# Will fiscal stimulus overheat the US economy?

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Panel
*US and EU fiscal policies: On different wavelengths*

SAFE Policy Center, Frankfurt

April 22, 2021

# Will the US economy overheat?

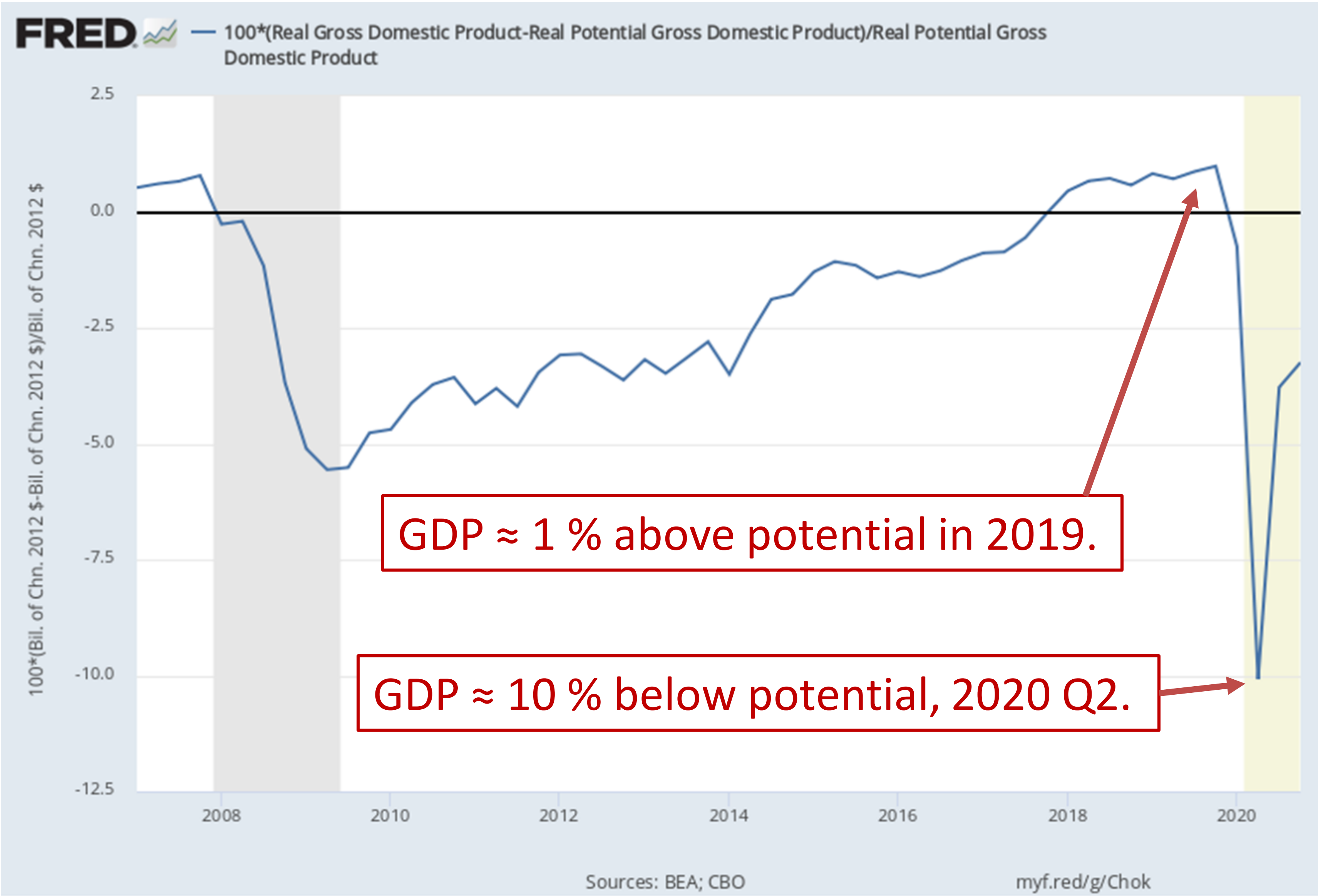
- Reasons to think so:
  - Biden's $1.9 trillion relief package (American Rescue Plan)
  - + infrastructure bill, $2.3 tr., 10 years (American Jobs Plan);
  - coming on top of big transfers in 2020,
  - + pent-up demand ($ 1½ - 2 trillion extra savings),
  - + aggressive Fed stimulus.

- My bottom line:
  - – US overheating is very likely, if defined as GDP **>** potential.
  - – Less likely, if it is defined as inflation above what the Fed wants.

