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Trump Gambles on Deficits, Inflation

THE OUTLOOK

| By Nick Timiraos

Two of the biggest legislative deals in Donald Trump's presidency—a \$1.5 trillion tax cut and a \$300 billion spending package—illustrate an emerging feature of Trumponomics: a willingness to tolerate larger budget deficits deep into an economic expansion.

Deficits normally swell during downturns, when tax receipts fall and spending rises on unemployment insurance and other safety net programs, and they shrink when the economy grows. The last two years are unusual because deficits have edged higher as the expansion advanced. Now they're set to go higher still.

The budget deficit fell to 2.4% of gross domestic product in 2015 before rising to 3.4% last year. Economists at J.P. Morgan expect the tax cuts and spending deal will boost that to 5.4% of GDP next year, or \$1.2 trillion.

By adding to deficits, Mr.

Trump has undertaken a fiscal policy experiment with little precedent for a peacetime U.S. economy, and one with risks.

Fiscal largess risks adding upward pressure on inflation and interest rates that could boomerang and undercut the growth the Trump administration has set out to achieve. A related risk for Mr.

Trump's experiment: It could be for naught if it prompts the Federal Reserve to raise short-term interest rates even faster because officials worry the economy will overheat.

The Fed is already raising rates and gradually winding down a large portfolio of Treasury and mortgage bonds to prevent overheating. It could act more aggressively if officials fear fiscal stimulus goes too far.

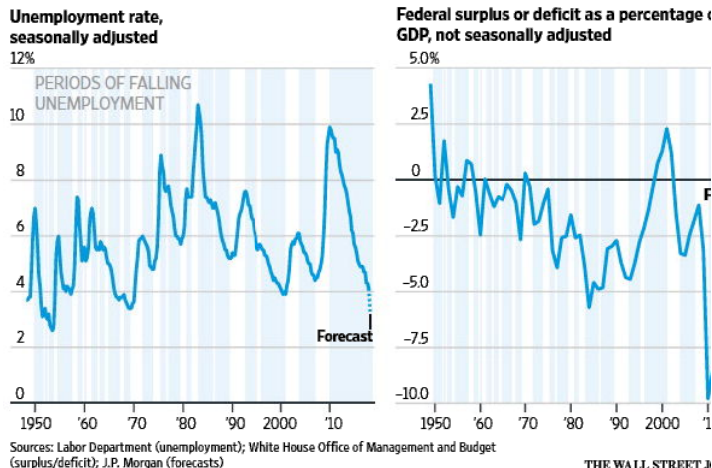
The jobless rate is at 4.1%, a 17-year low, and economists at J.P. Morgan project it will fall to 3.2% next year, a level not seen since the Korean War. Such a low rate is likely to make the Fed nervous.

During the recession, there was a large gap between the economy's output and its potential given available workers and productivity. The Congressional Budget Office estimates that gap has closed and the economy is expanding at a pace that exceeds its potential. That's a combination that could cause overheating.

"It is a mistake to add on tremendous stimulus when the output gap has already closed," said David Rosenberg, chief economist at Gluskin Sheff & Associates in Toronto.

Out of Sync

Deficits as a share of economic output normally get smaller during peacetime when the unemployment rate is falling, which makes the recent increase in deficits highly unusual.



Mr. Trump's focus on stronger growth follows a decade that shows what happens without it: Trust in institutions suffers, inequality rises and central banks face enormous pressures, said Mohamed El-Erian, chief economic adviser at Allianz SE, the German insurance giant.

Mr. El-Erian has been considered for a Fed post by White House officials. While fiscal stimulus "would have been better timed a few years ago," he said, the U.S. is still better off with it than without it.

Mr. El-Erian said he sees little sign of a so-called return of bond vigilantes who will demand higher yields to compensate for risks of fiscal profligacy. U.S. and German bonds have been moving in sync lately, which suggests U.S. yields aren't rising because of U.S.-specific deficits concerns, he said.

Even though the economy doesn't need stimulus right now, there's a strong case for both cutting corporate taxes to make the U.S. more competitive and boosting military spending, said Andy Laperriere, a policy analyst at Cornerstone Macro. "We are making military spending more consistent with the reality of what we're asking the military to do," he said.

The problem, Mr. Laperriere said, is that no one has been willing to address deficits by tackling the biggest driver of spending growth: programs such as Social Security and Medicare.

Tax cuts and government spending could boost the economy in two ways. They give businesses and consumers money to spend on equipment, homes and other goods. That's called demand-side stimulus, and tends to be short-

He estimates around three quarters of the stimulus could be offset by higher interest rates borrowers may have to pay and stock declines.

“The biggest risk is the bond market revolts, sort of like it did in the early 1990s,” said Jim Millstein, a financier

who led the Obama administration’s recapitalization of American International Group after the financial crisis.

Another risk: Larger deficits give the federal government less flexibility in the future to cut taxes or boost spending should the economy sink and need stimulus in the next downturn.

But not everyone is as concerned.

lived. Certain policies also encourage people to work more and businesses to invest more, raising productivity. That’s called supply-side stimulus, and in theory has long-lasting benefits that produce growth without inflation.

The Trump administration is betting it is delivering the latter. In addition to tax cuts, a deregulatory agenda and infrastructure spending are designed to make the economy more efficient. If that happens, the Fed won’t have to push against fiscal policy and the bond market won’t rebel.

If not, Trumponomics could lead to trouble after a brief economic burst.

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