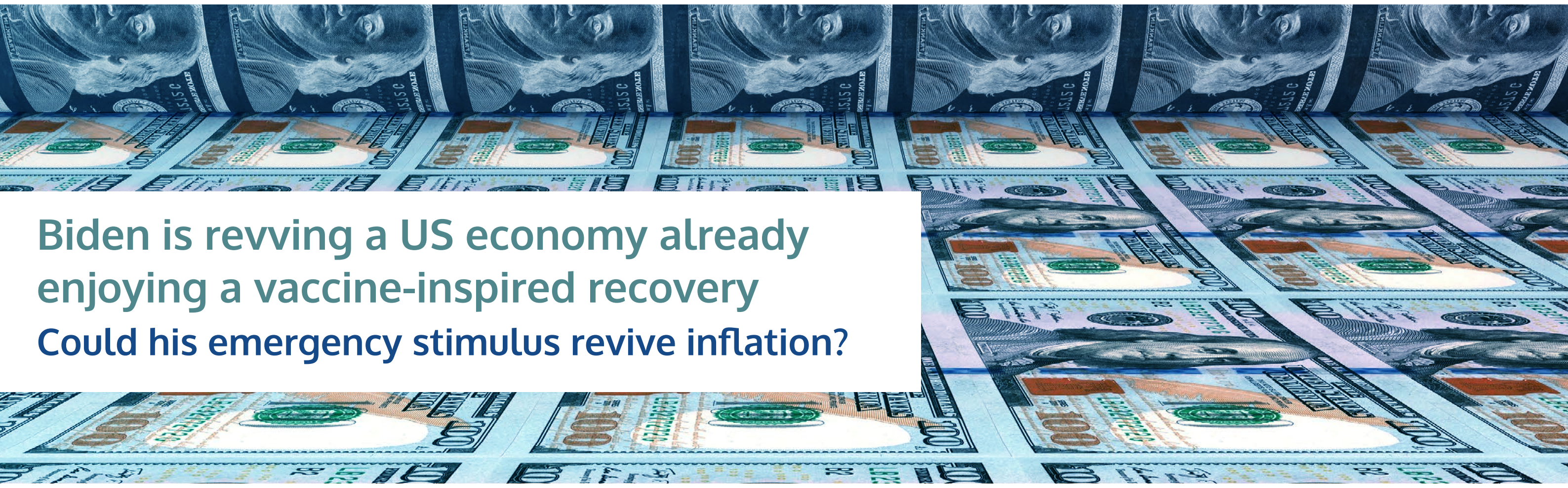

Biden is revving a US economy already enjoying a vaccine-inspired recovery

Could his emergency stimulus revive inflation?

Detroit's giant carmakers were among the US businesses tottering as the Great Recession took hold. About 2.6 million Americans lost their jobs over the four months from when the global financial crisis erupted in September 2008 until President Barack Obama assumed office at the start of 2009.[1] The modelling of Christina Romer, Obama's chair of the Council of Economic Advisers, showed the then-US$15 trillion economy needed stimulus of about US$1.8 trillion to close the 'output gap' within two years.[2]

But the Democrat-controlled Congress was infused with the era's conventional wariness of budget deficits and government debt. Obama sought fiscal stimulus of only US$775 billion, though he expected the usual bartering among lawmakers to bloat the package to US$1 trillion. Republican outcries about government squandering, however, swayed enough moderate Democrats, and the American Recovery and Reinvestment Act of February 2009 contained only US$725 billion in new money.[3] The jobless rate jumped from 8.3% that February to a then-post-war high of 10% eight months later as the number of unemployed swelled by another 3.5 million people.[4] No surprise, the Obama stimulus of 5% of GDP has gone down in Democrat folklore as a "measly" response that was partly to blame for the party losing Congress in 2010 elections.[5]

President Joe Biden appears determined not to repeat the errors made when he was vice president. Capitalising on the new Democrat control of Capitol Hill, Biden is implementing a record peacetime stimulus package worth 9% of GDP, even though the US economy is well past crisis-mode and the output gap – the difference between the economy's actual and potential performance – is narrowing. The recovering US$22 trillion economy is enjoying a vaccine-inspired reopening. The preceding split Congress passed four covid-19 fiscal packages worth more than US$4 trillion that are still energising spending.[6] The jobless rate has plunged from 14.8% in April last year to 6%. Housing prices are soaring at a 12% clip.[7] The Federal Reserve has pledged to maintain its ultra-loose unconventional monetary policy.

