Reflation under Trump may look very different from reflation under Roosevelt

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The recent election of Donald J. Trump may share something with that of Franklin D. Roosevelt back in the 1930s, but less so than that which the former or some of his supporters wish to believe[1]. Some conservatives even claim that both men actually share foreign policy ideals and even their tendency to fascism[2]. Regardless of whether their discourse resembles or not, some key aspects of the economic context of their times are indeed similar, but these go well beyond their personalities.

Both Trump and Roosevelt were elected after a deep and prolonged slump, although the former's election took place after an also long period of mild recovery under his predecessor's successful post-crisis program (which is paradoxically gaining momentum just now). Both men play a key role in making important decisions (or at least just signing them) that have important consequences for the rest of the world. Both men are seen as the main character that impersonates a drastic change with respect to previous "business as usual" thinking. And of course both attract a lot of attention because of their job positions.

This note focuses on the economic context in which these two characters were elected, and gives more weight to this context rather than to the personality of either. Some similarities clearly stand out between the first hundred days of 1933 and 2017 (still to come), but again these have hardly anything to do with the president-elect involved.

A natural starting point of (hopefully cautious) comparison is the strong parallel between the 1929 stock market crash, the Great Depression and the New Deal, the sequence of which echoes that of the 2008-09 financial crisis, the Great Recession and the new economic plan that is still to come. A common feature between then and now is the deflationary bias in policy-making prior to these two men being elected. A second feature is the fact that both are also associated with a dollar devaluation once they are in power...

Devaluation and public works

In 1933 the Roosevelt administration put in place a massive public works program. This is often perceived as being the core of the New Deal and the single most important reason for the recovery from the Great Depression (October 1929 - April 1933). This may or may not have

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[1]See http://www.cbsnews.com/news/donald-trump-defends-muslim-plan-by-comparing-himself-to-fdr/

[2]http://thefederalist.com/2016/01/26/the-uncanny-parallels-between-donald-trump-and-fdr/

been the case[3], but a key feature that is often neglected of this interesting episode of economic history is summarized by Temin and Wigmore, who in their 1990 article (p. 490) highlighted that:

> The first one hundred days of the new administration from March to July 1933 (...) contained a clear change in the economic policy regime that could not have been anticipated from the election campaign or the interregnum period. The focus shifted from a strong dollar to devaluation, from international cooperation to domestic recovery, from deflation to inflation, from emphasis on financial markets to direct intervention in the economy, and from budget balancing to fiscal stimulus.

That is to say, the authors put forward the notion that the "devaluation of the dollar was the single biggest signal that the iron grip of the gold standard had been broken", thus that a weaker dollar (or the U.S. going off the gold standard) was the key to recovery from the Great Depression (and not public expenditure, as the legend has it).

So, if deflation was (at least part of) the problem and inflation (which induced the devaluation) was the cure back in the thirties, why did authorities not follow the same path right after the 2007-08 crisis or, at worst, four years after the crisis had hit ? The answer may be found in a 2015 article by Barry Eichengreen, who argues that the Federal Reserves' transcripts right after 2008 "show that the FOMC [Federal Open Market Committee] was preoccupied by inflation, rendering it reluctant to do more, even when the clear and present danger was deflation, this inflation phobia reflected the impact of high inflation in the 1970s on the preoccupations of U.S. central bankers" (p. 5).

Now, with respect to deficit spending, an August 2016 article by Christopher Sims[4] (also discussed last year at the Jackson Hole meeting) puts forward the notion that expansionary fiscal policy can replace monetary policy at the zero lower bound, that is, when the nominal interest rate is so low that it can no longer fall and stimulate the economy. In simpler terms, Sims' idea is that when lowering the interest rate no longer stimulates output and employment, fiscal policy may do the job (contrary to what contemporary policy makers tend to believe).

Moreover, Sims also argues that "deficits must be seen as financed by future inflation". In other words, by lowering the expected future cost of financial liabilities (say, debt) via inflation, real sector investors may simply be able to borrow at a lower cost and invest more.

Sims' arguments provide a link between devaluation and public debt (which of course may ultimately finance public works) via inflation. Inflation lowers the value of a currency, which makes the country in question more competitive (as long as it doesn't make its citizens poorer than more competitive) while at the same time it lowers debt loads and transfers purchasing power from debt holders (banks) and debt issuers (firms, governments or households).

Taking stock of the discussions above, this calls for a revision of a link between currency devaluation, inflation, economic growth and lower public debt or, what amounts to the same but in

[3]Of course, public expenditure at a time when the private sector is unwilling and/or unable to spend is a good idea and of course this no doubt contributed greatly to the recovery. However, what is here in doubt is whether public works were 'the' core element of the recovery.

