



# PERSPECTIVE

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## WHAT TO EXPECT WHEN YOU'RE EXPECTING *U.S. FISCAL POLICY AND THE ECONOMY*

Since November 9th, there is a common theme among the questions being asked by our clients:

1. **What are the implications of fiscal policy for the economy?**
2. **Will fiscal policy lead to a faster pace of monetary tightening?**
3. **Could President-elect Trump stack the deck to get that outcome?**

This note looks at these in turn. First, in terms of the fiscal impact, there is plenty of guidance on the new administration's likely path of policy: tax reform, infrastructure spending and deregulation. For economists, the devil is in the details and these are in very short supply. Thus, it's too early to incorporate fiscal impacts into our economic forecast, but it's not too early to provide a road map on how we will interpret policies once details are known.

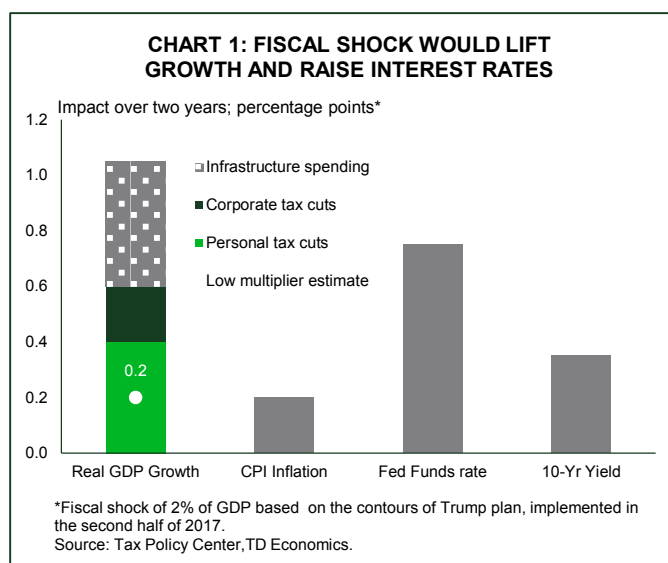
Our baseline view, without incorporating any new fiscal measures, is for real GDP to expand by 2.2% in 2017 and similarly in 2018. An important element to this forecast is that the economy will outpace its trend rate of growth, estimated to be slightly under 2%. In other words, America is on track to reach full employment and the Federal Reserve to hit its 2% inflation target, no matter who became President.

Layering fiscal expansion into an economy near-full capacity will add to these pressures. One way to benchmark the economic impact of fiscal policy is determining what a \$1 change in government spending or taxes will do to the level of GDP. Economists refer to this as a "fiscal multiplier". Unfortunately, this influence is not directly observable and requires an economic model to backout a counterfactual. The process lends itself to a wide range of estimates and little consensus on the precise size of multipliers for a given government initiative.

Despite this uncertainty, there is at least a clear hierarchy of which fiscal multipliers provide the biggest bang-for-the-buck. Table 1 shows a simplified ranking and estimates by the Congressional Budget Office (CBO), which have a general consistency with research conducted on other advanced economies. The themes are:

- spending multipliers tend to be larger than revenue multipliers (i.e. tax cuts);
- permanent fiscal measures have a more persistent impact on output than temporary ones;
- revenue multipliers take longer to derive peak economic impacts (generally 8-10 quarters)

<b>Table 1: CBO Multiplier Estimates</b>	<b>Low</b>	<b>High</b>
Federal Govt. purchases	0.5	2.5
Transfers to State & local govts. for Infrastructure	0.4	2.2
2-Yr tax cuts - low & middle income	0.3	1.5
1-Yr tax cut - higher income	0.1	0.6
Corporate tax provisions (primarily affecting cash flow)	0	0.4
Source: Congressional Budget Office (CBO). Note: The estimates above were produced for CBO's analysis of the American Recovery and Reinvestment Act of 2009.		