In an era when 'magic money' theories dismiss concerns about government debt, the American Rescue Plan entails US$1.9 trillion of fiscal stimulus that will boost the budget shortfall for fiscal 2021 to 18% of GDP. Washington's debt load will soar from the pre-stimulus forecast of 102% of output, most likely well past the record 107% of GDP it reached around the end of World War II.[8]

To its proponents, the "most robust relief package" [9] since the New Deal of the 1930s means that "Reaganomics is officially dead".[10] The inequality-fighting stimulus gives money to poorer households via child allowances and child-care subsidies, extends unemployment relief, adds funds to vaccination programs, helps schools reopen and plugs gaps in the finances of local and state governments that generally must run balanced budgets.[11] The mostly one-off spending is popular and presaged more durable outlays such as the infrastructure plan Biden announced on March 31 that, if passed by Congress as announced, would over the next eight years entail US$2 trillion of fresh spending partially funded by higher taxes on companies and the wealthy.[12] Other Democrats are calling for a US$2 trillion 'Green New Deal' and expanding free healthcare to those aged below 65.

As for the macroeconomics, the emergency relief prompted Fed officials to lift their US growth forecasts for 2021 from 4.2% to 6.5%, which would be the fastest pace since 1984's result of 7.2%.[13] Others have raised their US growth forecasts for this year to as much as 8%,[14] a speed last matched in 1951.[15] Unfazed by the faster growth, Fed officials offered the 'forward guidance' that the US cash rate would stay at near-zero in coming years. They have pledged to maintain their asset-purchase program, which assures a buyer for Washington's debt at suppressed rates.

To its critics, much of the stimulus is a superfluous 'sugar hit' because the economy's spare capacity is shrinking anyway. They worry that government debt is reaching troublesome levels. This first points to higher taxes and reduced benefits in coming years – thus the package boosts intergenerational inequality while hindering growth from 2022. The major concern is that the package is bound to lift consumer prices. Inflation, as the Fed concedes, is most likely to accelerate beyond the Fed's 2% target, though the central bank is unruffled by any spike in inflation above target. The critics worry that the expected rise in inflation beyond 2% proves more permanent. Biden's relief thus could backfire if it were to spark sooner- and larger-than-expected increases in official and market interest rates (and other tightenings of monetary policy). Biden's first big legislative victory shows the new president is prepared to take risks on fiscal policy that could shape the rest of his presidency.

To settle a quibble, Obama's stimulus should be better remembered because what was one of the largest post-war stimulus programs set up a record US expansion.[16] More urgently, the pandemic is far from over. Mutations that nullify the vaccine would upend the economy. Yet Biden's stimulus might make it much harder to conjure up more huge sums without political and financial ructions. As to the threat from higher prices, hasn't the neoliberal age of 'independent' central banking killed inflation? The Fed can always do a U-turn and crush inflationary pressures.

That, however, would thump the economy and upset capital markets. The most likely outcome is less threatening. In an era of low inflationary expectations and relatively weak labour bargaining power, there appears to be enough of an output gap to make it highly likely that the expected acceleration in inflation proves fleeting and Biden's bold approach will reinforce just how cautious Obama was 12 years ago.

URGENT THEN. NOW?

In 1987, former president Richard Nixon visited vice-president George H Bush, who would contest the 1988 presidential election. "You know you were right about 'voodoo economics'?" Nixon said to Bush, who during the Republican primary in 1984 had so dismissed the "economic madness" of the supply-side policies espoused by soon-to-be two-term president Ronald Reagan. This theory says that lower taxes spur growth so much it repairs budgets. As Reagan's tax cuts only extended the consecutive deficits the US had recorded since the 1960s, Nixon warned Bush: "You've got to handle the deficit. You know there is going to have to be a tax increase."[17]

Bush's core political problem as president from 1989 was that when accepting the Republican nomination he had pledged: "Read my lips. No new taxes."[18] So what budget disaster prompted Bush in 1990 to break such a key promise that – in his later assessment – politically "it did destroy me"?[19] Bush confronted a federal deficit at 3.7% of GDP and federal debt at 41% of output.[20]

The federal shortfall this year is more than four times that gap. The Congressional Budget Office before the latest stimulus forecast Washington's debt by 2051 to reach five times (202% of GDP) the level Bush confronted 41 years ago.[21] Biden is realistic enough to know that he must enact the biggest tax increases in decades because large public debt burdens are laced with trouble.

These pitfalls include the risk that at some point the US government might lose some of its creditworthiness, which means higher borrowing rates – Standard & Poor's refuses to reinstate its highest AAA rating the US lost during the debt-ceiling standoff in 2011.[22] A second problem is that high public borrowing can 'crowd out' private investment, thus reduce productivity, while higher debt-servicing payments can smother essential spending.