[4]https://www.kansascityfed.org/ /media/files/publicat/sympos/2016/econsymposium-sims-paper.pdf

the extreme opposite, a link between over-valuation, deflation, stagnation and high public debt.

In any case, a strong parallel between FDR's election and Trump's election is that both were preceded by a major financial crisis and a period of deflation, and that both are associated with massive public works programs, reflation and recovery...

FDR is considered a hero, Trump is not (and should not)

The discussion up to here makes it clear that the Great Depression of the thirties and the ongoing Great Recession are two comparable events that call for the same kind of policy agendas: devaluation, public expenditure and reflation (that is, a return to inflation and a weaker dollar).

Roosevelt's New Deal provided the basis for these three, along with: banking regulation (Glass-Steagall Act), legalization of alcohol that effectively reduced criminality in the country, strong ties between firms and workers' unions that helped wages, the basis for a relatively generous welfare system, and other policy measures that got the economy back on its feet.

The New Deal is perhaps the most important reason why FDR is considered a hero, although he may have contributed little to its design and implementation[5]. What he surely did was to provide the charisma and self-confidence his country and the rest of the world needed as a psychological sidekick for the recovery program to be well perceived by all economic agents. In contrast, Trump's statements are far from being reassuring on a diplomatic basis.

Trump's economic program, opaque as it is, does make it clear that reflation is underway[6] thanks in part to expansionary fiscal policy that is expected to pay for large infrastructure programs[7].

Clearly, the contrast between the past two decades and a half and today's brave new world is the change in perception with respect to previous macroeconomic policies that relied heavily on inflation targeting aiming low, and that a new regime more prone to higher inflation (and thus higher economic growth) may be paradoxically associated with a right-wing populist with no political experience who often contradicts himself and gives plenty to talk about to the media.

Today's context is, of course, different. But let us focus on other similarities other than the ones just described, first for the U.S., then for the rest of the world.

The devaluation of the USD provides the basis for recovery of American exporters (and to countries whose currencies are tied to the USD). Inflation makes debt loads lighter, allowing firms and households to invest more than in times of deflation, public expenditure in infrastructure improves the quality of public goods, in all likelihood wages increase, firms' profit margins are restored, illegal substances are legalized in several states (alcohol back in the thirties, cannabis nowadays), and many other policy measures may happen that improve the lives

[5] His policy advisers should in any case take the credit.

[6] See http://www.cnbc.com/2017/01/05/2017-is-the-year-inflation-makes-a-comeback-and-donald-trump-could-play-a-role.html and https://www.blackrock.com/investing/insights/blackrock-investment-institute/global-macro-outlook.

[7] See "Rebuilding infrastructure may be profitable for the every rich" in the 01/13/2017 issue of the New York Times.

of average Americans. This in itself is good, but the danger is that this new prosperity risks being associated with a very dangerous political agenda.

As far as the rest of the world is concerned, all these positive trends may be shared in other economic blocks if major economies follow the same pattern. However, from an economic point of view, since their currencies compete with the dollar in the exchange market, and given that the dollar 'must' depreciate, inflation may increase less rapidly in other countries (i.e. in Europe) than in the U.S. so that things will also improve outside of the U.S., but perhaps less so than in the latter.

Unfortunately, however, all this expected prosperity may come at a price, and this price has to be paid. In contrast to Keynes' hypothesized 'euthanasia of the rentier' (which he only considered an undesirable second best) such price is likely to be paid by other economies in the form of tariffs, protectionism an other forms of financial and commercial hostility from the current U.S. administration.

Going back to monetary issues, it is often ignored that a currency's depreciation implies other currencies' over-valuation. But of course, if the dollar depreciates, other competing currencies will have to appreciate. The natural 'enemy' is the yuan. Allegedly, China has taken advantage of American exporters thanks to its cheap manufacturing labor force, and this has been done unilaterally by Chinese authorities, so the story goes. However, this argument misses the point of the co-dependence between the Chinese export surplus and the American addiction to Chinese debt[8] (which are simply two sides of the same coin).

Other diplomatic problems, not necessarily linked to the exchange rate, are likely to arise with other economies. For instance, the current trend ever since the Republican presidential campaign started makes it clear that Russia is heavily involved in U.S. politics, and this may suggest that business may be influenced as well by Russian interests (particularly so in the oil business).

Bottom line, 2017 may be perceived as 1933 in many respects. The economic plan, however, is quite different and the outcome may turn out to be more catastrophic, mainly on a diplomatic basis.

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[8]This has been highlighted by McKinnon and Schnabl, 2015