

TRUMP VERSUS REAGAN – GROWTH AND MARKETS

Did Reagan boost growth, and how?

Since last November, many have sought to compare the economic platform, and effects, of the new Trump administration in the U.S. with that of President Reagan in the 1980s. Optimistic observers, and to some extent markets, have latched on to the possibility that the Trump administration could boost world growth through a mixture of fiscal stimulus and deregulation. In addition, the Trump policy mix is seen as potentially positive for the dollar, stock markets and commodity prices.

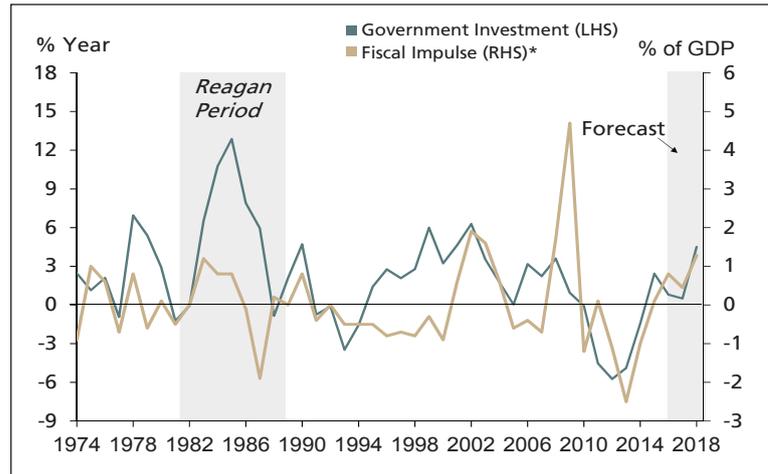
U.S. economic policy in the 1980s is often remembered as featuring a strong ‘supply-side’ element: tax cuts, deregulation, smaller government and freer trade.

The reality is more nuanced. The Reagan administration was more ‘Keynesian’ than many acknowledge, with much of the boost to U.S. and world growth in the 1980s coming from demand-side stimulus. Indeed, U.S. growth in the 1980s benefitted from a number of tailwinds that are wholly or partially lacking now.

- **Excess capacity and high unemployment after the 1980-82 recession.** Today, we are eight years into an economic upturn with spare capacity much more limited.
- **A steep decline in interest rates from late 1982 from very high initial levels.** Today, rates are low but on an upward trajectory.
- **Modest initial private sector leverage.** Today, leverage is down from pre-crisis highs but still quite high.
- **Sharp drop in world oil prices 1983-86.** Oil prices have been rising over recent months.
- **Large fiscal expansion.** The U.S. structural budget deficit rose from 1.8 per cent of GDP in 1981 to 4.5 per cent of GDP in 1986, a large and sustained stimulus. Government investment rose at a double-digit pace in 1984-85 (see Chart 1).

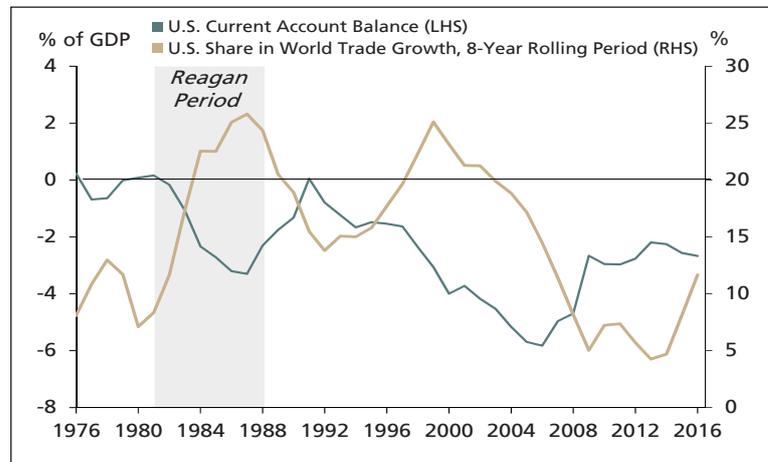
The Trump administration is also planning a large fiscal stimulus; our forecast is for the U.S. structural deficit to rise by around 2.0 per cent of GDP to 5.9 per cent of GDP by

