ECONOMIC VIEWPOINT

Can the U.S. economy accelerate sustainably?

Donald Trump's pledge to get U.S. real GDP to 4% growth faces several constraints

During his election campaign and even after he entered the White House, Donald Trump was predicting that his policies would accelerate the U.S. economy. The White House website still mentions a return to 4% growth. Such a result would of course help the new administration limit the budget impacts of its election promises, particularly the tax cuts. Faster growth is still possible in the near term, but over the medium term, the challenge is a big one. The U.S. economy's growth potential should be more around 1.8% in the coming years. Moreover, the policies Donald Trump's government is likely to put forward do not suggest any acceleration by the main components that support that potential, i.e. labour force productivity and growth. It would therefore be astonishing to see sustained 4% growth in the years to come.

4% growth ... or better!

In his 2016 election campaign, Donald Trump repeatedly said that the United States could reach real GDP growth of 4%. Now that he is President of the United States, the promise still seems to stand. The White House website says that "To get the economy back on track, President Trump has outlined a bold plan to create 25 million new American jobs in the next decade and return to 4 percent annual economic growth."

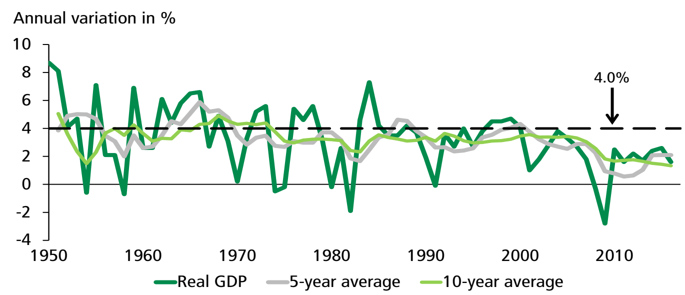
As you may remember, this ambitious 4% target was sometimes used as a floor. In the third presidential debate, Donald Trump even said that growth could be higher than 4%, that it could go to 5% or 6%.

For the U.S. economy, this kind of performance is rare (graph 1); we have to wonder whether it is possible for the United States to achieve such a pace. The immediate conclusion is that it will be difficult and that a number of factors, particularly demographics, argue against true acceleration. Already, some members of the new government seem to be quietly distancing themselves from what has been promised. Treasury Secretary Steven Mnuchin recently spoke of returning to more normal growth "of 3% or more."

The Trump effect on confidence and the economy

The promise to achieve stronger growth is based on the positive effects the new administration will have on the economy,

GRAPH 1
Growth of 4% or better is very rare



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

confidence and financial markets. For now, we can say that the two latter targets have been impacted. Consumer confidence is up and the latest levels suggest good acceleration by personal consumption (graph 2 on page 2). Business confidence also seems better. The effect is obvious among small businesses, as well as the larger ones. In this case, the ISM indexes' good performance suggests stronger growth by investment and the overall economy. Also noteworthy is the good performance delivered by the stock indexes since the election.

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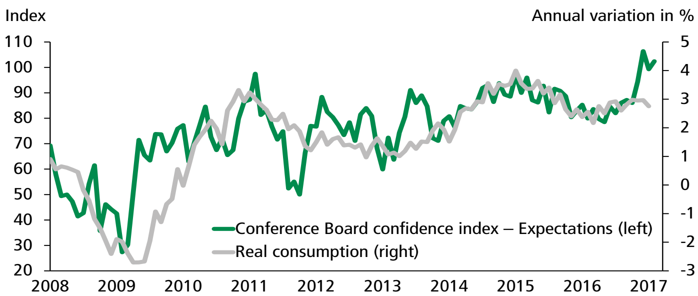
GRAPH 2
Improved household confidence could result in an acceleration in real consumption



Sources: Conference Board, Bureau of Economic Analysis and Desjardins, Economic Studies

Economic agents seem to be excited about the promised cuts to personal and business taxes. Deregulation also seems like a positive point, as does a promised increase in infrastructure investment. The fallout from renewed protectionism and questions over immigration could be less positive for the economy, however.

If Congress and the White House actually manage to put forward more favourable policies, we could in fact see a Trump effect on U.S. economic growth. We cannot rule out quarters with growth better than 3% or 4%. However, there is a world of difference between an economy that is getting short-term stimulus and an economy that can generate much stronger growth sustainably over the longer term. Questions also arise about the budget costs of such stimulus.