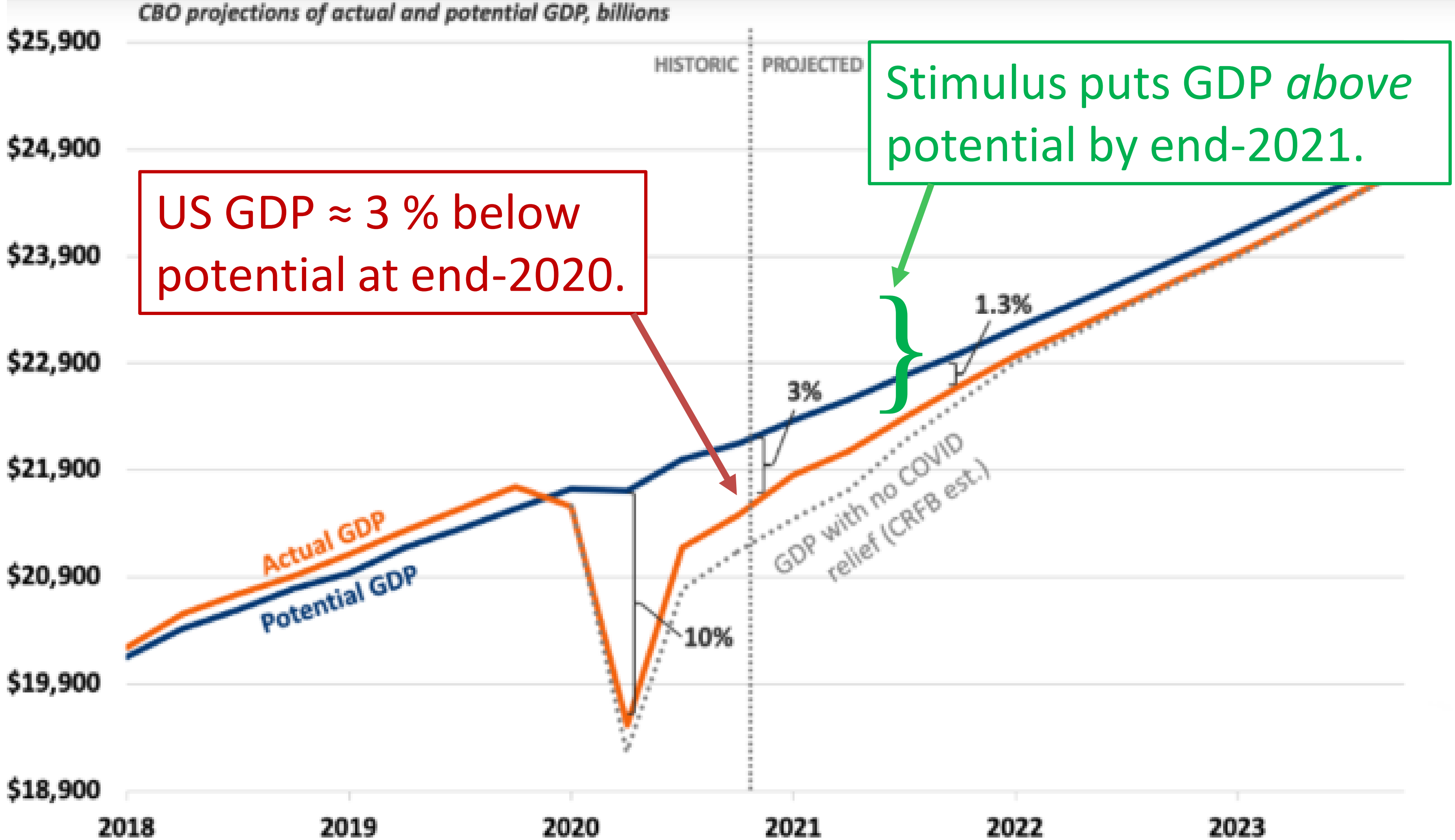
# The basic multiplier logic is simple

- as laid out by Summers in his *W. Post* column, Feb. 4.
- The Keynesian multiplier normally is high when interest rates & inflation remain low.
- Call the multiplier 1.0,
  - since some of the transfers will again be saved
  - & long-term interest rates may rise.
    - 10-yr rate has already risen since January, to 1.6%.
- 1.0 x $1.9 trillion = $1.9 trillion = 9 % of GDP.
- GDP at end-2020 ≈ 3 % below estimated potential.
- => 9% boost would put GDP 6 % *above* est. potential.
- Even a 0.5 multiplier would put us 1 % above potential.