Using the mid-range of these multipliers and assuming a fiscal shock of slightly over 2% of GDP (just over \$500 billion) that takes shape in the second half of 2017, real GDP would be boosted by roughly 1 percentage point over two years (Chart 1). However, we consider this to be a high water mark for both the size of stimulus and the economic impact. Given the need to pay for changes in taxes or spending without adding to the deficit over the longer-term, offsetting expenditure restraint forces will need to come into play, in addition to the feedback loop of tightening financial conditions (discussed shortly).

If, instead, we use the bottom end of the CBO’s fiscal multiplier ranges, that one percentage point Trump-bump turns into only 0.20 percentage points in extra economic growth. This too presumes no offsetting measures in government expenditure control. While this may appear too low, it’s not as far-fetched as you might think.

There is one more common theme on fiscal multipliers supported broadly by the research: fiscal multipliers are smaller during expansions than downturns. When an economy is already at or nearing full capacity, as the U.S. is today, public funds are more likely to crowd out private investment and place greater upward pressure on prices. In other words, there is a risk that the new administration’s spending may be more inflationary than it is growth enhancing, and this outcome could propel a stronger policy response by the Federal Reserve.

This analysis offers some insight into why we have refrained from becoming too enthusiastic in the absence of details. It also demonstrates why bond yields backed-up sharply following the election outcome, as market expecta-

tions on inflation and term premiums were quickly re-priced. In this dynamic world, offsets to a fiscal-bump will occur through higher yields (as we have already witnessed) and potentially a swifter monetary policy response. This, then, offers a great segue to the second question:

### Will fiscal policy lead to a faster pace of monetary tightening?

Let’s tackle this in the context of the baseline view and what it would take to steer us off that course. The Federal Reserve will raise rates by a quarter-point tomorrow. Market probabilities of this outcome are pretty much 100% baked in, so this call isn’t exactly a leap of faith. Going forward, the pace of rate hikes is expected to be a quarter-point roughly every nine months.

We can definitely say that the risks are skewed to more, rather than fewer rate hikes, perhaps in the order of an extra hike per year. But, that outcome may turn out to be a story for 2018, rather than one for 2017 for several reasons:

- The forward-looking nature of investors tends to make them excited about possibilities, but perhaps underappreciative of near-term practicalities. Fiscal policy implementation almost always involves long lags before evidence of real economic impacts materialize due to both political and procedural issues. To give an example, when Congress passed President Obama’s \$763bn stimulus package (ARRA) in 2009, about 20% of investment outlays were out the door by the end of the first fiscal year, and another 40% by the end of the following fiscal year<sup>i</sup>. As it is today, the passage of that stimulus package had the benefit of a single party in control of both the legislative and executive branches of government. However, unlike today, the stimulus was proposed at the depth of one of the most severe recessions on record. If ever there was political will to get money out the door quickly, it was then.

President-elect Trump faces far less economic urgency and a more fractious Republican Congress that will be just as diligent on answering the question, “how are we going to pay for this?” as they will be on, “what stimulus are we going to do?”. Deficit-financed initiatives have not been part of the Republican playbook and there are a number of procedural impediments that limit improvisation, such as Byrd and PAYGO rules. Receipts from individual income taxes are the largest source of government revenues at just over 8% of GDP, and corporate tax receipts are the third largest source. The

