IN-DEPTH ANALYSIS

Requested by the ECON committee

Monetary Dialogue Papers, June 2021

European Parliament

Implications for the Euro Area of US Macroeconomic Policies

Policy Department for Economic, Scientific and Quality of Life Policies
Directorate-General for Internal Policies
Author: Karl WHELAN
PE 662.917 - June 2021

EN

Implications for the Euro Area of US Macroeconomic Policies

Monetary Dialogue Papers
June 2021

Abstract

The US has undertaken much larger discretionary fiscal packages than euro area governments, particularly in 2021. The large 2021 US fiscal package is likely to provide a welcome boost to the euro area economy. There is a risk, however, that US fiscal policy could lead to overheating of the US economy and a possible monetary tightening from the Fed which could trigger a recession. This paper argues this scenario is unlikely to occur but discusses the implications for the ECB if it did.

This paper was provided by the Policy Department for Economic, Scientific and Quality of Life Policies at the request of the committee on Economic and Monetary Affairs (ECON) ahead of the Monetary Dialogue with the ECB President on 21 June 2021.

This document was requested by the European Parliament's committee on Economic and Monetary Affairs (ECON).

AUTHOR
Karl WHELAN, University College Dublin

ADMINISTRATOR RESPONSIBLE
Drazen RAKIC

EDITORIAL ASSISTANT
Janetta CUJKOVA

LINGUISTIC VERSIONS
Original: EN

ABOUT THE EDITOR
Policy departments provide in-house and external expertise to support European Parliament committees and other parliamentary bodies in shaping legislation and exercising democratic scrutiny over EU internal policies.

To contact the Policy Department or to subscribe for email alert updates, please write to:
Policy Department for Economic, Scientific and Quality of Life Policies
European Parliament
L-2929 - Luxembourg
Email: Poldep-Economy-Science@ep.europa.eu

Manuscript completed: June 2021
Date of publication: June 2021

This document was prepared as part of a series on "US Macroeconomic Policy Response to COVID-19: Spillovers to the Euro Area", available on the internet at:
https://www.europarl.europa.eu/committees/en/econ/econ-policies/monetary-dialogue

Follow the Monetary Expert Panel on Twitter: @EP_Monetary

DISCLAIMER AND COPYRIGHT

For citation purposes, the publication should be referenced as: Whelan, K., *Implications for the Euro Area of US Macroeconomic Policies*, Publication for the committee on Economic and Monetary Affairs, Policy Department for Economic, Scientific and Quality of Life Policies, European Parliament, Luxembourg, 2021.

CONTENTS

LIST OF FIGURES

LIST OF TABLES

LIST OF ABBREVIATIONS

APP	Asset purchase programme
ARP	American Rescue Plan
CAA	Consolidated Appropriations Act
CARES	Coronavirus Aid, Relief, and Economic Security
CBO	Congressional Budget Office
ECB	European Central Bank
GDP	Gross domestic product
PEPP	Pandemic emergency purchase programme
TIPS	Treasury Inflation-Protected Securities
TLTRO	Targeted longer-term refinancing operations

EXECUTIVE SUMMARY

- **In response to the global pandemic, the US has undertaken much larger discretionary fiscal packages than euro area governments, particularly for 2021.**
- **The composition of the US fiscal plans are quite different from those in the euro area with a greater reliance on direct payments to households.** This is partly due to the weakness of the US social welfare system but it is also related to the political difficulties in passing spending bills in a gridlocked political system.
- **The US government's approach to supporting employment has focused mainly on small businesses and seems to have been less efficient than the supports for businesses put in place in Europe.**
- **However, the smaller fiscal response in the euro area also likely reflects the inability to trigger a joint common fiscal package that can be put in place quickly.** The NextGenEU plan represents progress on the EU's ability to plan joint spending programmes but the "Own Resources" procedure is not one that can allow the EU to respond quickly to a crisis.
- **The large 2021 US fiscal package is likely to provide a welcome boost to the euro area economy.** Estimates from the OECD and the European Commission suggest it might boost euro area GDP growth by between 0.3% and 0.5%. This paper presents some arguments in favour of the likely effect being larger.
- **There is a risk that US fiscal policy could lead to overheating and a possible monetary tightening from the Fed which could trigger a recession**. This paper argues this scenario is unlikely to occur.
- **Arguments that US fiscal programmes will trigger inflation because they are much larger than the estimated "output gap" do not take into account the ongoing negative impact of the pandemic-related effects on the economy.**
- **It is also likely that the fiscal multiplier for this year's US fiscal programme will be relatiely low**. This paper presents a set of calculations that indicate how fiscal policy and the easing of pandemic-related effects could combine to deliver a strong recovery but no overheating.
- **There is evidence of a return of inflation in the recent US and euro area data.** However, it seems likely to reflect temporary factors. Neither investors nor economic forecasters are expecting a bout of high inflation in the coming years.
- **If the Federal Reserve raises interest rates, it could potentially trigger a rise in long-term interest rates around the world.** This could raise borrowing costs for firms, household and governments in the euro area.
- **The ECB could, however, counteract this impact.** This could be achieved with a combination of forward guidance, asset purchases or perhaps an explicit policy of "yield curve control" in which long-term interest rates are deliberately controlled at rates below what the market would set. That said, higher levels of asset purchases or yield curve control could both raise legal issues relating to monetary financing.
- **If the US economy did tip into recession next year due to a monetary tightening, it would be difficult for the ECB or euro area governments to prevent a substantial economic slowdown from occurring.**

