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New Paradigm?

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Since the U.S. election, I've been trying to make up my mind about whether so-called Trumponomics could spell the beginning of a "new paradigm" of stronger growth, higher inflation and higher natural interest rates, and thus spell the end of PIMCO's New Normal *and* The New Neutral, *Larry Summers'* Secular Stagnation *or Ben Bernanke's* Global Savings Glut. *Pick your favorite label for what had become the consensus view (more than) priced into financial markets over the past year or two. I'm still of two minds about this, and we will surely debate the issues at our upcoming December Cyclical Forum, but with markets having started to romance the new paradigm, here are my preliminary thoughts.*

Framework is everything, so let's go back to the one I described a little over a year ago in my *Macro Perspectives,* "No End to the Savings Glut." I used the term "savings glut" as short code for a situation where the world's desired (ex ante) saving exceeds the desired investment. Excess global savings have depressed demand, inflation and the natural interest rate, which is the theoretical level of rates that equilibrates saving and investment ex post. Ex ante saving is high mainly because of demographics (rising longevity makes people save more for old age), rising inequality (the rich save more than the poor) and large emerging market (EM) current account surpluses, which have reflected a mix of export-led development models and a lack of domestic safe assets. Ex ante investment and thus the demand for savings is low mainly because of technology and the rising share of services in overall output, both of which imply less of a need and thus less demand for capital goods.

In that piece, I also used the results of an important study by two Bank of England economists that quantifies the impact of desired saving, desired investment and other factors on the secular decline in world real interest rates. This isn't easy, because desired saving and investment cannot be directly observed and the estimates are therefore highly uncertain. In a nutshell, the authors estimate that of the 450 basis point (bp) decline in world real interest rates since the 1980s, about 100 basis points was due to lower potential growth, some 300 basis points was due to changes in desired saving and investment and only the remaining 50 basis points remains unexplained. Figure 1 offers a bit more detail on the relative importance of the factors explaining the secular decline in interest rates.

Figure 1: Secular drivers of lower global real interest rates, 1980–2015

Lower potential output growth		–100 bps
Higher saving, *of which:*		–160 bps
Demographics	*–90 bps*	
Inequality	*–45 bps*	
EM current account surpluses	*–25 bps*	
Lower investment		–140 bps
Unexplained		–50 bps
Total		**–450 bps**

Source: Bank of England Staff Working Paper #571, December 2015

So how would Trumponomics, defined as a combination of lower personal and corporate tax rates, higher infrastructure spending, curbs on immigration and more protectionist trade policies, affect these secular drivers of low interest rates? In all of this, keep in mind that the sources of the savings glut are global and that the U.S. accounts for only 25% of world GDP.

POLICIES THAT COULD NUDGE RATES LOWER

Quite a few aspects of President-elect Trump's potential policies might actually work toward *lowering* the natural, or equilibrium, interest rate rather than increasing it.

What's known of Trump's plans to lower personal and corporate tax rates, abolish the estate tax and roll back some of the regulations in financials and energy would tend to increase income and wealth inequality further. The wealthy can and do save more than the needy, so this would add to rather than subtract from the savings glut.

Curbing immigration and sending back undocumented workers would tend to reduce U.S. labor force growth and thus potential output growth further. Of course, those sent back or not able to immigrate into the U.S. might then be employed outside the U.S., adding to global potential output growth. However, with productivity levels in most home countries of actual or potential U.S. immigrants lower than U.S. levels, this implies a net loss to global potential growth.

MAJOR FACTORS UNLIKELY TO CHANGE

Whatever Trumponomics will look like exactly, it will be unable to affect some of the other secular drivers of the global savings glut.

Global demographics, one of the major drivers, is a given. And when it comes to domestic U.S. demographics, Trump's plans to curb immigration along with the well-documented trend toward increasing longevity and rising labor force participation of wealthy, high-saving individuals above 65 years of age (see Matt Tracey's and my *In Depth* article, "70 Is the New 65") both work to increase rather than lower the savings glut.