A third is that excess debt can undermine the willingness of foreigners to hold a currency. On top of uninterrupted US current-account deficits since 1981 (apart from a surplus of 0.05% of GDP in 1991)[23] and the country's net international position plunging to minus US$14 trillion,[24] Washington's deteriorating finances could tarnish the US dollar's lustre as the world's foremost reserve currency, a status that makes it cheaper for Washington to sell debt. A fourth problem is that high debt loads make it harder to resort to conventional fiscal stimulus when it's needed to avert a recession or combat emergencies. A fifth hazard is that high public debt heralds future tax increases that will crimp economic growth via reduced consumer spending or less business investment.

The 2017 tax cuts of President Donald Trump slashed the US corporate tax rate from 35% to 21%, the lowest since the 1930s and less than half its peak of 52.8% in the 1960s. Trump trimmed personal income tax rates but mostly only until 2025. The top rate was pruned from 39.6% to 37%, well below its record high of 94% in 1944 and below its level above 70% where it sat from the 1950s to the 1970s.

Biden's infrastructure plan is to be partly paid for by increasing the corporate tax rate to 28%, forcing multinationals to pay more on foreign earnings and targeting the wealthy. Amid all the talk that the rich will pay higher personal, wealth and inheritance taxes, Biden has constantly said he would spare those earning less than US$400,000 a year; such people won't pay "one single penny in additional federal taxes".[25] Biden will have to squeeze business and the wealthy if he doesn't want to break election promises on tax as did Bush senior.

TOO FEW FOR TOO FEW

Larry Summers was a treasury secretary in the administration of President Bill Clinton and was director of the National Economic Council during Obama's presidency. In 2013, Summers gave a speech that revived a term from the 1930s that encapsulated the slow pace of the Obama recovery.[26] Summers referred to "secular stagnation", a phrase coined by Harvard economist Alvin Hansen (1887-1975). Hansen was a passionate Keynesian who ,when advocating for governments to stimulate their economies (in an era when they didn't), was describing how an economy could get stuck with too many jobless.[27] Within days of Summers reviving Hansen's phrase, the term once again became identified with pleading for more fiscal stimulus.

It was thus notable when such an influential Keynesian economist with such sturdy Democrat credentials as Summers described Biden's stimulus as "the least responsible macroeconomic policy we've had in the last 40 years".[28] Summers said there was a one-third chance the stimulus would boost inflation but not growth, a one-third chance the Fed would act against inflation – a "dramatic fiscal-monetary collision"[29] – and only a one-third chance of the hoped-for outcome of faster growth and tame inflation. "There are roughly zero historical examples where we got inflation to the point where the Fed got nervous and had to tighten and the whole thing happened smoothly," he warns.[30]

Such pessimism about Biden's stimulus goes against the thinking these days that government deficits don't matter much. Many reputable economists have switched from advocating for austerity to supporting fiscal stimulus. Olivier Blanchard, former chief economist at the IMF, for example, says that the fiscal and social costs of fiscal stimulus are smaller than thought for countries where the 'safe' interest rate is less than the growth rate.[31] Japan's reliance on ultra-loose settings since the early 1990s without triggering inflation supports this thinking.

More radical pro-stimulus views are captured in the influential 'Modern Monetary Theory' (that is popular in Democrat circles). Its proponents argue that because a government can never

default in its own currency it can perpetually create money to pay for spending that exceeds its receipts and borrowings. Adherents say that having a central bank buy a government's bonds to balance the accounts means a government can always spend enough to ensure full employment. The theory says the main limits on fiscal spending are the availability of resources (labour and equipment) and inflation. But spending levels, tax rates and, say, competition policy can be altered to smother price rises.

Modern Monetary Theory is just another name for the ancient and risky practice of money printing.[32] Money printing's big handicap has always been that it fails to solve the basic economic problem; that limited resources must satisfy infinite wants. Giving the public newly created money does nothing to increase the resources available to quench unlimited demand. It thus risks igniting inflation and undermining a currency.

Fiscal stimulus is not money printing if a government is selling bonds to fund the deficit spending. But the Fed's bond-buying brings the US fiscal stimulus closer to money printing. Even if Washington's stimulus were fully funded by conventional means, it could still be inflationary because more money would be still chasing a finite supply of goods and services.

The inflationary consequences of an expansion in the US money supply of US$4 trillion over the past 12 months are more evident in the 15-year-high double-digit inflation[33] of the housing market than in the goods, services and labour markets.[34] But as the vaccine revives people's confidence to spend, Biden's stimulus could unleash enough pent-up demand to rekindle inflation as measured by consumer-price indices (that, in perhaps an anomaly, don't track housing).