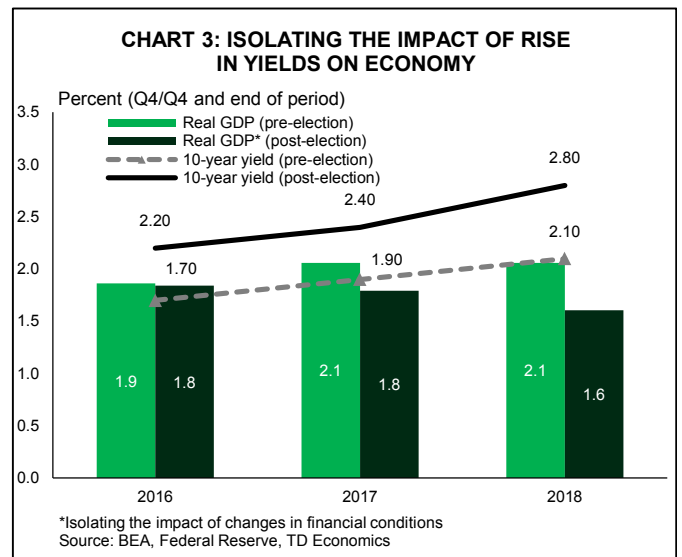
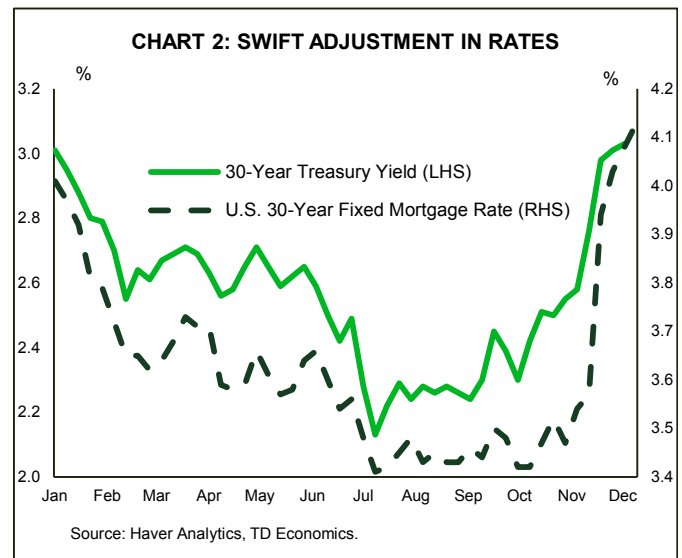
point being: more than the strike of a pen will be required to put in place broad tax reform. In turn, initiatives will be benchmarked against current Congressional Budget Office estimates that already project persistent and widening budget deficits through the next decade.

- While fiscal policy outcomes remain in limbo, tighter lending conditions are hitting the economy immediately. The jump in bond yields following the election has quickly passed through to mortgage rates (Chart 2). The 30-year conventional mortgage rate has jumped 60 basis points since early November. The weight on housing activity may become evident in 2017 before income tax cuts even land in consumer pockets, let alone propel stronger spending. U.S. corporations are also now facing higher borrowing costs and export-oriented firms must contend with a higher greenback. Applying a simple rule of thumb, the 3% rise in the trade-weighted dollar since the election equates to roughly 25 basis points in Federal Reserve tightening (Chart 3).
- These influences will intersect with ongoing geopolitical risks that may reassert themselves in 2017. Since the U.S. elections, market euphoria has pretty much led to a one-way trade in equities. But, significant financial and geopolitical risks will run through the financial pipeline next year, extending from the Italian banking sector and counterparty exposures, to the risk that populist movements gain traction in European elections and undermine confidence in the monetary union.

All this to say that there is little doubt that fiscal measures will play a more prominent role in the economy in the future, but this does not imply that the central bank will be more aggressive with interest rates right off the mark. This is a better possibility for 2018 once the policy mix is known (which includes both sides of their balance sheet) and real economic impacts can be estimated.