# CBO-estimated output gap



# A Shrinking Output Gap




Committee for a Responsible Federal Budget, Feb. 2, 2021

CRFB.org

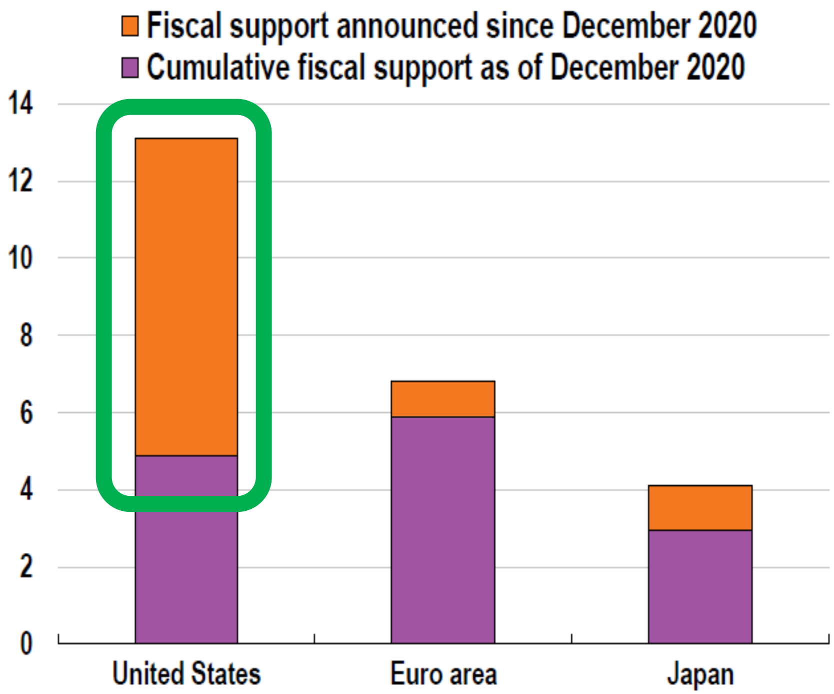
Source: Congressional Budget Office, CRFB Calculations.

# Planned 2021 stimulus in US >> in Eurozone or Japan.

## Differences in fiscal policy and health management are affecting output

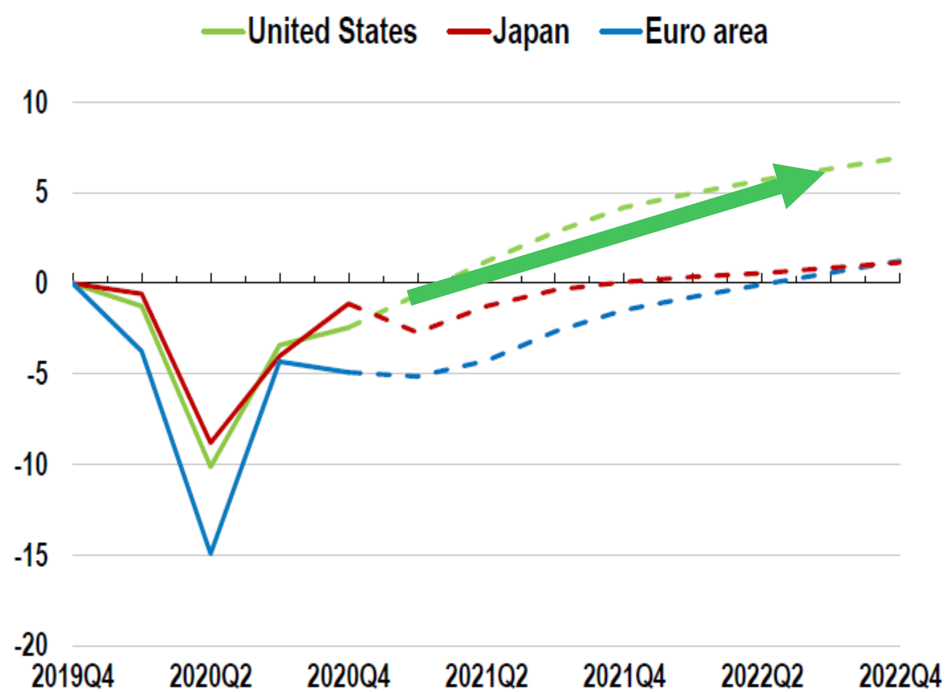
### The amount of fiscal support varies between countries

*% points of GDP*




### Output is diverging

*% difference in real GDP from pre-pandemic levels, dashed lines represent forecasts*




Note: LHS: Calculations are based on December 2020 projections. Cumulative fiscal support is measured as the cumulative change in net government lending as share of GDP between 2019 and 2021. Fiscal support announced since December is measured as share of 2020 GDP OECD Economic Outlook. RHS: % difference in real GDP since the fourth quarter of 2019.
Source: OECD Economic Outlook database; national sources, and OECD calculations.