Many analysts including Nobel laureate Paul Krugman, however, think people and businesses have such low inflation expectations they won't react to the temporary increases in some prices by seeking higher wages or by putting up the prices they charge for their goods and services – the steps that would presage a more durable and worrying acceleration in inflation.[35] Fed Chair Jay Powell too is relaxed about inflation staying under 2.5% on the Fed's key inflation barometer because he says that while the US economy is strengthening "the recovery is far from complete". [36]

Biden's decision to inject almost double the Obama stimulus into a US economy well beyond crisis is thus a bet the output gap is large enough to cope with any increased demand. The modelling on which Biden based his bold approach is highly likely to prove sound.

By Michael Collins, Investment Specialist

[1] US Bureau of Labor. Data. 'Top picks'. Series 'Unemployed Level - LNS13000000.' The number of officially unemployed rose from 9.5 million in September 2008 to 12.1 million in January 2009 compared with 7.7 million in January 2008. data.bls.gov/timeseries/LNS13000000

[2] Adam Tooze. 'Crashed'. Penguin Books. 2019. Pages 276 to 279.

[3] Tooze. Op. cit. The package had a headline figure of US$820 billion.

[4] US Bureau of Labor. Data. 'Top picks'. Series 'Unemployment Rate - LNS14000000'. data.bls.gov/cgi-bin/surveymost?ln

[5] Senate Majority Leader Chuck Schumer. 9 March 2021. CNN transcript. 'Anderson Cooper 360 Degrees.' transcripts.cnn.com/TRANSCRIPTS/2103/09/acd.01.html

[6] Under President Donald Trump, the Democrat-controlled House of Representatives and the Republican-controlled Senate passed the US$192 billion Families First Act, the US$2.2 trillion CARES Act, the US$733 billion Paycheck Protection Program Enhancement and the US$915 billion Response and Relief Act.

[7] Federal Housing Finance Agency. 'US House Price Index March 2021.' US house prices increased 12.0% in the 12 months to January 2021. fhfa.gov/AboutUs/Reports/Pages/US-House-Price-Index-March-2021.aspx. The Zillow Home Value Index rose 9.9% to US$272,446 in the 12 months to February. Zillow. 'US home values.' zillow.com/home-values/

[8] Congressional Budget Office. 'The 2021 long-term budget outlook.' 4 March 2021. As measured by federal debt in the hands of the public. cbo.gov/publication/56977. Pre the stimulus, the IMF forecast US gross general government debt to hit 134% of GDP this year. IMF. 'World Economic Outlook Database.' January 2021. imf.org/en/Publications/WEO/weo-database/2020/October. General government debt is a better international measure

[9] Senate Majority Leader Chuck Schumer. 'Help is on the way': Schumer says $1.9T stimulus deal is most crucial relief package since the New Deal.' Daily News. 7 March 2021. nydailynews.com/new-york/nyc-crime/ny-schumer-stimulus-package-new-deal-20210307-b4hnipfcdjekxcwcmgyznggju-story.html..

[10] Robert Reich, member of the cabinet of President Bill Clinton and Chancellor's Professor of Public Policy at the University of California, Berkeley. 'How Bidenomics can unite America.' 15 March 2021. newsweek.com/how-bidenomics-can-unite-america-opinion-1576188

[11] The White House. 'American Rescue Plan.' Undated. whitehouse.gov/american-rescue-plan/

[12] The White House. 'Fact sheet: The American Jobs Plan.' 31 March 2021. whitehouse.gov/briefing-room/statements-releases/2021/03/31/fact-sheet-the-american-jobs-plan/

[13] Federal Reserve. Media release. 'Federal Reserve Board and Federal Open Market Committee release economic projections from the March 16-17 FOMC meeting.' 17 March 2021. federalreserve.gov/newsevents/pressreleases/monetary20210317b.htm

[14] Goldman Sachs is one company forecasting the US economy to expand 8% in 2021.

[15] Federal Reserve of St Louis. 'Economic research.' Table 1.1.1 'Percent change from preceding period in real gross domestic product. Annual'. Found under 'Real gross domestic product (A191RL1A225NBEA)'. fred.stlouisfed.org/series/A191RL1A225NBEA

[16] The expansion over 128 months from June 2009 to February 2020 beat the previous record of 120 months set from March 1991 to March 2001. National Bureau of Economic Research. 'US business cycle expansions and contractions.' nber.org/research/data/us-business-cycle-expansions-and-contractions

[17] Jon Meacham. 'Destiny and Power.' The American odyssey of George Herbert Walker Bush. ' 2016 Random House Trade Paperback Edition. Chapter 31. If it weren't for the deficit …'. Pages 360 to 362. The "economic madness" quote came from page 235.

