Keynes on steroids: Biden’s stimulus rekindles macroeconomics

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/ VIEWS & OPINION

In his first 100 days in office, President Joe Biden has created large waves in economic policy with his proposals for $ 6 trillion (or six lac crore) worth of stimulus and investment packages.

In March, he proposed the $ 2.2 trillion American Jobs Plan to build and rebuild American infrastructure and provide better care for the elderly and children. In April, he followed with the American Families Plan of $ 1.8 trillion to provide public funds for universal pre-school, community college education, and tax cuts for lower-income households. These two much-needed proposals are the most significant American government investment programmes since President Eisenhower built the American interstate system in the 1950s or when President Johnson introduced Medicaid and Medicare programmes in the 1960s. However, these two packages are still only proposals for expenditures over the next eight to 10 years. They also claim to be fiscally neutral by being financed through higher corporate, capital gains, and income tax on the rich. Most importantly, these proposals have still to be approved by Congress.

However, Congress has already approved Biden’s first unprecedentedly large and deficit-financed stimulus, the American Rescue Plan, which he signed on March 11. Under this plan, $ 1.9 trillion will be spent in two years, fiscal 2021 (Oct 1-Sept 30) and 2022. Now add the previous $928 billion package approved in December 2020 and, then again, add regular U.S. government expenditures. Altogether this will bring U.S. government expenditures in fiscal 2021, Biden’s first year, to about $7.4 trillion, compared to the last regular budget of $ 4.4 trillion in 2019.

The 2021 expenditure of U.S. $7.4 trillion means U.S. Federal Government plans to spend more money in 2021 than the annual income or GDP of all the countries in the world except China. It will also mean that the U.S. government will spend more money in 2021 than during the four years of World War II measured by today’s dollars. That is, indeed, putting Keynes on steroids.

The American Rescue Plan can be transformative. After decades of tax cuts under Reagan, Bush, and Trump that unabashedly favoured the rich and sharply increased inequality, Biden’s package helps the poor and the middle class. First, there is direct relief for households. Each household member earning $75,000 annually or less or working couples earning $150,000 or less will receive $1400. So will their children. In sum, such a household of four persons – if the children are less than 18 years old – will receive close to six thousand dollars – close to median American household income.

Second, the Plan expects to cut child poverty rate by half– by cutting taxes or paying subsidies to lower-income households with children. Again, for a lower-income family of four, this measure can add anywhere between $2000 to $5600 in additional income. Third, the plan supports healthcare for the poor. More than one hundred billion dollars are provided as subsidies to expand health insurance coverage under Obama care. Fourth, it offers additional support for the 5.6 per cent of the labour force or nearly 10 million unemployed. Altogether, a family of four with one working and one unemployed parent will receive $12,460 in bene?ts – close to 20 per cent of the median household family’s income.

America’s aggressive stimulus packages and an effective vaccination campaign are also leading to a robust economic recovery. Current projections suggest that U.S. growth in 2021 will be anywhere from 5 per cent to 7 per cent – perhaps the second-highest U.S. growth rate ever recorded.

Not surprisingly, the American Rescue Act is widely popular. According to surveys, about three-fourths of Americans, including 60 per cent of Republicans, support it. Even Republican members of Congress who voted against it have pretended to take credit for the package.

However, the American Rescue Plan and the budget for 2021 are also high wire macroeconomics. The fiscal deficit for F.Y. 2021, likely to be over 15 per cent of national income, will be the highest peace time deficit in U.S. history after the World War-II years. In the 60 years since World War-II ended – i.e., until the global financial crisis (GFC) of 2008 — annual deficits in the U.S. were only 1.6 per cent of GDP. When the 2008 GFC came, the U.S. budget deficits increased to just over 8 per cent in Obama’s first term as part of the policy to revive the economy. During the second term, deficits declined to about 3 per cent. Another way to appreciate the massive size of American deficits is to compare it with the 4 per cent deficit in Germany and only 2 per cent in the U.K.

The vast size of the stimulus and fiscal deficits clearly create risks. Unsurprisingly, these have rekindled a vigorous debate about the U.S. macroeconomic policy among economists. Republican policies of unilateral tax cuts, mainly of the rich, rarely caused much discussion because mainstream economists were almost all united against them.