OECD, March 9, 2021

# Major counterargument:
# We may be underestimating potential GDP.

- <= inflation did not rise much in 2018-19,
  - when GDP was 1% above potential
    - & unemployment fell as low as 3 ½ %.

- But a better explanation is a flat Phillips curve.

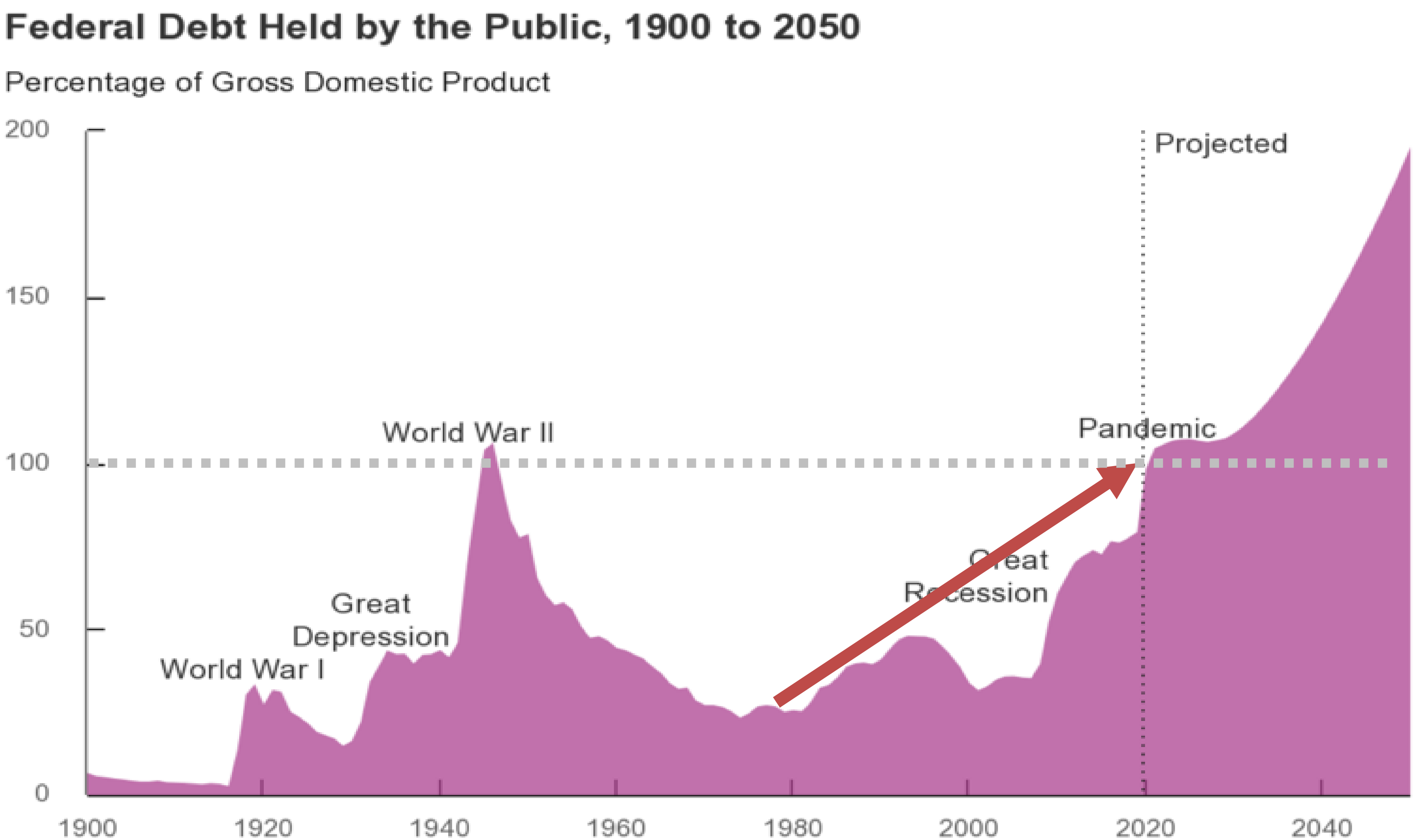
- After all, inflation also didn't *fall* very much 2010-14,
  - even though output was still below potential,
    - & unemployment was declining only slowly from its 10 % peak.