1. INTRODUCTION

The global pandemic has triggered economic events that are without precedent in modern times. The pandemic required severe restrictions on economic activity which effectively shut down large parts of the global economy. Governments have responded with enormous fiscal supports and central banks have stepped up their unconventional monetary policies. The nature of the policy responses has differed across countries, however, reflecting differences in political preferences, differences in the severity of the pandemic's impact and also institutional differences in pre-COVID welfare systems.

This paper will discuss the response of the US authorities to the global pandemic. Its response will be compared with the approach taken in the euro area and the potential impact of US macroeconomic policies on the euro area will be addressed. The discretionary US fiscal response in 2020 was much larger than the direct response in the euro area: Total discretionary fiscal actions in the US equalled about 11% of GDP compared with 4% in the euro area. However, some of this difference reflects the weak nature of the US social safety net, with existing automatic stabilisers playing a greater role in Europe while the US federal government ended up spending a lot of money in 2020 supplementing weak state-level welfare systems.

There is an even greater difference for planned fiscal policy in 2021, with euro area direct fiscal action falling to 2.4% of GDP while the passing of the President Biden's stimulus plan, the American Rescue Plan (ARP), will see discretionary US fiscal response again being about 11% of GDP. In the short-run, this additional US fiscal impetus is likely to have a modest and welcome positive impact on the euro area economy via trade channels and more indirect finance and sentiment-related channels.

Over the medium term, however, there are concerns that the ARP—and the potential increase in infrastructure spending under the proposed American Jobs plan—could see the US economy over-heating, thus leading to a rise in inflation and a tightening of monetary policy from the Fed. Such an outcome could cause problems for the ECB if it led to higher inflation through higher import prices or the depreciation of the euro. It could also place upward pressure on longer-term funding costs of European governments and businesses and there is the possibility of financial stability problems if a sharp and unexpected increase in short-term interest rates catches out businesses, household and financial institutions that had made plans based on global interest rates being low for a long time. A more serious concern would be that a Fed tightening to get inflation under control triggers a US recession which could then spill over to the rest of the world.

Concerns about potential US overheating have been raised not only from the "usual sources" who tend to oppose all fiscal stimulus proposals but also from high-profile Keynesian macroeconomists such as Olivier Blanchard (2021) and Larry Summers (2021). My judgement is that risks of an outbreak of high inflation or a Fed-induced recession remain relatively low. Much of the ARP's stimulus will not be spent. And as of April, employment in the US economy was still 5% below its pre-pandemic level, meaning factors inhibiting the economy remain in place and high levels of supports are still warranted. In relation to the Fed, their new monetary framework makes it less likely they will induce a recession if inflation rises above 2% and more likely they would see tolerate a temporary increase in inflation while waiting for the fiscal impacts of the ARP to ease in 2022.

2. COMPARING THE US AND EURO AREA POLICY RESPONSE

This section compares the response of US and euro area authorities to the pandemic, starting with fiscal policy and then discussing monetary policy.

2.1. US fiscal policy response

The US fiscal response has largely been accounted for by three pieces of legislation. The USD 2.2 trillion Coronavirus Aid, Relief, and Economic Security Act (CARES act) signed in March 2020 was followed in December 2020 by a USD 868 billion package as part of the year-end Consolidated Appropriations Act (CAA). This was followed by the passing in March 2021 of the USD 1.855 trillion ARP programme. Taken together, these measures dwarf previous modern US fiscal packages. For example, the Obama stimulus programme of 2009/10 had an estimated cost of USD 831 billion.

Consistent with the unprecedented nature of the pandemic shock, the fiscal packages have included a wide range of items with the major elements being as follows.

