US Stimulus: Setting a new agenda?*

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With President Joe Biden having put through Congress and signed a $1.9 trillion American Rescue Plan, the world is set to experience one of the biggest fiscal boosts of recent times, larger than that resorted to in response to the 2008 Global Financial Crisis. Together with the $900 billion short term stimulus announced by the earlier administration end-December 2020, the level of pandemic induced Federal spending in the US is estimated at 13 per cent of GDP this year. Coming after the $2 trillion of fiscal spending last year, under the CARES Act, this is indeed a gigantic vote for big government in response to the pandemic.

The money would immediately unleash spending, with the key components of the package being a sum of $1,400 being paid to each individual earning up to $75,000 per year, continued payment of federal jobless benefits of $300 a week till early September, increased tax credits for children, and money to accelerate vaccination, reopen schools (with ventilation and sanitation) and provide financial assistance to state and local governments. Besides supporting the unemployed and the middle class, the bill is likely to prove a boon for businesses, especially in the service sector, that expects to see activity resume as the vaccination drive covers a rising proportion of the adult population.

The decision to persist with the stimulus, which is likely to take the fiscal deficit close to the record levels touched during World War II, marks a move away from the fiscal conservatism and dependence on monetary policy instruments characteristic of the neoliberal era that began with Reagan. Spending, especially deficit spending, was frowned upon, and easy money policies and low interest rates favoured. But given macroeconomic circumstances the stance that combined fiscal conservatism and monetary easing was paradoxical. For a host of reasons, not least because of the internationalisation of production and relocation of capacities to low wage countries, inflation was consistently low. Simultaneously, globalisation and fiscal conservatism slowed global growth. Exploiting the low inflation environment to pump-prime the system with government spending would have seemed a go-to policy option. Instead, the danger of a 1970s-style inflation was constantly raised to keep fiscal doves at bay and promote monetary policy instruments as the better option.

In the event, with the economy awash with ample and cheap liquidity, capital found its way to asset markets, triggering an equity and real estate price boom. The speculation this encouraged triggered periodic crises, which culminated in the global financial crisis of 2008 and the Great Recession that followed. But even on that occasion, after a limited resort to a fiscal stimulus to stop the economy’s slide into a recession that was the worst since the Great Depression, governments retreated and called on central banks to take on the task of reviving economies. What followed was a cheap money era with low and even negative interest rates. This did not do enough to ensure a robust recovery, but it did help save the banks and revive asset markets, especially equity and bond markets. The performance of financial markets and the real economy diverged significantly, and inequality increased.

Given this long-term policy stance and accompanying macroeconomic scenario that lasted through the 2009 crisis, the current decision to hugely ramp up government spending does mark a departure. It not only signals a return to proactive government intervention, but also leans in favour of a reduction in inequality, given the cash transfers and unemployment benefits included in the package. To the extent that this is financed with government borrowing, it could push up bond yields and divert funds away from the stock market that has shown signs of losing the sheen it has managed to retain for many years after the 2008 financial crisis. That marks a turn in policy away from one boosting financial markets to one aiming to lift the real economy, even if indirectly, by supporting consumption spending by the unemployed and the middle class.

Strangely, even some who favoured more fiscal push at the time of the 2008 crisis are calling for caution in the current context. In fact, middle of the road economists and commentators like former Treasury Secretary Lawrence Summers and Financial Times chief economic commentator Martin Wolf have expressed concern about the size of the package, for a number of reasons. To start with, the current crisis is being seen as primarily the result of the social distancing and lockdowns that were precipitated by the pandemic. With those bottlenecks gradually getting cleared, and likely to be dismantled as the vaccination drive achieves extensive coverage, the economy is expected to bounce back. Even now the output shortfall relative to potential is seen as having reduced considerably. That is unlike the case during the 2008 crisis when the burden of household and corporate debt delayed the revival of demand even after the worst of the financial crisis was over. So, the case for a prolonged and large stimulus is not strong, it is argued. Moreover, there is some perception of a maximum to which state spending can be pushed underlying the argument, without reference to options for additional resource mobilisation. Thus, Summers refers to a trade-off between the current stimulus and the much-needed "public investment in everything from infrastructure to preschool education to renewable energy". This is an assertion not backed up with any discussion of why other means to finance this required expenditure cannot be found.

But the real case of those questioning a large stimulus is the fear that the spending can spur inflation. Given long years of low inflation, a spell of buoyancy in prices is not necessarily something to be overly fearful of. But the concern seems to be that in response to inflation the Federal Reserve may be forced to raise interest rates and adopt a tighter monetary policy that can change the game in financial markets long used to the availability of abundant and cheap liquidity. In fact, bond markets are already signalling a likely rise in yields, triggering an exit of investors from equity. Thus, fear of disruption in financial markets in case the large stimulus does push up prices seems to be the factor underlying concerns about the size of the stimulus. The power of finance to dictate policies that favour it still holds. As of now, however, that power has not been able to stymie the new administration's fiscal push. One reason is the popularity of the decision to opt for the stimulus. Seventy per cent of adults covered in a poll by the Pew Research Centre favoured the Biden bill, with just 28 per cent saying they are opposed to it. And even though no Republican senator supported the bill, many welcomed it in private because Republican voters were in favour.

The likely benefits of a large stimulus are not just higher growth, lower unemployment and improved income distribution in the US. It is bound to have global ramifications as well. Evidence collated by Mathew Klein in Barron's, shows that as a result of the 2020 stimulus disposable personal income in the US rose by 7 per cent in 2020 relative to 2019, ramping up consumer spending on durable goods from passenger cars to furniture by 6 per cent. Since demand in America is in substantial measure met with imports, a part of the benefit of that increase in consumer spending flowed through to foreign locations, including to China which many expected would be adversely affected by Trump's tariffs on imports from that country.

Since America's generous spending hike was not matched by Europe and Japan among other potential markets for US exports, imports into the US rose faster than exports from that country, widening it trade deficit to 5 per cent of GDP in 2020. The American Rescue Plan Act would only prolong this tendency, contributing to growth elsewhere in the world. While growth in the US is expected to accelerate by close to 4 percentage points, the Organisation for Economic Cooperation and Development estimates that the Rescue Plan will push up global growth by one percentage point. That additional growth will be driven by a further increase in the US trade deficit by one per cent of GDP.

The large number of globally distributed beneficiaries of the US decision to depart, even temporarily, from the fiscal conservatism makes a strong case for it. That must be seen as a positive fallout of the chosen US response to the Covid pandemic. The international community must build on that experience with plans for a resilient, green and just recovery.

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