Chart 1: U.S. Fiscal Spending



Source: Oxford Economics, Haver Analytics and CBO
* Change in structural budget deficit

Chart 2: U.S. as World Trade Motor



Source: Oxford Economics, Haver Analytics and WTO

2018. However, even assuming this stimulus does occur, it will be taking place against a much less supportive economic background than Reagan’s did.

In addition to running quite large fiscal deficits, the Reagan administration also supported world growth by allowing the U.S. current account deficit to expand, from near balance in 1980 to more than 3.0 per cent of GDP by the mid-1980s. The U.S. accounted for around a quarter of world trade growth in the eight years to 1987 (see Chart 2).

So, the growth boost of the Reagan period relied greatly on the widening of the U.S.’s ‘twin deficits’. It is open to price for stronger

growth. The Trump administration may face resistance to expansionary fiscal policy in Congress, and to date has expressed a notable lack of tolerance concerning U.S. external deficits.

Economic re-run of the 80s unlikely

What about the prospects for boosting growth through deregulation and other ‘supply-side’ reforms? The Reagan period did see productivity growth in the U.S. improve compared to the 1970s (see Chart 3). However, the improvement was partly cyclical and was also visible in other advanced economies.

A key area of 1980s reforms was cutting marginal tax rates, but the impact was less dramatic than it appeared (many households did not see falling marginal rates). Meanwhile, Reagan's record on trade was very mixed. The 1980s saw tariffs falling but non-tariff barriers increasing, including restrictions on Japanese cars and electronics as well as steel imports from various partners.

Overall, the Fraser Institute measure of economic freedom suggests the U.S. became 'freer' in the 1980s, but from an already fairly strong position, and by less than economies like the UK and New Zealand.

There are reasons for believing that the U.S. could benefit now from a dose of supply-side reform; productivity growth is slow and signs of flagging dynamism (e.g. falling entry and exit rates of firms) have been visible for some time.

However, the Reagan period warns us to be cautious about how much to expect. Moreover, it is not clear that the policies so far put forward by Trump are well-suited to reversing the U.S.'s loss of dynamism. The emphasis on financial sector deregulation, in particular, looks misplaced with little evidence that the Dodd-Frank Act (despite its flaws) has damaged credit supply. Protectionist actions are also unlikely to be conducive to faster productivity growth.

'Trumponomics' and asset prices

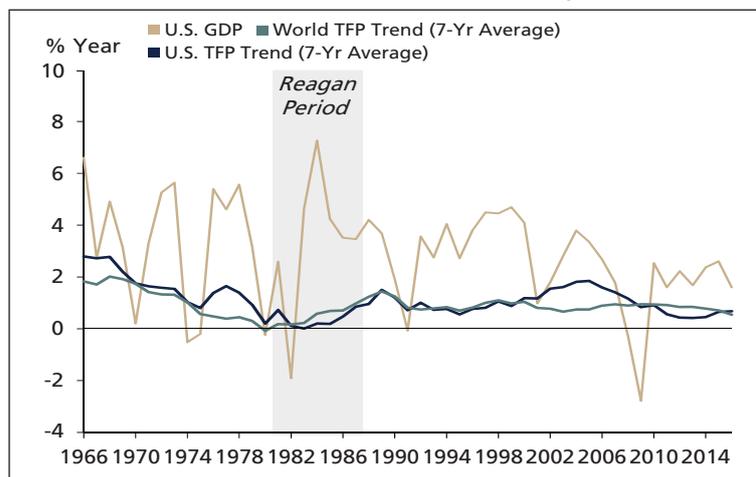
What about asset prices? Superficial similarities exist between the initial impact on asset prices of Trump's election and Reagan's, notably rising stocks (especially financials), a stronger dollar and a rise in oil prices.