- Hence my conclusion that, though 2022 GDP will rise above potential, it is less likely that inflation will rise above what the Fed wants.

# *Other* possible downsides to so big an expansion, aside from inflation.

- Net national debt/GDP > 100%,
  - highest since 1945.
  - Unsustainable path, if interest rates rise.
  - But less of an issue for US than other countries
    - especially EMDEs.
- If the Fed succeeds in keeping interest rates low, it may prolong asset market bubbles.
- The trade deficit will rise,
  - which could exacerbate protectionism...
- Much depends on *how* the money is spent.
  - Mostly, it looks to be well-spent.

# US debt/GDP was set to exceed 100% in 2021, even before the Biden stimulus.




CBO, Sept. 2020

# The "mistake of 2009"

- Obama's $0.8 trillion stimulus was too little
  - & too short-lived.
  - It did help end the GFC recession in 2009 Q2;
  - but the recovery was too slow.
  - En
- I'm not sure it was *Obama*'s mistake:
  - It was the most he could get through Congress,
    - given Republican opposition.
- Regardless, Biden is now making sure that the US doesn't repeat the mistake.

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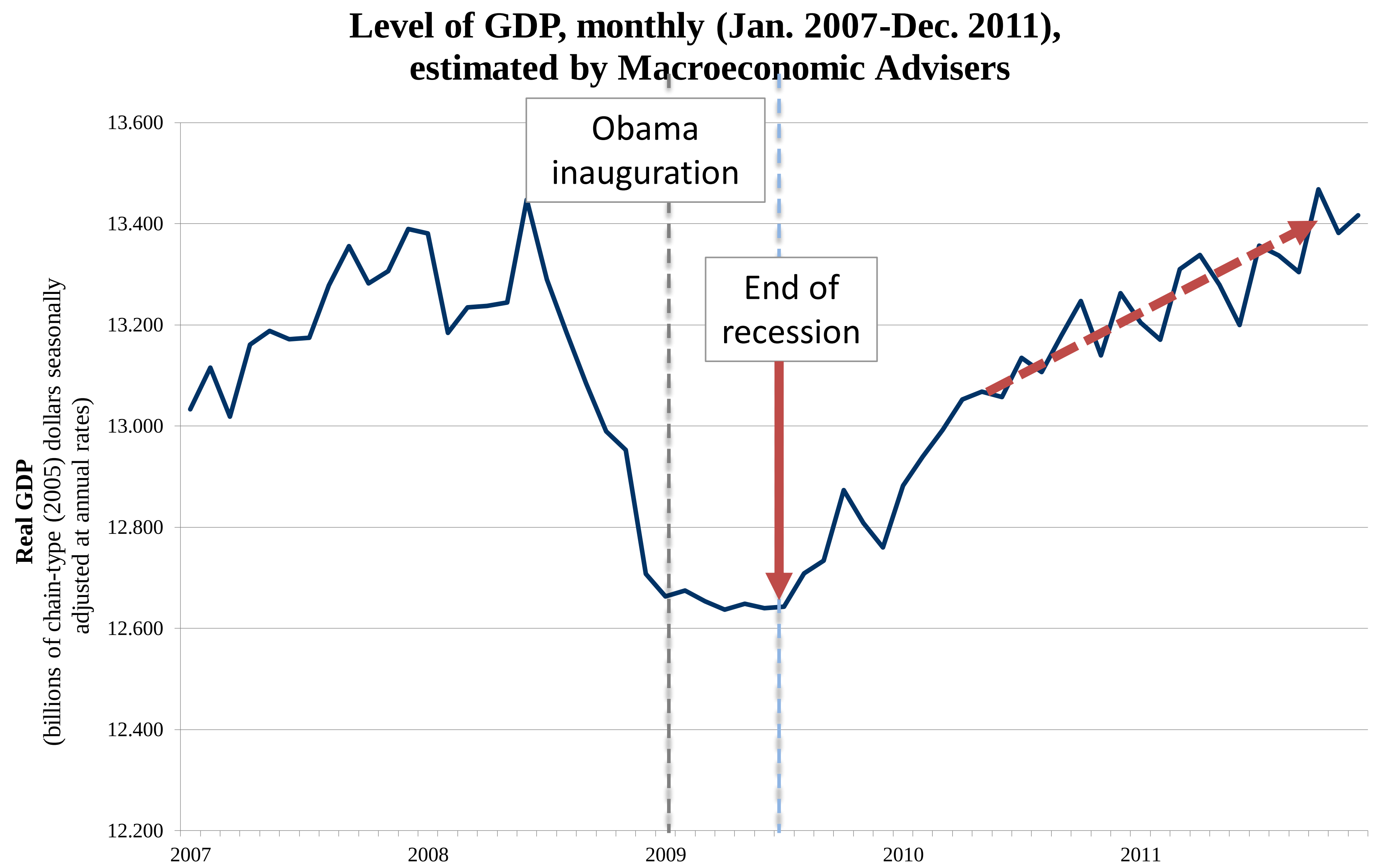
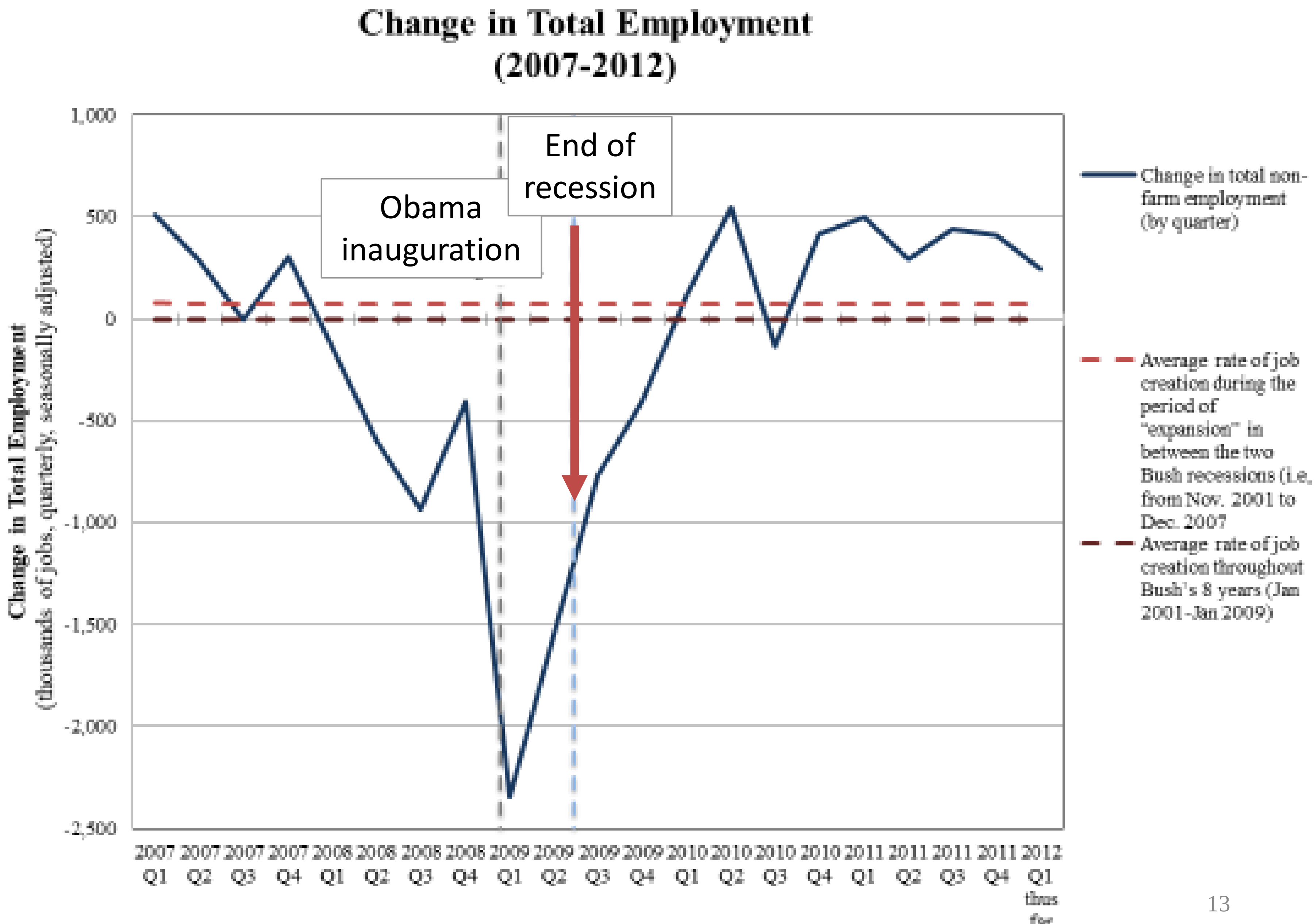
# Appendix: Obama stimulus helped end recession in 2019.

