year.

In short, Congress and the Fed are immediate obstacles to a debt-fuelled economic boom. Over a longer period, Mr Trump could be his own worst enemy. Markets are betting that he will abandon the issues that defined his candidacy and disappoint the voters who won him the election. They may turn out to be right. But if they are not then, like Clinton supporters, they are in for a painful realisation.