However, we doubt that asset price performance over the next few years will mirror that of the 1980s, particularly the spectacular gains recorded by stocks and the dollar. The real exchange rate of the dollar soared by around 40.0 per cent by mid-1985, while the S&P 500 doubled by 1987.

The prospects for dollar gains on a similar scale to the 1980s look thin. The dollar was weak in 1980 but has seen strong gains since 2014, and may be moderately overvalued. Moreover, though the dollar should in theory gain from rising U.S. yields, quite a lot is arguably already priced into markets in terms of expected Fed rate hikes. We expect dollar gains from here to be modest.

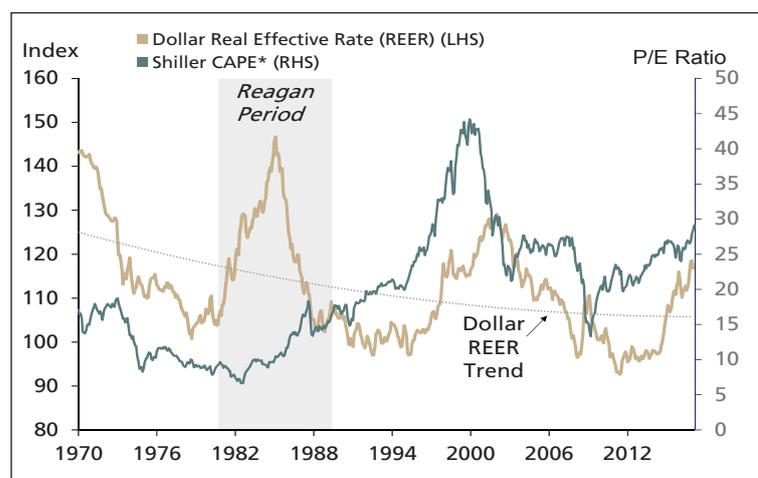
The same argument can be used for stock markets. Stock valuations were low in 1980, and worsened in 1981-82 amid high yields and recession. Stocks today, if anything, look expensive based on long-term valuations.

Chart 3: GDP and Total Factor Productivity (TFP)



Source: Oxford Economics and Haver Analytics

Chart 4: U.S. Dollar and Stock Variations



Source: Oxford Economics and Haver Analytics
* cyclically adjusted p/e ratio

Moreover, collapsing interest rates from 1983 onward helped stocks, but equity markets now face rising yields. As we are also cautious that a supply-side revolution will transform the outlook, a 1980s-style stock surge looks unlikely. To us, the more pertinent question is whether the rally since November is sustainable.

One area where the Trump administration may be more positive than Reagan's is commodity prices. A surging dollar and initially high interest rates contributed to a big decline in global commodity prices in the 1980s. With these factors missing and moderately higher U.S. growth adding to demand, commodity prices may register further modest gains. This will be good news for emerging markets, which by contrast had a rough time in the 1980s with slow growth and a slew of debt defaults.

Conclusion

There are some similarities between the Trump and Reagan eras but also many differences. Reaganomics relied more on demand-side measures and less on supply-

side measures than is often remembered, and U.S. growth in the 1980s benefitted from a number of tailwinds that are missing today.

As a result, Trump's proposed fiscal stimulus will occur against a much less favourable backdrop. The likelihood of a 'productivity miracle' is also limited, especially given the policy proposals seen so far. For global growth, a key issue is whether the Trump administration and the U.S. Congress will be willing to see the U.S. budget and current account deficits widen in the way the Reagan administration did in the 1980s. This looks doubtful.

On asset prices, a re-run of the dollar and stock price booms of the 1980s looks unlikely: both assets were undervalued at the start of the 1980s but are not now. Emerging market assets, however, could do better than in the 1980s if the Trump stimulus leads to modestly higher growth and commodity prices, and protectionist actions are limited. ■■