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GROWTH IN THE YEAR AHEAD

BY STEPHANIE SEGAL

After years falling below expectations, economic growth in the United States is on track to outperform beginning-of-year forecasts. The Federal Reserve estimates the U.S. economy will grow 2.5 percent in 2017, nearly a full percentage point higher than last year. Business and consumer confidence remain well above their long-term averages; U.S. equity indices are at record levels; and the president is on the verge of signing into law a massive fiscal stimulus. In the just-released National Security Strategy (NSS), the Trump administration rightly links economic vitality, growth, and prosperity at home to American power and influence abroad. The near-term growth outlook looks bright; however, there are downside risks on the horizon that could impact economic prospects—and American power—if not carefully managed.

Upcoming Events

- January 1: Canada G7 Presidency begins
- January 8: Assessing Innovation in China's Digital Economy (CSIS)
- January 23rd-28th: NAFTA Renegotiation Round 6 (Montreal)
- January 24th: Asia Forecast 2018 (CSIS)

Tighter monetary conditions are already factored into the baseline. Monetary tightening and policy normalization in the United States have been well-communicated by the Fed and understood by the market. As expected, the Fed increased rates this month, the third such rate increase in the past year. The Fed has also started to reduce its holdings of securities first acquired in response to the global financial crisis. Tighter monetary policy is intended to prevent the economy from overheating. It will also attract portfolio flows to the United States from other countries. One estimate from the International Monetary Fund (IMF) suggests policy normalization—raising the policy interest rate and shrinking the Fed's balance sheet—will reduce portfolio inflows to emerging markets by about $70 billion over the next two years. Some countries, especially those dependent on portfolio inflows to finance large current account deficits and external debt obligations, will be vulnerable. The standard response by countries to the associated market pressure is to tighten macroeconomic policies. Such tightening assures investors that the authorities are committed to macroeconomic stability, but it usually comes at the expense of economic growth.

Higher interest rates in the United States could also complicate the outlook for China. Economic growth in China is already expected to slow as the authorities wean the economy off debt-financed investment in property and infrastructure. Higher interest rates are also likely to lead to dollar strength and, other things equal, renminbi (RMB) depreciation against the dollar. Recall that the expectation of a weaker RMB drove capital outflows in 2015–2016, costing China hundreds of billions in reserves and forcing the tightening of capital controls as it sought to stabilize the exchange rate. Add China's financial fragility to the mix, and there is reason for concern, especially given China's level of indebtedness on the one hand and contribution to global growth and commodity price support on the other.

Trade-related risks may be underestimated. Aside from military confrontation, the biggest threat to the U.S. and global economic outlooks is rising protectionism. There are multiple potential flash points, but U.S. withdrawal from the North American Free Trade Agreement (NAFTA) and a further escalation in trade tensions between the United States and China are at the top of the list. Back in October, during the annual meetings of the World Bank and IMF, the anxiety around trade was evident. Observers of NAFTA renegotiations were not encouraged by reports from the talks, and some even speculated that the United States was pushing proposals it knew Canada and Mexico could not accept. While a modernized NAFTA would be the best outcome, now just a few months shy of the start of the Mexican presidential campaign season, it is also the least likely. Even if we step back from the brink of NAFTA withdrawal, the uncertainty created by an indefinite renegotiation will likely have costs in terms of delayed or foregone investment.

News around the U.S. and Chinese bilateral economic relationship is equally worrisome. U.S.-China economic relations were already deteriorating when President Trump took office in January. With just a week left in office, the Obama administration launched a new trade enforcement complaint against China at the World Trade Organization (WTO) concerning China's subsidies for aluminum production, the 16th trade enforcement challenge the administration had launched at the WTO

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against China. Now, less than a year into office, the Trump administration has initiated numerous antidumping and countervailing duty investigations against China, including the first self-initiated case in more than 25 years. It initiated "Section 232" investigations under the Trade Expansion Act of 1962 to determine the effects on national security of steel and aluminum imports, and it launched a "Section 301" investigation under the Trade Act of 1974 to determine if Chinese practices related to technology transfer, intellectual property, and innovation are damaging to U.S. commerce.

While U.S. frustrations with China have been building for a while, the Obama administration's approach, which centered on taking action through the WTO, has been replaced by the makings of a unilateral one under the Trump administration. There may be good reason for a change in approach, but a strategy built around unilateral actions and bilateral treaties spells trouble for the multilateral trading system. News out of the WTO Ministerial Conference in Buenos Aires earlier this month did little to alleviate fears about the future of the multilateral trading system.

For those following trade issues closely, the muted reaction outside of policy circles has been noteworthy. The best explanation is the belief that the United States and others will avoid permanent damage to a system that has so clearly worked in their national interest. But this perspective ignores the legitimate concerns of those groups that have not clearly benefitted from an open trading system. Their domestic political influence, in the United States and elsewhere, will have important impacts on the future of trade and should not be underestimated.

Fiscal policy presents upside potential in the near term but downside risks over the medium and long term. As this month's GEM goes to print, the president is poised to sign the largest one-time reduction in the corporate tax rate in U.S. history, from 35 percent down to 21 percent. The bill is also expected to lower taxes for the majority of Americans, although the durability of cuts will be decided by a future Congress when those cuts expire in 2025. Supporters of the "Tax Cuts and Jobs Act" point to the expectation that the lower tax burden will draw companies back to the United States, stimulate corporate investment, and lead to higher consumer spending. Regarding its impact on growth, Fed chair Janet Yellen commented that the tax package "would tend to provide some modest lift to GDP growth in the coming years," but beyond that there is "considerable uncertainty."

Opponents of the tax cuts point to various downside risks, among them higher fiscal financing costs and fiscal dominance as the government issues more debt to finance larger deficits. Estimates of the overall increase in government debt range from $1.0 to $1.5 trillion—depending on how the economy responds to tax cuts—over the next 10 years, assuming no reduction in outlays. Opponents also expect the legislation to worsen income inequality, given the distribution of benefits to high-income earners. And they suggest lawmakers will ultimately tackle higher deficits by cutting expenditures. Some lawmakers have already announced plans to prioritize entitlement reform in the year ahead; if consumers anticipate lower entitlement spending, there could be a near-term impact on consumer confidence and a longer-term structural shift on individuals' decisions to save rather than spend their incomes.

There also may be cuts to government spending on items that influence potential growth, for instance infrastructure, education, and basic research. These items arguably have a greater impact on growth prospects over the medium term, notwithstanding the impact of tax cuts. Despite the market euphoria in anticipation of tax cuts, we may come to see the downside as focus shifts to debt, income inequality, and expenditure considerations. Fair trade, tax reform, and investing in our future—all priorities spelled out in the NSS—can support American prosperity and U.S. influence abroad. But the details matter, and rhetoric cannot substitute for policies that effectively advance these goals.

Stephanie Segal *is Senior Fellow and Deputy Director of the Simon Chair in Political Economy at CSIS.* *Global Economics Monthly is published by the Center for Strategic and International Studies (CSIS), a private, tax-exempt institution focusing on international public policy issues. Its research is nonpartisan and nonproprietary. CSIS does not take specific policy positions. Accordingly, all views, positions, and conclusions expressed in this publication should be understood to be solely those of the author.* *© 2017 by the Center for Strategic and International Studies. All rights reserved.*