Direct support: The CARES act saw USD 1,200 payments to individuals and USD 500 to dependents. The CAA provided further USD 600 payments to individuals including dependents and the ARP has provided USD 1,400 payments for those with incomes up to USD 75,000.

Small business supports: US policy has focused on maintaining employment at small businesses, typically defined as those with fewer than 500 employees. These supports have largely worked through the Payment Protection Programme (PPP) which has provided business with forgivable loans that they obtain via commercial banks.

Unemployment supports: Existing US unemployment schemes are state funded, pay low benefit rates and generally limit the length of time people can collect them to 26 weeks. The federal government has provided funding to supplement these state schemes, increase the weekly compensation level, widen eligibility criteria and extend the term of benefits to 52 weeks.

State and local governments: Funding has been provided to state and local governments to allow them to maintain staffing and service levels and prevent them having to raise state and local taxes.

Miscellaneous: The bills have spent money on vaccine development and distribution, schools, childcare, supplementary nutrition programmes, supporting the airline industry and the post office and other areas.

Table 1 shows a summary from the Congressional Budget Office (CBO) of the estimated effects of pandemic-related legislation on the budget deficit for 2020. Table 2 provides a summary of the measures taken in the CAA and the ARP.

In terms of their impact on the economy, the vast majority of measures passed in 2020 had an immediate impact, with a budgetary effect in 2020 of USD 2.3 billion, equivalent to 11% of GDP. Calculating the full size of fiscal measures for 2021 is trickier because spending is occurring under all three of the bills that have been passed. Based on various CBO publications, I believe the fiscal impact in 2021 will be about USD 2.5 trillion, combining USD 576 billion from measures passed prior to December 2020, USD 737 billion from the CAA and USD 1.16 trillion from the ARP. Thus, the size of direct fiscal measures taken during 2021 will be about the same as during 2021, again being about 11% of GDP. [1]

[1] This is based on an estimate of nominal US GDP in 2021 of USD 22.74 billion. I have used the European Commission's forecast of an 8.5% increase in nominal GDP this year.

Table 1: Congressional Budget Office estimates of the effect of pandemic-related fiscal measures passed in 2020

The Effects of Pandemic-Related Legislation on the Deficit

Billions of Dollars

	2020	2021	2022	2023	Total 2020–2023	Total 2024–2030
Paycheck Protection Program and Related Provisions[a]	616	13	0	0	628	0
Enhanced Unemployment Compensation	370	71	0	0	442	0
Recovery Rebates for Individuals[b]	272	20	0	0	292	0
Direct Assistance for State and Local Governments	150	*	0	0	150	0
Other Spending Provisions[c]	359	218	101	21	700	13
Other Revenue Provisions[d]	539	253	-186	-182	425	-50
Federal Reserve's Emergency Lending Facilities	11	0	0	0	11	0
Total	**2,317**	**576**	**-85**	**-160**	**2,648**	**-37**

Sources: Congressional Budget Office; staff of the Joint Committee on Taxation.

The years shown are federal fiscal years.

Positive numbers indicate an increase in the deficit.

Source: Congressional Budget Office (2020a).

Table 2: Combined fiscal measures in the Consolidated Appropriations Act (CAA) and American Rescue Plan (ARP)

	CAA	ARP	Combined
Direct payments to households	USD 166 billion	USD 402 billion	USD 568 billion
Unemployment compensation	USD 120 billion	USD 206 billion	USD 326 billion
Small business assistance	USD 325 billion	USD 54 billion	USD 379 billion
State and local government	USD 12 billion	USD 362 billion	USD 374 billion
Vaccination	USD 69 billion	USD 93 billion	USD 162 billion
Schools	USD 82 billion	USD 176 billion	USD 258 billion
Other	USD 94 billion	USD 562 billion	USD 656 billion
TOTAL	**USD 868 billion**	**USD 1,855 billion**	**USD 2,723 billion**

Sources: Author's calculations based on Congressional Budget Office (2020b, 2021), Probasco (2021) and Haagensen (2021).

One area of the US fiscal response that has generated some controversy has been the important role played by direct payments to households. Table 1 lists USD 272 billion in direct rebates but there were additional discretionary payments such as aid for student loans and direct payments to airline workers. The US National Income and Product Accounts personal income tables record an increase in "Other Transfers" (transfers not related to unemployment insurance or other federal programmes such Social Security, Medicaid or Medicare) of USD 461 billion in 2020, so these payments amounted to about 2% of US GDP in 2020.

With the passing of the ARP, there will be a similar amount of direct payments this year, with most of the payments having been made in March. These direct payments are universal and so they were not targeted at those in need. In contrast, euro area governments were able to support those in need in a more efficient and cheaper way using their better-developed social welfare systems.

