## US FISCAL STIMULUS: DOING NOT ENOUGH IS THE GREATER RISK

**The dire state of the labour market requires a major support effort for the economy. This view is shared by Fed Chairman Jerome Powell and Treasury Secretary Yellen. The massive fiscal stimulus plan prepared by the Biden administration has received criticism from prominent economists. They argue that the plan is too big and could trigger a sizeable increase in inflation. In deciding on the size of the fiscal plan, risk management considerations play an important role. Doing not enough is clearly the greater risk. However, doing a lot will eventually force the Federal Reserve to demonstrate its independence by not shying away from raising rates despite the impact on government finances.**

In her recent nomination hearing before the US Senate Committee on Finance, Janet Yellen observed *"Economists don't always agree, but I think there is a consensus now: Without further action, we risk a longer, more painful recession now – and long-term scarring of the economy later."*[1]

With the benefit of hindsight, this statement has turned out to be somewhat optimistic. The USD 1.9 trillion fiscal stimulus plan that has been put forward by the Biden administration has received criticism, most notable from Larry Summers[2]. Whilst noting that the Biden plan's *"ambition, its rejection of austerity orthodoxy and its commitment to reducing economic inequality are all admirable"*, he is concerned about the size, which would correspond to at least three times the output gap. This could "*set off inflationary pressures of a kind we have not seen in a generation, with consequences for the value of the dollar and financial stability."*

Moreover, at a later stage, it would limit the possibility to increase public investment in infrastructure, education, renewable energy, etc. Coming from a prominent economist and former Treasury Secretary, these remarks should not be taken lightly. Former IMF chief economist Olivier Blanchard also has his reservations about the size of the plan and considers that USD 1 trillion should be sufficient[3]. Paul Krugman, the recipient of the 2008 Nobel Prize in Economics, on the other hand, argues that the plan is not too big. The necessary size has been determined based on a bottom-up process with careful identification of the needs. Moreover, we don't know for sure the size of the inflation risk and, should inflation rise too much, the Federal Reserve could bring it back under control without triggering a recession[4].

1. *"Hearing to Consider the Anticipated Nomination of the Honorable"* Janet L. Yellen to Secretary of the Treasury, United States Senate Committee on Finance, 19 January 2021, www.finance.senate.gov.
2. Larry Summers, *"The Biden stimulus is admirably ambitious. But it brings some big risks, too"*, The Washington Post, 4 February 2021.
3. Olivier Blanchard, *"The Federal Debt and the Covid-19 Recession"*, podcast, Econofact, 8 February 2021.
4. Paul Krugman, *"Fighting Covid is Like Fighting a War"*, The New York Times, 7 February 2021.

The necessity to "act big", as stated by Janet Yellen in her confirmation hearing and the concern raised by others about what happens to inflation reminds us of the inflation/unemployment trade-off that has been at the heart of macroeconomic debate for decades. This relationship – also known as the Phillips curve – has for a long time underpinned the conduct of monetary policy, leading to preemptive tightening when the unemployment was on a strongly declining path and approaching the natural rate.

However, the link between the unemployment rate and inflation has gradually become very loose in recent years, which – already in the latter part of Alan Greenspan's Chairmanship at the Fed – has triggered a change in the conduct of monetary policy. It has become reactive with respect to inflation based on the view that the natural rate of unemployment is very hard to estimate with sufficient precision[5].

5. This was clearly explained by Jerome Powell in his Jackson Hole speech in 2018. See: Fed: Avoiding the risks of stargazing, BNP Paribas, Ecoweek, 31 August 2018. https://economic-research.bnpparibas.com/pdf/en-US/Avoiding-risks-stargazing-8/31/2018,31226

US CUMULATIVE JOB CREATIONS SINCE CYCLICAL TROUGH OF EMPLOYMENT

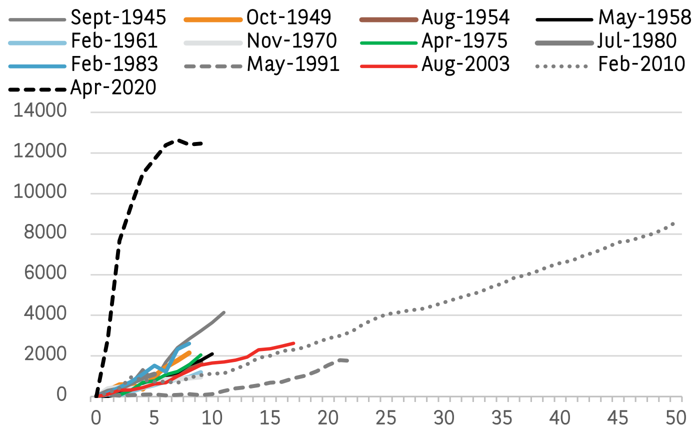


CHART 1

SOURCE: BLS, BNP PARIBAS

> Risk management considerations warrant a major fiscal stimulus in the US but this will eventually force the Federal Reserve to demonstrate its independence by not shying away from raising rates despite the impact on government finances.

Moreover, as an outcome of its Strategy Review, the Federal Reserve last year has adopted an asymmetric approach with respect to employment. A high level of unemployment would trigger easing measures whereas a very low level will not necessarily cause a tightening, unless inflation or instability risks would be on the rise[6].

