ALTERNATIVE SCENARIO

Scenario based on US economic policy plans

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The economic policy measures planned by the new US administration are geared towards fuelling growth. The form, magnitude and timing of the measures, nevertheless, are still undecided. Their potential effects are, therefore, not captured by the Bank of Finland's baseline forecast for the global economy. The following alternative scenario explores the effects of one potential policy package on total output, the rate of inflation, interest rates and the external value of the US dollar. The broad infrastructure investments scheduled for the following decade, together with concurrent tax cuts for households and businesses, are key elements of the scenario. The assumption of the scenario is that the increase in public spending will be funded by levying taxes on imports and taking on additional debt.

Financing a fiscal stimulus

In this scenario, measures of fiscal stimulus are expected to mainly take the form of infrastructure investments and tax cuts. The election programme of President Trump targeted both privately and publicly funded infrastructure investments in the amount of USD 1,000 billion over the next decade. In addition, the new administration also plans to relax both household and corporate taxes by roughly USD 5,000 billion over the same period.

Furthermore, the new budget proposal contains an increase in defence spending by USD

54 billion annually, to be financed by savings in other public expenditure. According to the Congressional Budget Office, the bill for an American Health Care Act recently introduced by the Republican administration would reduce federal expenditure by USD 337 billion over the coming decade.

According to some proposals[1], the rise in public spending caused by the fiscal stimulus will be funded by the introduction of a border adjustment tax, which would levy a corporate tax of e.g. 20% on US imports, while US exports would be exempt from tax, i.e. US export companies would be paid production subsidies in the amount of e.g. roughly 20%. The border adjustment tax is estimated to raise revenue in the amount of USD 1,000 billion over the next decade[2].

Table 1 shows the effects of these pending economic policy measures on federal revenue and expenditure, assuming that infrastructure investments are publicly funded.

Table 1.

Policy objectives of the new US administration for the next decade, USD 1,000 billion

Revenue		Expenditure	
Border adjustment tax	1	Infrastructure investments	1
Public expenditure savings	0.54	Defence spending	0.54
American Health Care Act	0.34	Tax reform	5

Source: Bank of Finland calculations.

Policy package would spur growth in immediate years ahead

The effects of US economic policy plans can be analysed using a general equilibrium model[3] developed by the IMF (Table 2). Taken together, the measures analysed have a significant upward effect on growth. Fiscal stimulus measures financed by the border adjustment tax pull the pace of economic growth up by a full ½ of a percentage point per annum during the first three years.

In the scenario, the Federal Reserve responds by raising its policy rate by more than 1½ of a percentage point, prompting a major appreciation of the nominal trade-weighted exchange rate, by roughly 22%. Notwithstanding this, inflation will pick up by close to a percentage point before gradually moderating.

1. Proposal of the House of Representatives (Ryan – Brady), see https://waysandmeans.house.gov/taxreform/.
2. The GDP ratios of US exports and imports are 12% and 15%, respectively, which means that the additional revenue raised by the border adjustment tax would amount to 0.2x0.15-0.2x0.12, or around 0.6% of GDP.
3. Kortelainen (2013) Global Integrated Monetary and Fiscal Model, Bank of Finland Bulletin 1/2013.

According to the scenario, private consumption will decline in response to the rise in import prices due to the border adjustment tax. Investments will grow mainly through a reduction in the corporate tax rate. This economic policy package will not improve the external balance of the US economy, given that the current account deficit will grow wider as imports are boosted by the fiscal stimulus. Nor will the economic policy under review generate any substantial savings in expenditure and, consequently, will not resolve the issue of how to maintain fiscal sustainability in the longer term.

Table 2.

Effects of economic policy of new administration on the US economy: deviations from baseline

		Over 3 years, on average
GDP	%, level deviation	2.1
Consumption	%, level deviation	–2.4
Investment	%, level deviation	10.3
Consumer price inflation	% points	0.9
Policy rate	% points	1.7
Current account/GDP	% points	–1.0
Nominal effective exchange rate	%, (–) is appreciation	–21.9

Source: Bank of Finland calculations.

The amount, timing and particulars of fiscal stimulus are surrounded by major uncertainties. Taken together, the measures analysed here have a significant upward effect on growth. However, such an economic policy approach is associated with a considerable risk of increasing protectionism at the global level.

The introduction of a border adjustment tax could trigger instant trade counter measures in other countries. The realisation of these risks could have adverse consequences for the international economy, gradually rolling back the upward growth effects on the US economy.

Tags

alternative scenario, economic policy, fiscal policy, USA