But it is different this time. The chief critiques of the American Rescue Plan have come from left leaning centrist economists including the former Secretary of the Treasury Larry Summers. Former MIT professor and IMF Chief Economist Olivier Blanchard, NYU Professor Roubini, Wall Street whiz kid, and now also President of a Cambridge University college, Mohammad El-Erian, and the formidable economic commentator Martin Wolf have joined Summers in expressing concerns.

What worries these formidable economists? They have all expressed concerns that the inordinately large American Rescue Plan and its deficit financing risks significant macroeconomic instability. The stimulus packages of fiscal 2021 add up to about 10 per cent of GDP. However, the U.S. economy is already in a strong recovery – recording more than 6 per cent annual growth in the first three months. At present, the estimate is that the economy only 2 to 4 per cent below "potential output" — the maximum output that the economy can provide in the next two to three years. So even if households and businesses spend only half of the 10 per cent of stimulus, there will be significant excess demand with all its attendant risks.

That is not all. There is also a sizeable monetary overhang. In 2020 alone, the Fed presided over a money supply growth of 26 per cent– from \$15 to \$19 trillion. While this contributed to a bubble in the stock market, a considerable portion has been saved resulting in an excess savings of \$ 2 trillion in banks.

The Summers's camp worry is that when the economy starts growing, and households start spending their savings, demand will soon outrun supply by a large margin. That will trigger high inflation rates and interest rate increases that can create dangerous dynamics on the nearly 72 trillion dollars of debt owed by the public and the private sector in the United States. Even a one or two percentage points increase in interest can create distress for firms and governments. Add to this the likely pressure to depreciate the US dollar, leading to additional inflation and reducing the enormously helpful foreign financing of several hundred billion dollars that the US receives each year. Finally, there is the nightmare scenario of supply shocks such as another pandemic, or a persistent shortage of computer chips, or a significant disruption of global trade. That raises the spectre of a full-blown return to the stagflation of the 1970s.

So why is not the Biden team concerned? First, it is worth mentioning that it is a formidable team. Biden's Treasury Secretary Janet Yellen's credentials as the previous highly respected Chair of the Fed, make her the most qualified person to ever hold that post. She was earlier a Professor at the University of California, Berkeley, one of the top Economics departments in the country. And having come to macroeconomics after first being a labour economist, her concern about working people probably has deep roots. Her modest demeanour makes her highly credible. The current Chairman of the Fed, though independent, and the competent Council of Economic Advisors are other members of this team.

Their response is the following. First, the main concern is to revive the economy quickly towards full employment; even if excess demand led to overheating, their target is full employment and higher wages. Backed by some research, their view is that without stimulus, recovery will be slow. More than 10 million unemployed and discouraged workers will continue to live hand-to-mouth until 2025. The concern comes from the experience of the Obama administration when unemployment and low wages persisted for several years because the Republican ruled Congress would not agree to fiscal stimulus.

Second, their experience in the past few years is one where several years of monetary stimulus have not increased inflation over the target 2 per cent. The main reason is that firms and consumers have chosen to hold cash and savings and buy stocks to create a bubble, instead of increasing consumption and investment. It is only in the two to three years before the pandemic that demand for goods and services reduced unemployment rates to about 3.5 per cent and increased wages.

Third, they monitor the dangers of excess demand and inflation and feel confident that they have the tools to deal with inflation dangers, should they appear. The Federal Reserve can lower money supply growth and raise interest rates, while the Treasury can slow the spending of stimulus packages.

How should one conclude? The risks of excessive demand and inflation are real. Biden's competent economic team is aware of them. And, as they say, they have the means to make midcourse corrections. There are also right in thinking that the more significant risk is not stimulating the economy fast enough and letting it sink into the morass of slow growth and persisting unemployment.

There are two other factors. The first is expectations. It is helpful for firms and investors to know that the government has enough fiscal ammunition in the large stimulus packages to keep demand high. That makes them more optimistic about the future. Optimism and confidence about the future, “animal spirits,” as Keynes famously put, is one of the most critical, often self-fulfilling, factors in producing a vibrant economy. The second factor is the mid-term elections – that traditionally votes against the sitting President's party – are only 18 months away. The hope is that the stimulus will create a robustly recovering economy that with low unemployment and higher wages can break that electoral tradition and lead the Democratic party to victory in the mid-terms. If not, the United States will likely return to the chaos and decline of the last four years.

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