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Lead Left Interview – Mickey Levy (Part 2)

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This week we continue our conversation with Mickey D. Levy, chief economist for US and Asia, Berenberg Capital Markets. Mickey is a long-standing member of the Shadow Open Market Committee and conducts research on a wide range of global economic, financial and policy issues. ***Second of two parts* – *View part one***

TLL: The Fed seems poised to raise rates in December. Does the election change the pace of their hiking?

ML: Yes, I expect the Fed will raise rates 25 basis points in December. In 2017, the Fed can be expected to raise rates moderately faster than earlier anticipated if enactment of pro-growth fiscal policy generates stronger growth. Even before the election, Federal Reserve Vice Chairman Stanley Fischer spoke about the Fed's estimates of how fiscal stimulus –either tax cuts or spending increases–would raise real interest rates. Keep in mind the real Federal funds rate remains negative and the Fed's balance sheet is bloated with $4.5 trillion in assets even though the Fed has achieved its employment objective and inflation is close to the Fed's long-run inflation target. So monetary policy will remain accommodative even as the Fed raises rates. Also, if the economic growth picks up in response to a shift in fiscal policy, the Fed would also be on heightened alert for signs of higher inflation, which would elicit faster rate increases.

TLL: Last November you thought we were in the bottom of the 5th in terms of the economic cycle. Where are we today?

ML: I think we're in the 7th inning, but well-designed tax reform and deregulation could add new life into the economic expansion. I have been worried about the slow growth and particularly the disappointing growth in business investment despite the Fed's successful efforts to lower bond yields and the real costs of capital, and the associated weak productivity growth. Jump-starting business investment and easing up on some of the burdensome regulations on labor mobility are critical to lifting potential growth. And infrastructure improvement and expansion–if executed properly–could also add jobs and add to economic efficiencies.

TLL: Does the "Trump Rally" give the economy new life, or will it be short-lived?

ML: My hunch is that the market rally in response to the Trump victory and Republicans maintaining control of both the House and Senate is a good forecast of stronger growth. Let's be clear–there are many obstacles along the way. An obvious one is Trump's stance on international trade. Imposing onerous barriers to trade always exerts the most harm on the country that imposes the barriers. But I do anticipate that Trump's harsh campaign rhetoric on trade will be watered down and not become as imposing as the rhetoric. Further, I expect that the benefits of tax reform, thrust of deregulation and infrastructure spending will more than offset any negative impacts of either misguided trade initiatives or a stronger US dollar.

TLL: In our previous chat, you told us tax reform should be a bipartisan priority. Do you think we have a better chance of that now?

ML: It depends. If Trump proposes fiscal reforms that involve outsized increases in deficits, the fiscally conservative Republicans in Congress will push back, while Democrats will push back on reform measures that seem titled toward helping business or the wealthy. On the other hand, there will be many provisions in a Trump corporate tax reform–the reduced values of deductions, deferrals, exemptions and credits required to broaden the corporate tax base in order to lower the corporate tax rate–that will be favored by Democrats. And on personal income taxes, Democrats will support lower taxes on lower income households. Also, there are some important regulatory changes that could receive significant bi-partisan support, like legalizing imports of select pharmaceuticals from Canada and allowing interstate competition among health insurers. Both of these would ease the financial burdens of middle income workers and households.

TLL: Economists seem worried that some of Trump's policies – infrastructure spending, for example – will be inflationary and add significantly to the deficit. Is that a worry of yours?

ML: Yes, I worry about big increases in infrastructure spending that are not offset by savings elsewhere. Budget deficits have receded to 3% of GDP as a consequence of the 7 years of economic expansion, but projections of deficits and debt based on current law rise significantly into the future, largely due to two factors: more entitlement spending on Social Security and health care (Medicare and Medicaid). Regardless of the near-term inflationary impact, it is very important to hold the line on deficits but at the same time promote stronger potential growth. So while the current focus of the media and financial markets is primarily on who is chosen to Trump's transition team, I'm focusing just as much on how Congress may respond to the Trump Administration's proposals. Remember the path from campaign platforms and promises to legislation must go through Congress.

TLL: You've noted that it's difficult to predict what will happen to ACA reform. Any insights to share with regard to the healthcare industry?

ML: I absolutely do not expect Congress to approve repeal of the ACA without an adequate and detailed replacement. Instead I expect modifications to the ACA aimed at improving the efficiency of the provision of medical services. A few examples are to allow interstate competition of health insurers that would result in lower health insurance premiums and the legalization of importing select pharmaceuticals from Canada that would significantly lower costs of select drug costs. Over time I anticipate closer scrutiny of eligibility requirements for Medicaid, perhaps through providing the states more control over eligibility and benefit structures. Other modifications are very possible; but don't look for any repeal of the ACA.

TLL: Finally, Mickey, when we interview you again a year from now, what will be the biggest surprise we'll be talking about in that interview?

ML: Great question. My hunch is a year from now investors may be pleasantly surprised that some tax reform was enacted with a normal amount of political acrimony but also some bi-partisan agreement on key provisions, and that economic performance was improving. I expect that if this is anywhere close to correct, markets will be focusing on any signs of inflation pressures. Amid this environment, markets will be speculating on who will be nominated to replace Janet Yellen as Chair of the Federal Reserve, and how the thrust of monetary policy will be transformed. This will generate tons of uncertainty, but in my mind it will be a good kind of uncertainty.

Contact: Mickey Levy
Mickey.Levy@berenberg-us.com