Questions can be asked about whether the direct payment approach is the most efficient way to respond to an economic downturn. Many of the payments have gone to relatively well-off households who do not need them. However, in the US context, three arguments can be made for this approach.

The first is that the US has a far weaker system of "automatic stabilisers" than Europe so it is more reliant on direct fiscal actions to respond to severe recessions. The US government has responded to its last three recessions by augmenting the existing tax and welfare system with direct payments to households. Indeed, prior to the pandemic there had been an active debate about automating payments of this sort when the economy went into recession, inspired by Claudia Sahm's (2019) proposal to trigger direct payments when the three-month average unemployment rate rose by at least 0.5 percentage points above its low point of the previous year.

The second reason is that weak social welfare systems mean targeted or means-tested interventions aimed at helping only those with low incomes or low holdings of liquid assets are likely to leave a lot of people "falling through the cracks", particularly in an environment where state-level unemployment schemes are weak.

The third reason is political. "Money for everyone" is politically popular and thus easier to get passed. In an environment where big spending proposals often get blocked because of political gridlock, sometimes it is best to not let the perfect become the enemy of the good and to focus on what can pass rather than what is the best-designed response to a crisis.

2.2. Comparison with the euro area

Table 3 provides a comparison of the fiscal policy responses to the pandemic in the US and the euro area. The US had a much larger deterioration in its budget balance than Europe (a 9.5% deterioration compared with a 6.6% deterioration for the euro area) and a smaller reduction in real GDP. US GDP fell by 3.5% compared with 6.6% for the euro area. A common element, not shown in the table, is that the deterioration in the budget balance in both the US and euro area was solely driven by increased expenditure. The discretionary fiscal packages were dominated by spending increases and tax revenues as a share of GDP held up well in both areas, partly because many of the higher income workers who pay most income tax continued working from home during the crisis while much the feared loss in sales taxes was replaced by taxes on online shopping.

The other notable element of this comparison is that direct fiscal action in 2020 corresponded to 11% of GDP in the US (more than accounting for the change in the budget deficit) but only 4.2% of GDP in the euro area. An even greater difference emerges in 2021, with US fiscal action remaining at about 11% while the euro area equivalent falls to 2.4%.

I can suggest three contributors to the large difference between the size of the US and euro area fiscal responses.

The first is the US reliance on direct payments to households was not replicated in the euro area because its members have larger and better-organised welfare states. The operation of these traditional automatic stabilisers explained the additional 2.4% decline in the euro area's budget balance in 2020 above the effect of the discretionary fiscal actions.

The second possible contributor is the US approach to employees of firms affected by the pandemic has perhaps been less efficient than the approach taken in Europe. Autor et al. (2020) argued the Paycheck Protection Programme did not save many jobs. And for larger firms, the US policy was effectively to allow firms let workers go and have them claim unemployment benefits. In contrast, the European approach focused on maintaining the links between firms and their employees via funded furloughs or part-time working schemes. As Figure 1 below shows, these schemes constituted more than half of the cost of fiscal measures undertaken in the euro area and less than 20% of the euro area action was focused on household supports, tax cuts or capital spending. It may be that this was a less costly way to react to the pandemic than the US approach.

The third possible contributor is the absence of a centralised fiscal policy in the euro area. In open economies, many of the benefits of fiscal policy spill over to other countries. The result may be that the euro area as a whole adopted a fiscal response that was smaller than if they had been setting a common single fiscal policy. This interpretation would imply one of the reasons the euro area had a weaker outcome for GDP in 2020 was its smaller fiscal response.