## But subsequent recovery was slow.

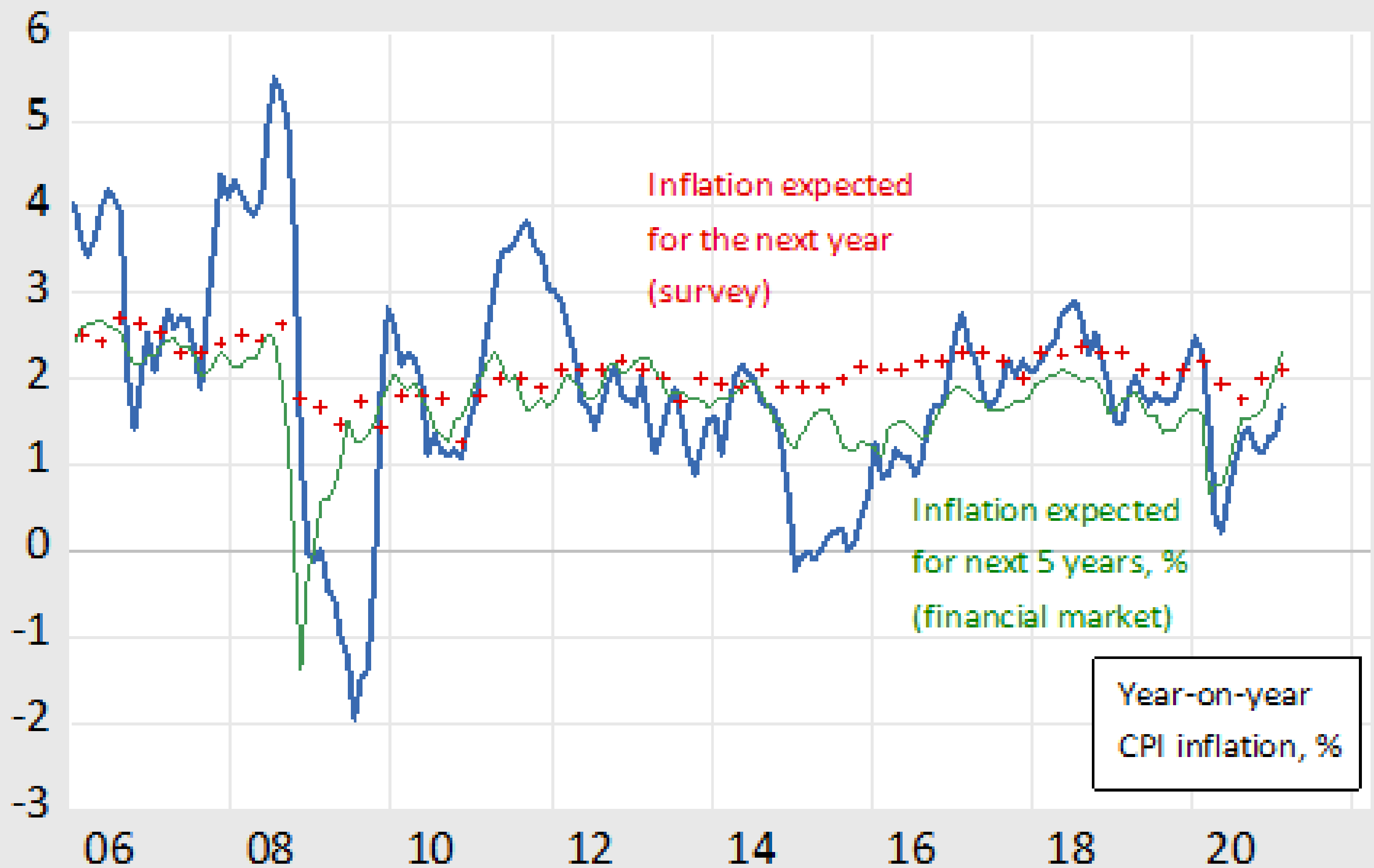



Source: Macroeconomic Advisers www.macroadvisers.com




Data Source: U.S. Bureau of Labor Statistics

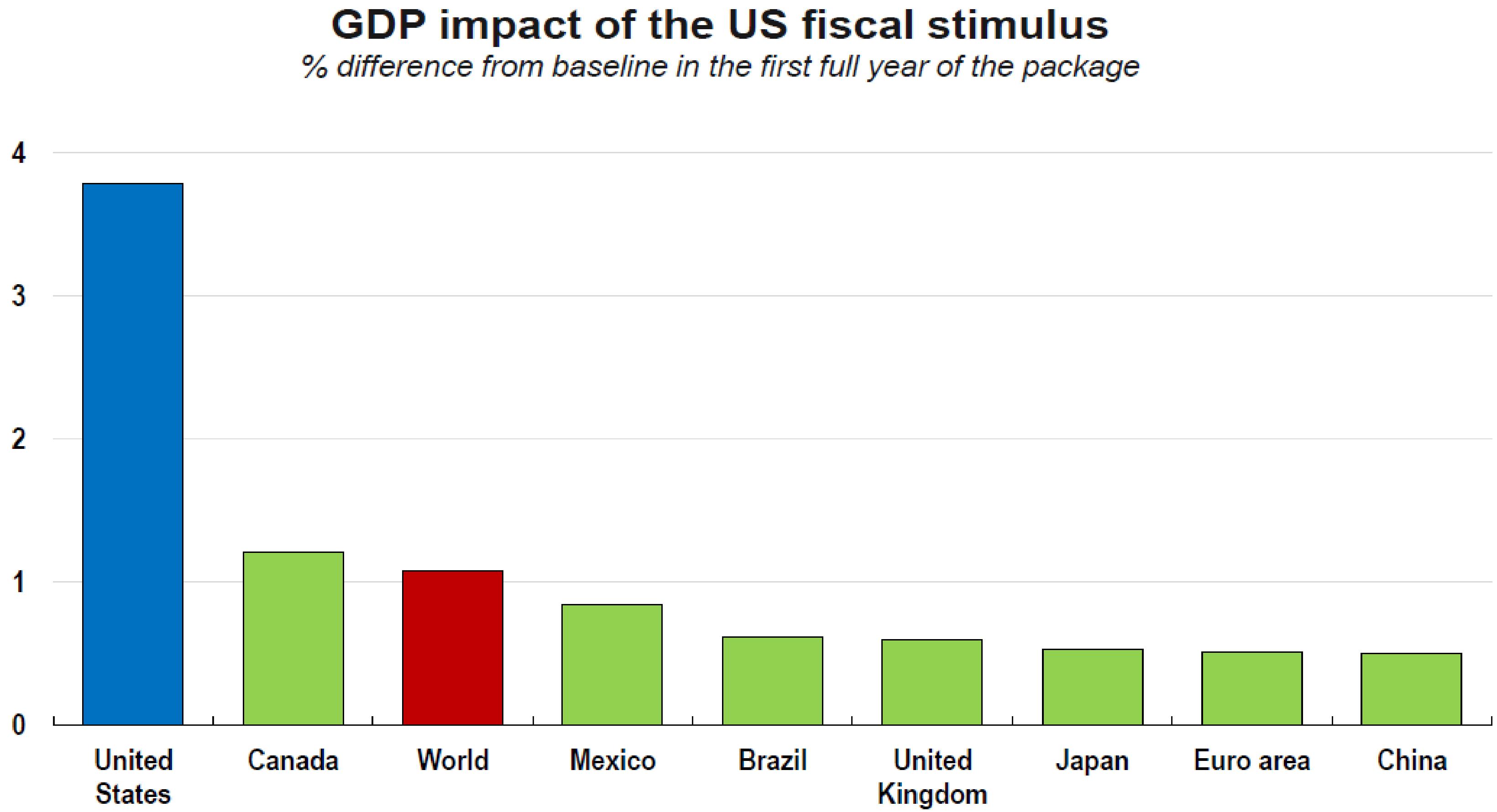
# Well-anchored expectations keep inflation stable.




Source: Menzie Chinn, March 2021

# Effect on other countries, 2021 Q2 – 2022 Q1

## US fiscal stimulus will boost the world economy




Laurence Boone, OECD, March 9, 2021.

Note: The chart shows the average percentage difference in GDP relative to baseline over the first full year of the package (2021Q2-2022Q1). Simulation of the planned fiscal stimulus in the United States, set out in the American Rescue Plan. The new measures are worth up to USD 1.9 trillion (around 8 ½ per cent of baseline GDP). Measures are assumed to take effect over 2021Q2-2022Q2. Policy interest rates remain unchanged in the United States and other advanced economies until mid-2022, but are endogenous in the emerging-market economies. The GDP impact shown assumes that consumers are relatively sensitive to current income developments and thus immediately benefit from the stimulus package.
Source: OECD calculations using the NiGEM macroeconomic model.