In a recent speech[7], Jerome Powell has expressed at length his concern about the dire state of the labour market. The decline of the published unemployment rate to 6.3% in January *"dramatically understated"* the deterioration in the labour market. Correcting for the decline in the participation rate and for misclassifications – certain unemployed people being reported as having a job –, the unemployment rate is close to 10%. Moreover, disparities have increased: *"the decline in employment for workers in the top quartile of the wage distribution has been only 4 percent, while the decline for the bottom quartile has been a staggering 17 percent (...) employment for these workers has changed little in recent months, while employment for the higher-wage groups has continued to improve."*

About 10 million jobs still need to be created to reach the pre-pandemic employment level. Following the Great Recession, it took the US economy about 50 months to create the 8 million jobs that had been lost before. The longer it takes, the more hardship in the short run but also the bigger the risk of longer-lasting consequences, e.g. due to the increased difficulty of finding a job for the longer-term unemployed. Against this background, the necessity for ongoing monetary support is beyond doubt: *"My colleagues and I are strongly committed to doing all we can to promote this employment goal."* However, *"achieving and sustaining maximum employment will require more than supportive monetary policy. It will require a society-wide commitment, with contributions from across government and the private sector."* Clearly, there is full alignment between Powell and Yellen in terms of the analysis and what needs to be done. The central bank needs fiscal policy to enhance the effectiveness of its policy whereas the Treasury needs the Federal Reserve's accommodative stance to keep the cost of new borrowing low.

In deciding on the size of the fiscal plan, risk management considerations play an important role. The consequences of not doing enough – out of fear of triggering an outburst of inflation – are pretty clear. It would mean slow progress in reducing unemployment, in particular for lower income households, which have suffered more than others and are already financially stretched. Assessing the consequences of doing too much is more difficult. 'Running the economy hot' should allow for a swift return to maximum employment and a closing of the output gap. It is not clear how much of a lasting acceleration in inflation this would generate, considering that the relationship between the unemployment gap – the difference between the unemployment rate and the natural rate of unemployment – or the output gap and inflation is not that close. This implies that it is not clear how much of a monetary tightening a 'doing too much' scenario would trigger, nor how financial markets – the part of the economy which, together with housing, is most sensitive to rate hikes – would react. Unsurprisingly, based on a risk management approach, it is recommended to avoid ending up in a situation of not having done enough.

6. *"The Federal Reserve enters a new era of inflation targeting"*, BNP Paribas, Ecoweek, 31 August 2020. https://economic-research.bnpparibas.com/pdf/en-US/Federal-Reserve-enters-inflation-targeting-8/31/2020,39276

7. *"Getting Back to a Strong Labor Market"*, Remarks by Jerome H. Powell at the Economic Club of New York, 10 February 2021. Source: Federal Reserve. https://www.federalreserve.gov/newsevents/speech/powell20210210a.htm

US CORE PCE AND UNEMPLOYMENT RATE

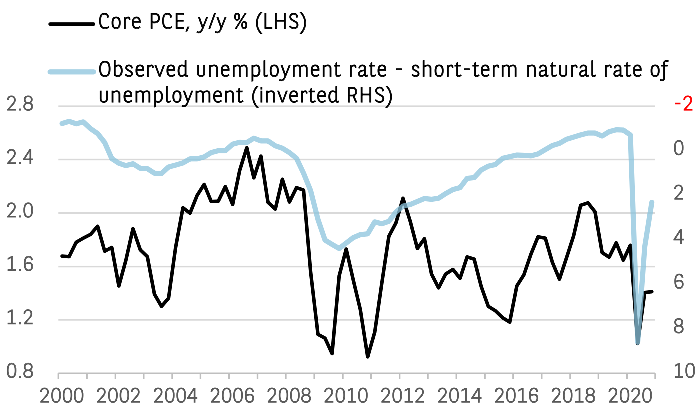


CHART 2 SOURCE: BEA, BLS, FRED, BNP PARIBAS

US CORE PCE AND OUTPUT GAP

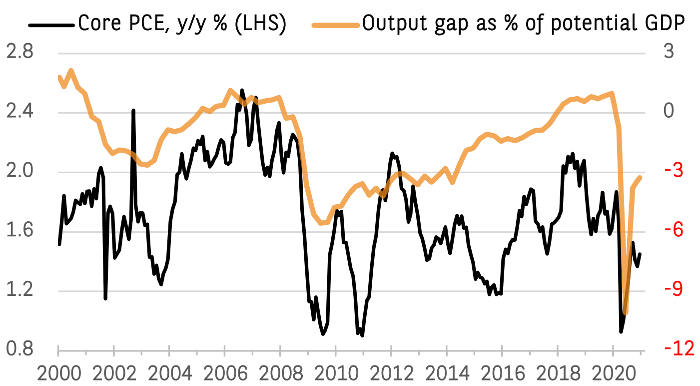


CHART 3 SOURCE: BEA, CBO, BNP PARIBAS

The Federal Reserve will appreciate that this would bring forward the start of monetary policy normalisation. However, it will also be confronted with the key challenge of being able to demonstrate its independence and to not shy away from raising rates despite what this would mean for an economy with a significantly higher public indebtedness.

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