LAWRENCE H. SUMMERS

FT Financial Times Column

A badly designed US stimulus will only hurt the working class

Not even US presidents with political mandates can repeal the laws of economics

November 13, 2016

READ MY BLOG

Following a brief market plunge, the President-elect's speech on Tuesday night was more conciliatory than many expected and emphasised his commitment to infrastructure investment. Investors have, on balance, concluded that the combination of a shift to very expansionary fiscal policy and major reductions in regulation in sectors ranging from energy to finance to drug pricing will raise demand and reflate the American economy.

The result has been a rise in real interest rates and inflation expectations, along with a strong stock market and a strong dollar. Experience suggests, however, that initial market responses to major political events are poor predictors of their ultimate impact.

The late MIT economist Rudiger Dornbusch made an extensive study of the results of populist economic programmes around the world, finding that while they sometimes had immediate positive results, over the medium- and long-term they were catastrophic for the working class in whose name they were launched. This could be the fate of the Trump programme given its design errors, implausible assumptions and reckless disregard for global economics.

I have long been a strong advocate of debt-financed public investment in the context of low interest rates and a decaying US infrastructure, so I was glad to see Mr Trump emphasise it. Unfortunately, the plan presented by his advisers, Peter Navarro and Wilbur Ross, suggests an approach based on tax credits for equity investment and total private sector participation that will not cover the most important projects, not reach many of the most important investors, and involve substantial mis-targeting of public resources.

Many of the highest return infrastructure investments - such as improving roads, repairing 60,000 structurally deficient bridges, upgrading schools or modernising the air traffic control system - do not generate a commercial return and so are excluded from his plan. Nor can the non-taxable pension funds, endowments and sovereign wealth funds that are the most promising sources of capital for infrastructure take advantage of the program.

I am optimistic regarding the efficacy of fiscal expansion. But any responsible economist has to recognise that, past a point, it can lead to some combination of excessive foreign borrowing, inflation and even financial crisis. As Dornbusch showed, in emerging markets this can happen quite quickly. In the US the process would take longer.

Even without taking account of the likely costs of the infrastructure plan (which the Trump team badly underestimates) or the proposed defense build-up, the Trump tax reform proposals are too expensive. Many, like the proposed abolition of the estate tax, will only benefit the high-saving wealthy.

While drastic changes in the proposed domestic programme are necessary for it to work, the general direction of increasing public investment, reforming taxes and adjusting regulation is appropriate.

The same cannot be said of Mr Trump's global plan, which rests on a misunderstanding of how the world economy operates.

Consider the immediate effects of Mr Trump's victory. The Mexican peso has depreciated about 10 per cent relative to the dollar over fears of new protectionist policies, and many other emerging market currencies have also fallen sharply. The impact of this change is to raise the cost of anything the US exports to Mexico and to lower the cost of anything Mexico exports to the US.

It will also make Mexico and other emerging markets much cheaper relative to the US for global companies. So US workers, particularly in manufacturing, will see increased pressure.

The plan seems to assume that we can pressure countries not to let their currencies depreciate, as suggested by the intention to have the new treasury secretary name China as an exchange rate manipulator. This is ludicrous. While there are reasonable arguments that China manipulated its exchange rate for commercial advantage in the past, the reality is that for the past year the country has intervened to prop up its exchange rate. The same is true of most emerging markets. Not even US presidents with political mandates can repeal the laws of economics.

Populist economics will play out differently in the US than in emerging markets. But the results will be no better. All with a stake in the global economy must hope that now, as has happened often in the past, a US president faced with the responsibility of governing preserves the valid core of campaign economic plans while making major adjustments.

The writer is Charles W Eliot university professor at Harvard and a former US Treasury secretary.