### Will the Federal Reserve get Trumped?

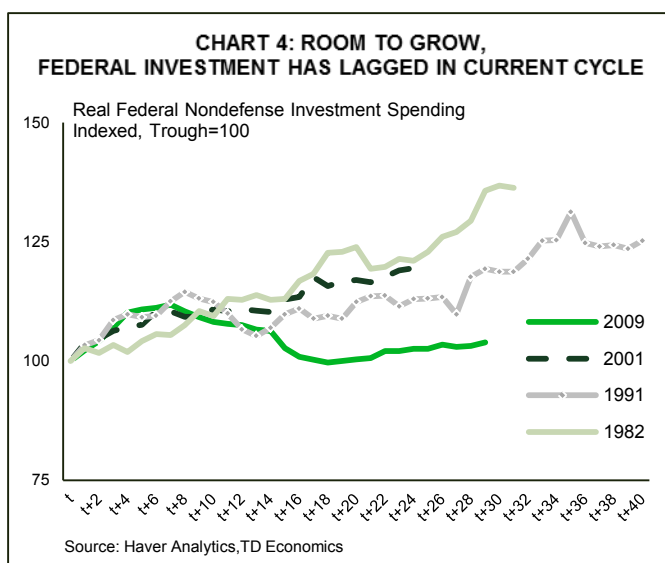
The remaining question is whether President-elect Trump will embed a stronger Federal Reserve bias favoring higher rates, irrespective of fiscal outcomes. The reason this market chatter exists is twofold. First, Trump was not shy about levying criticism on Janet Yellen and the Federal Reserve during the election campaign. The Fed's reluctance to raise interest rates was said to be politically motivated in support of the Democrats. Second, if Trump wanted to make good on that criticism, then the coming year presents an opportunity to start to change the playing field. There are currently two



vacant governor seats within the FOMC that he can fill next year. And, Janet Yellen's term expires in February 2018.

Here's how the process works. The Committee consists of seven governors and five district bank presidents. The FOMC governors are appointed by the President, which the Senate must confirm. In the case of FOMC president appointments, those are done by the local Boards of Directors, with approval by the Board of Governors. The reason two FOMC governor vacancies exist is because President Obama was unable to get Republican-controlled Senate confirmations, which will become less of an issue after January 20th.

There is statistical merit to Trump's view of potential political bias among governors. Research published by the St. Louis Federal Reserve indicates that historically when governors dissent, it has tended to be in favor of easier policy. In fact, this was true for 78% of governor dissents,



expire in 2017. But above all, my advice is to block out the chatter that may occur on Fed appointments and stay focused on developments within the economy. It doesn't serve the U.S. President or the FOMC any purpose to raise interest rates if not warranted by economic fundamentals. Based on speeches by Fed members and their published economic and monetary policy assessments, they have already articulated a bias towards tightening monetary policy going forward consistent with economic growth and inflation expectations.

### Final thoughts

Fiscal initiatives focused on removing inefficiencies within the economy and targeted to areas "in need" have the greatest chance of boosting economic activity and long-term productivity (Chart 4). Ultimately, few economists would argue against this. Done in a thoughtful and targeted manner, tax reform and productivity-enhancing infrastructure investment could jump-start the U.S. economy into a permanently higher running speed. But, if done poorly and concentrated in areas with low fiscal multipliers, policy runs the risk of simply raising debt levels and putting upward pressure on inflation with little-to-no long term economic benefit. In this case, fiscal stimulus will prove counterproductive and lead to an even greater fiscal cost tomorrow.

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while only 28% of dissents were for tighter policy<sup>ii</sup>. The opposite statistical outcome is true among Fed presidents. One theory is that because Fed governors are more closely tied to the administration, and the government always has its eyes cast towards re-election, governors have a greater tendency to prefer lower interest rates in order to stoke lower unemployment in the short run. In contrast, Fed presidents exhibit more discipline around the inflation mandate.

If you believe that Trump's criticism has statistical merit, why would this bias change under his administration? Tightening monetary policy too much or too quickly would undermine the economic expansion, which is clearly not in his administration's interest.

If anything, I'd say to keep your eyes on the rotation of district bank presidents that occurs next year, rather than the governors. The dissent in favor of tighter monetary policy so far this year has occurred by three district presidents (George, Mester and Rosengren) whose voting terms

## Endnotes

- i The Bank Credit Analyst, A Q&A On Political Dynamics in Washington, November 24, 2016
- ii Thornton, Daniel L, and David C. Wheelock, Federal Reserve Bank of St. Louis, Making Sense of Dissents: A History of FOMC Dissents, Third Quarter 2014.

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