Effects on the federal budget

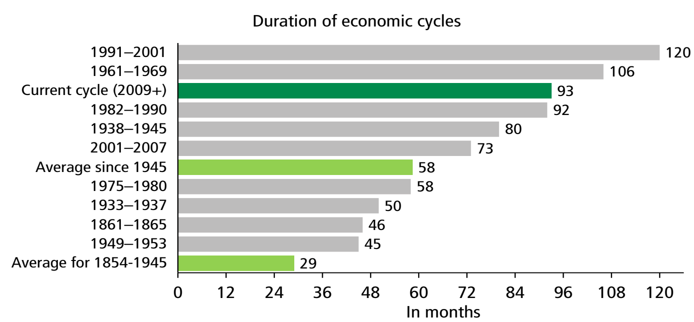
Assumptions of stronger real GDP growth would help keep the Trump administration from making deficits balloon too much in its future budget documents. In fact, sustained 4% growth would be a real panacea. In the Obama government's 2017 budget documents, the Office of Management and Budget estimated that growth that was 1% higher each year over 10 years would reduce the combined deficit for the period by US$3,157B. Such a hypothesis would of course help offset the cost of Donald Trump's promised tax cuts, which could make it easier to get them through Congress.

Recent rumours that the administration wanted to use 3.2% real GDP growth over 10 years as a budgetary assumption have raised some criticism. It now seems that the first budget proposal, which should be released on Thursday, March 16, will include a forecast of 2.4% (we don't know whether that is short or medium term). A more substantial budget, which is scheduled for May and should incorporate Donald Trump's main promises, could include faster growth, however. Obama's last budget proposal (August 2016) called for average growth of 2.3% over 10 years (including the impact of stimulus measures that were never adopted). In January, the Congressional Budget Office (CBO) was calling for average growth of just 1.9% over the next 10 years.

The current economic cycle will not last forever

This economic growth cycle started in the summer of 2009. The recovery was generally slow. It was only in the summer of 2011 that the ground lost on real GDP was recouped, while it took employment until May 2014. Although lacklustre, this cycle is ageing, with 93 months of growth. This is the third longest cycle since the National Bureau of Economic Research officially began compiling growth cycles and recessions (graph 3). The only two growth cycles that were longer came in the 1990s (120 months) and 1960s (106 months). It would therefore be astounding for growth to blithely continue uninterrupted for another 10 years. An end to the cycle or, at least, naturally flagging growth would frustrate the plans for a sustained increase to growth over a 10-year horizon.

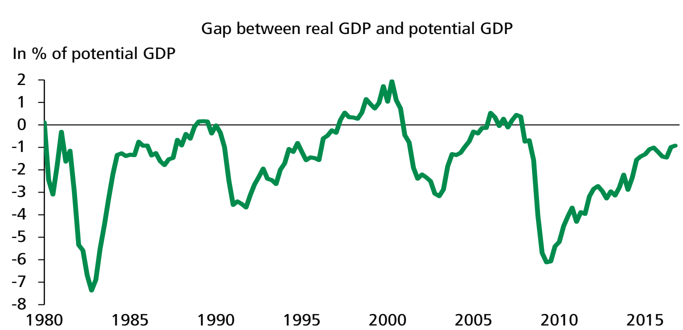
GRAPH 3
This economic cycle is relatively long



Sources: Wall Street Journal, National Bureau of Economic Research and Desjardins, Economic Studies

Over the course of the cycle, the combined growth has closed much of the gap between real GDP and potential GDP (graph 4). This means there are now fewer unused resources within the U.S. economy. However, once closed, the output gap suggests

GRAPH 4
The output gap is poised to close



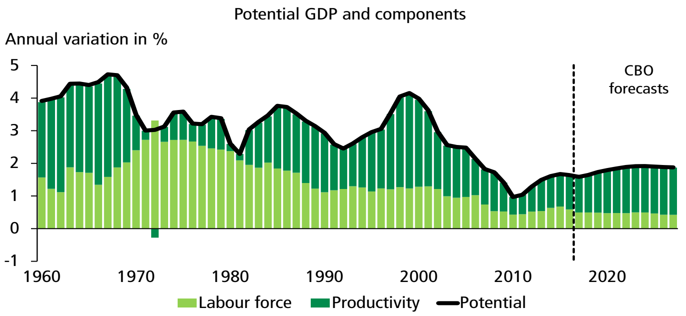
Sources: Bureau of Economic Analysis, Congressional Budget Office and Desjardins, Economic Studies that stimulating budget policy will, in the end, have less impact on real growth and could generate more inflation pressure. In this context, policies that aim to accelerate growth will only be effective over the medium term if they focus on the economy's potential, not just on cyclical impetus.