Moreover, trying to reduce large EM, Japanese or German current account surpluses – another source of global excess savings – through renegotiating bilateral trade deals is likely to be futile. The current account surpluses of these countries reflect an excess of domestic saving over domestic investment. If, say, the U.S. managed to make imports into the U.S. more expensive and exports more competitive through tariffs or a VAT-like destination corporate income tax, the U.S. dollar would simply appreciate to erase the tax- or tariff-induced gain in competitiveness because the underlying saving and investment pattern in the rest of the world wouldn't change. And so the current account deficit of the U.S. and the surplus of other countries wouldn't change. To be sure, affecting sectoral and bilateral surpluses and deficits is possible through trade or tax policies, but trying to change the overall aggregates is like Don Quixote's vain fight against windmills.

Similarly, some of the drivers of lower global desired investment are unlikely to be reversed by Trumponomics. Smarter technology makes much traditional capital investment obsolete. And even if Trumponomics manages to bring manufacturing jobs back to the U.S. through trade and other policies (a big "if"), the higher domestic business investment in these sectors would likely be canceled out globally by lower investment in these sectors abroad.

TURNING THE SECULAR TIDE IN INTEREST RATES?

Where and how could Trumponomics reverse the factors that have worked toward lowering the natural real rate of interest, and how meaningful would the reversal be? One potential avenue is through raising U.S. potential output growth, the other is through a much larger fiscal deficit caused by a combination of tax cuts and higher infrastructure and/or defense spending, which could absorb some of the ex ante excess savings of the private sector, including the EM/Japan/German current account surpluses.

Regarding U.S. potential output growth, I explained above why labor force growth, one of the two factors driving potential output, is more likely to slow than increase under Trump due to immigration policies. Labor productivity growth is the other factor, and this is where Trumponomics could potentially be positive. A bulk of research suggests that the main factor limiting labor productivity growth is the decline in capital deepening, i.e., weak business investment. It is certainly possible that a combination of corporate tax cuts, deregulation of capital-intensive sectors such as energy, and protectionist measures to support the capital-intensive manufacturing sector could raise capital expenditures (capex) and thus productivity over the next several years. However, the gains would probably be slow in coming and it remains to be seen whether corporate tax cuts won't be used primarily for mergers, acquisitions, share buybacks and higher dividends. Also, keep in mind that higher capex in U.S. manufacturing would likely be at the expense of capex elsewhere in the world.

So how about infrastructure spending and a higher fiscal deficit absorbing more of the global excess savings? Looking at the infrastructure plan advanced by Trump's economic advisors, the idea seems to be to finance the bulk of the higher spending not through higher government borrowing but through tax credits for (wealthy, I guess) private investors. This raises the chance that many of the investment projects would not be additive but merely projects that would have been undertaken anyway, and they could also crowd out other private investment. Moreover, it remains to be seen whether the deficit hawks in the U.S. Congress will agree to a major widening of the budget deficit.

NEW PARADIGM? NOT YET

In summary, while I started out by stating that I'm of two minds about the "new paradigm" thesis, nothing clarifies one's own thinking like writing it down. So for now, my tentative conclusion is that the secular forces holding down global growth, inflation and interest rates remain strong and that Trumponomics is unlikely to change them in any significant way, unless we get a massive increase in government-debt-financed infrastructure spending.

However, this doesn't mean the sell-off we've seen in global rates is irrational, for two reasons.

First, as I noted in the PIMCO Blog a few weeks before the election, it seemed most investors around the world were worshipping at the secular stagnation church and markets had actually undershot PIMCO's 2% New Neutral fed funds rate. This irrational despondency is now being corrected.

Second, my arguments above relate to secular trends, which I tend to believe won't be affected by Trumponomics in any meaningful way. However, cyclical swings around long-lasting, slow-moving secular trends can be quite vicious. For example, as my former colleague Gerard Minack pointed out recently (*Downunder Daily: Setbacks Amidst Secular Stagnation,* Minack Advisors, 22 November 2016), amidst a secular stagnation trend Japanese bond yields doubled in 2003 and quadrupled over a three-year period, before declining again for the rest of the decade and beyond until recently. And most of Trump's economic plans would tend to support a cyclical rise in inflation, as I wrote following the election.

A new (?) paradigm, a new president, the push-pull of global secular and cyclical trends: plenty of food for discussion at PIMCO's upcoming investment forum. As always, following the December Cyclical Forum we'll share our outlook for the global economy for the coming year.

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