[18] Meacham. Op. cit. Page 339.

[19] Meacham. Op. cit. Pages 413.

[20] Congressional Budget Office. 'Historical budget data.' cbo.gov/sites/default/files/cbo-files/attachments/45010-breakout-AppendixH.pdf

[21] Congressional Budget Office. Op. cit.

[22] Other countries face the risk of default. This is not so much a risk for the US unless there are more of these impasses.

[23] IMF. World Economic Outlook Database. October 2020. 'Current-account balance, percent of GDP.' www.imf.org/en/Publications/WEO/weo-database/2020/October

[24] Bureau of Economic Analysis Department of Commerce. Media release. 'US international investment position, third quarter 2020.' 29 December 2020. bea.gov/news/2020/us-international-investment-position-third-quarter-2020

[25] Bloomberg News. 'Biden determined to tax the rich after windfalls from covid crisis.' 22 March 2021. bloomberg.com/news/articles/2021-03-22/biden-determined-to-tax-rich-after-windfalls-from-covid-crisis. In perhaps what was a slip, the White House has talked of the US$400,000 being a threshold for families, not individuals – a theoretical halving that would capture the middle class. The White House. 'Press briefing by press secretary Jen Psaki and Secretary of Housing and Urban Development Marcia L Fudge, March 18, 2021.' whitehouse.gov/briefing-room/press-briefings/2021/03/18/press-briefing-by-press-secretary-jen-psaki-and-secretary-of-housing-and-urban-development-marcia-l-fudge-march-18-2021/

[26] Larry Summers, Professor at Harvard University, speaking during the session "Economic forum: Policy responses to Crises" at the IMF's 14th Jacques Polak Annual Research Conference, Washington, US on 8 November 2013. http://www.youtube.com/watch?v=KY-pVzBbQIX0

[27] The New York Times. Obituary. "Alvin Hansen, Keynesian, dead at 87." 7 June 1975. select.nytimes.com/gst/abstract.html. Wikipedia. "Alvin Hansen. en.wikipedia.org/wiki/Alvin_Hansen

[28] Bloomberg News. 'Summers sees 'least responsible' fiscal policy in 40 years.' 20 March 2021. bloomberg.com/news/articles/2021-03-20/summers-says-u-s-facing-worst-macro-economic-policy-in-40-years

[29] Bloomberg News. 'Summers sees 'least responsible' fiscal policy in 40 years.' Op. cit.

[30] The New Yorker. 'Larry Summers versus the stimulus.' 21 March 2021. newyorker.com/news/annals-of-populism/larry-summers-versus-the-stimulus

[31] Olivier Blanchard. 'Public debt and low interest rates.' Working paper 19-4. February 2019. piie.com/publications/working-papers/public-debt-and-low-interest-rates. He responds to criticism of the paper here: 'Why critics of a more relaxed attitude on public debt are wrong.' 15 July 2019. piie.com/blogs/realtime-economic-issues-watch/why-critics-more-relaxed-attitude-public-debt-are-wrong

[32] When money was in the form of coins, creating money from nothing took the form of reducing the amount of pure metal in coins. Under the gold standard, where the value of money was based on a fixed amount of gold, money printing was creating banknotes that weren't backed by gold.

[33] The S&P CoreLogic Case-Shiller National Home Price Index rose at 11.2% in the 12 months to January, the highest annual pace since the 12 months to February 2006. 'S&P CoreLogic Case-Shiller Index reports 11.2% annual home price gain to start 2021.' 30 March 2021. spglobal.com/spdji/en/documents/indexnews/announcements/20210330-1347565/1347565_cshomeprice-release-0330.pdf

[34] Federal Reserve of St Louis. 'Economic research. 'M3 for the US.' Updated 16 March 2021. fred.stlouisfed.org/series/MABMM301USM189S

[35] Paul Krugman. 'How not to panic about inflation.' The New York Times. 22 March 2021. nytimes.com/2021/03/22/opinion/us-inflation-stimulus.html

[36] Federal Reserve. 'Testimony by Chair Powell on the Coronavirus Aid, Relief and Security Act.' 23 March 2021. federalreserve.gov/newsevents/testimony/powell20210323a.htm. Fed officials have increased their favoured measure of inflation (PCE) from 1.8% to 2.4% for this year.

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