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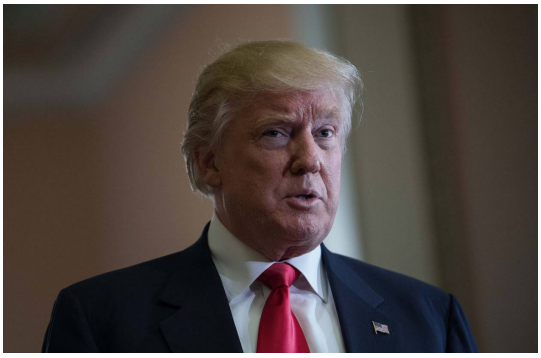
Trumpflation: Not Now, Maybe Later

Strong early reactions in the bond market to stimulus plan miss the bigger picture



Donald Trump's proposals to cut taxes and boost spending via tax credits on infrastructure has fueled strong reactions in the bond market, but his policies are likely to change the global economic picture only marginally. *PHOTO: NICHOLAS KAMM/AFP/GETTY IMAGES*

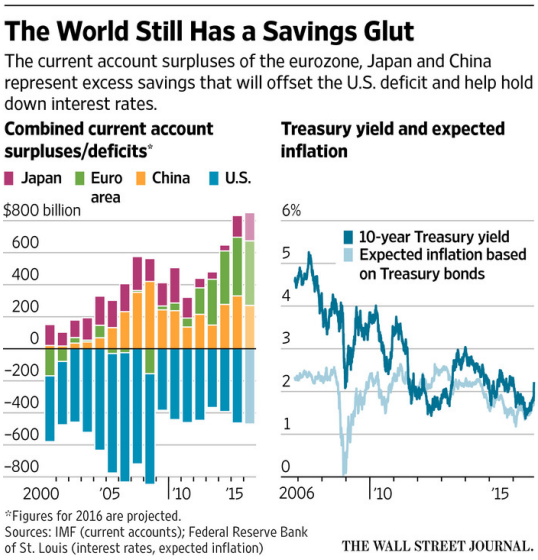
By **GREG IP**

Updated Nov. 16, 2016 1:24 p.m. ET

The bond market is a binary creature: It sees every event as either inflationary or deflationary. It has quickly concluded that Donald Trump's shock victory is the former. Since then the 10-year Treasury yield has leapt a third of a percentage point, about half of that because of higher expected inflation.

This is an overreaction. Presidents and policies make U-turns; inflation and economic growth don't. The U.S. and the world have been stuck in a low-growth, low-interest rate rut since 2009, and Mr. Trump's policies can at best change that at the margin.

That said, Mr. Trump's election is part of a rising tide of global populism, a phenomenon that in the past has usually brought inflation—a risk for a later date.



At first blush, Mr. Trump looks like he will usher in a new era of fiscal profligacy that will flood the world with new debt to absorb. He has proposed a tax cut that several outside analysts say would add about $6 trillion to deficits in the coming decade and spending hundreds of billions of dollars via tax credits on new infrastructure.

That's a lot, but then the world has a structural surplus of savings and a shortage of investment. This year, the euro area, China and Japan will run surpluses on their current accounts—the balance on all trade and investment income—of roughly $850 billion. In short, the bonds needed to finance Mr. Trump's deficits will find ready buyers.

The actual deficit impact is likely to be much smaller. Mr. Trump doesn't appear wedded to any specific numbers. Kevin Brady, Republican chairman of the House of Representatives' tax-writing committee, said Tuesday the tax overhaul would aim not to raise the deficit. The growth impact is also likely to be modest. The bulk of the tax cuts will likely go to corporations and the wealthy, whose spending doesn't vary much with their tax bills. Lower corporate tax rates should encourage investment and growth but the impact would be uncertain and gradual.

Macroeconomic Advisers estimates a $4 trillion tax cut along the lines of Mr. Trump's proposal would boost growth just 0.2 percentage point over the next three years. On infrastructure, Mr. Trump will encounter the same awkward reality that President Barack Obama did seven years ago: There aren't many shovel-ready projects.

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Unlike in 2009, this fiscal stimulus will be hitting when the economy is close to full employment with far less spare capacity. Yet it's premature to assume inflation will therefore jump. In the last decade inflation, excluding swings due to energy, has proven surprisingly inertial, barely moving in response to high unemployment. The same is likely true if unemployment drops further below its "natural" level.

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This will shape how the Federal Reserve responds. "I don't think we should say, even if there's going to be fiscal stimulus, we know that will translate into such-and-such an increase in inflation," Fed governor Dan Tarullo said Tuesday.

To be sure, fiscal stimulus will likely hasten the Fed's process of raising rates, but it's less likely to change the end point. In the long run, rates are being held down by structural factors such as aging population and slow productivity growth.

Mr. Trump's anti-globalization policies could bolster inflation. Goldman Sachs estimates that tariffs of 35% to 45% on Mexican and Chinese imports, as Mr. Trump has threatened, would add 0.2 percentage point to inflation while deporting 2.5 million illegal immigrants, by restricting the supply of labor, would add up to another 0.1 point.

But will Trump go that far? Though clearly a protectionist, Mr. Trump and his advisers have often described the threat of tariffs foremost as leverage to extract concessions rather than prelude to a trade war. His deportation threats have changed repeatedly.

And while restricting immigration and trade will hurt productivity, which raises costs, lower corporate tax rates and regulation should work in the opposite direction by bolstering investment.

Still, dissecting Mr. Trump's policies misses the bigger picture. He's the latest in a global wave of populists toppling the established political order with its appeals to disaffected working-class voters.

In emerging markets, populist leaders often presided over an initial economic boom fueled by easy fiscal and monetary policy; inflation and crisis usually followed. The U.S., of course, has much stronger institutions, including an independent Federal Reserve. And Republicans in Congress have been harshly critical of what they consider overly easy monetary policy and want to subject its monetary decisions to congressional audit.

But with one of their own in the White House, Republicans in Congress may worry less about inflation and deficits. Half a century ago, inflation began to climb when supposedly independent Fed chairmen succumbed to political pressure, first under

Lyndon Johnson and then under Richard Nixon. If Congress curbs the independence of the Fed now, it may inadvertently ease the way for inflation's return down the road.

Corrections & Amplifications:
Macroeconomic Advisers estimates a $4 trillion tax cut along the lines of Mr. Trump's proposal would boost growth just 0.2 percentage point over the next three years. An earlier version of this article incorrectly stated the estimate was for a $4.5 trillion tax cut. (Nov. 16, 2016)

Write to Greg Ip at greg.ip@wsj.com