The constraint of economic potential

To assess economic growth over a long period, we have to eliminate situational vagaries and focus on the normal pace of growth. To do that, we look at potential GDP growth, which is calculated as the sum of labour force and productivity growth.

The pace of potential GDP has slowed in the last few years (graph 5). One of the reasons is demographics: population ageing limits labour force growth. In recent periods of strong economic growth, the United States was able to draw on a major surge in the potential workforce as baby boomers and women entered the job market. However, the demographic outlook suggests fairly slow labour force growth in the coming years.

GRAPH 5
Growth by potential GDP is slower

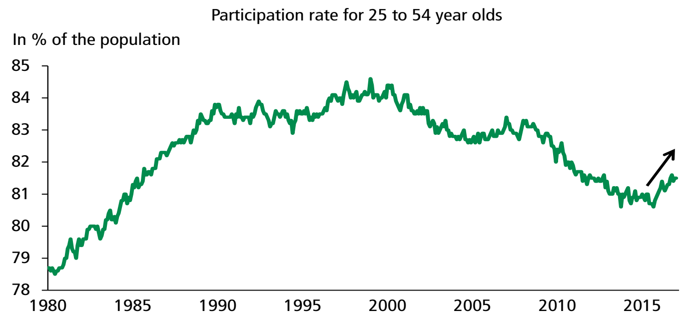


CBO: Congressional Budget Office
Sources: Congressional Budget Office and Desjardins, Economic Studies

The weakness in the labour force's contribution to potential growth will be hard to deal with. Donald Trump has repeatedly said that an incredible number of workers were available. The drop in the jobless rate contradicts this assertion, although there is still room for faster growth by the participation rate, especially among those aged 25 to 54 (graph 6). However, that will never be enough to fully offset the total impact of population ageing. The solution could be increased immigration, which would clash with the Trump administration's policies. To accelerate growth over the medium term, the focus would therefore have to be on better productivity.

Productivity growth has also slowed in recent years. Annual productivity growth has dropped from a pace of almost 3% at the end of the 1990s to under 1%. This variable is less entrenched than demographics for the coming years. The Republicans have often accused Barack Obama's economic policies of harming the entrepreneurial spirit. Donald Trump's

GRAPH 6
The participation rate could still go up



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

economic advisors are therefore hoping that rolling back regulations and reforming business tax will help increase the U.S. economy's potential. We could see a positive impact through faster business investment and infrastructure spending, but it would be astounding to see productivity double or triple, especially as this weakness is not unique to the United States, but is being seen in most advanced nations.

All in all, for 2017–2027, the CBO is expecting annual labour force growth of just 0.5%, and productivity growth of 1.3%, for an average increase of 1.8% in potential GDP.

It will therefore be hard to quickly get growth to 4% and keep it there for many years. Even a 3% target seems out of reach. Without banking on acceleration in the workforce, productivity would have to increase steadily by 2.5% to 3.5% to yield economic growth that would live up to Donald Trump's promises.

Moreover, we have to include the fact that some of the policies contemplated by Donald Trump could hurt potential growth. Protectionism tends to limit productivity. Restrictions on immigration curb labour force growth and innovation.

A promise that could act as an electoral barometer

The U.S. economy could actually pick up speed in the near term under the combined impact of better cyclical momentum and stimulating policies. However, the strong trend makes it hard to believe in sustained acceleration by real GDP. Failing drastic changes in the areas of productivity and the labour force, sustainable growth of 3% to 4% is hard to imagine over a long period. Moreover, the length of this economic cycle does not argue in favour of such a promise. In conclusion, it could well be broken. As economic growth and job creation are generally the focus of voters' concerns, an inability to deliver the goods could come back to haunt Donald Trump during upcoming visits to the polls.

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