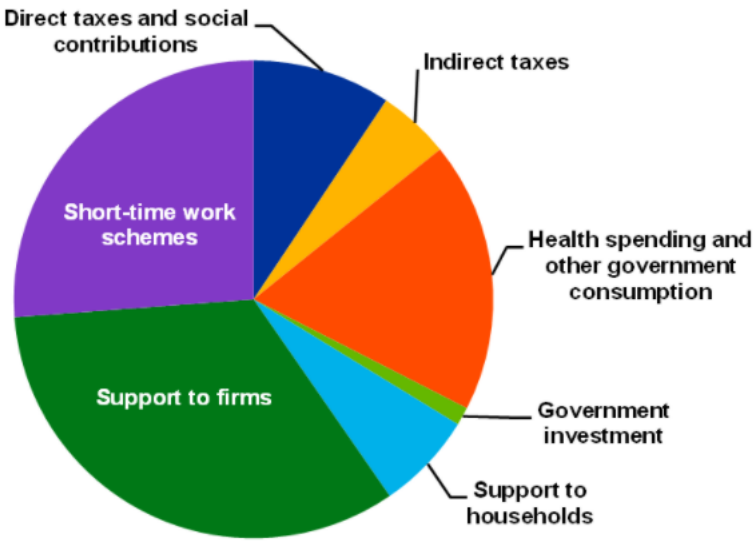
Of course, the EU has agreed its NextGenerationEU plan, announced with a face value of EUR 750 billion (about 6% of 2019 GDP) but there is less to this plan than meets the eye. While it can be considered a historical agreement to use joint fiscal capacity to respond to a crisis, EUR 360 billion of the total is in the form of loans. This does little to help most euro area countries since they can now borrow on their own at very low interest rates. Of the remaining EUR 390 billion in grants, more than two-thirds of these payments will not occur until 2023 and 2024. So, while European leaders are to be commended for showing they can take joint action—and the "Own Resources" procedure may well be the model for future joint action on climate change or other major issues of common interest—this approach is not a strategy capable of delivering quick joint action in response to a short-term crisis or recession.

Table 3: Comparison between the US and the euro area (budget balances and discretionary fiscal action both measured as a share of GDP)

		2019	2020	2021 Forecasts
Euro Area	Budget Balance	-0.6	-7.2	-8.0
	Discretionary Fiscal Actions		4.2	2.4
	GDP Growth Rate	1.3	-6.6	4.3
United States	Budget Balance	-6.6	-16.1	-16.0
	Discretionary Fiscal Actions		11.1	10.9
	GDP Growth Rate	2.2	-3.5	6.3

Sources: Data and forecasts on deficits are from European Commission (2021) and ECB (2021). Estimates of discretionary actions for the euro area as a percentage of GDP come from European Commission (2020). For the US, I used estimates of the size of discretionary fiscal actions in dollars from Congressional Budget Office (2020a, 2020b, 2021). Estimates of US GDP for 2020 come from the US Commerce Department's National Income and Product Accounts and the forecast for 2021 US GDP comes from using the European Commission's Spring forecasts.

Figure 1: Estimated composition of euro area fiscal measures related to COVID-19 in 2020



Source: ECB (2021).

2.3. Monetary policy

While the fiscal responses to the pandemic in the US and the euro area have been quite different, the monetary policy responses have been relatively similar. Both the Federal Reserve and the Eurosystem have responded with large-scale asset purchases aimed at easing financing conditions. The Fed's total assets have increased from about USD 4 trillion prior to the pandemic to about USD 8 trillion now, while the ECB's assets have risen from EUR 4.7 trillion to about EUR 7.6 trillion now, due to the introduction of its pandemic emergency purchase programme (PEPP) and the latest targeted long-term refinancing operation (TLTRO3).

In both the US and the euro area, the role of monetary policy in keeping government bond yields low has played an important role in allowing a large fiscal expansion to take place without concerns about fiscal sustainability arising. As discussed in Whelan (2020), the fiscal response to the pandemic has taken debt-GDP levels to unprecedented highs but the low cost of financing has meant that the burden imposed in financing this debt is relatively low by historical standards.

One difference in the responses is that the ECB's response was largely confined to using tools that were already in place (asset purchases and TLTROs). In contrast, the Fed launched a number of new facilities and reactivated some programmes that had not been in use since the global financial crisis. So, for example, the Main Street Lending Programme and Paycheck Protection Program Liquidity Facility were launched to provide liquidity to banks providing loans to small and medium-sized businesses. Other programmes were launched to purchase corporate bonds and state and local government bonds to maintain the supply of credit in these markets and loans were provided to money market mutual funds to maintain stability in this sector.

While this battery of new programme announcements made the Fed look more active than the ECB, these new programmes effectively replicated the ECB's ability to provide credit for a wide range of activities via its extensive list of eligible collateral for monetary policy operations and its wide mandate

for asset purchases. For example, loans to small businesses could already be used by European banks as collateral for obtaining credit from the Eurosystem. Moreover, the ECB has a wider remit to support lending. Most of the Fed's new programmes were funded via money provided to it by the US Treasury under the CARES act. With the Treasury having ordered most of the Fed's new programmes to be wound up at the end of 2020, the ECB's independent ability to provide credit to the financial system could again be considered superior to the Fed.

The other major monetary policy event of 2020 was the announcement in August of the Fed's new "Statement on Longer-Run Goals and Monetary Policy Strategy".[2] This statement de-emphasised the importance of reacting to low rates of unemployment by raising interest rates, effectively signalling the Fed's loss of faith in the Phillips curve relationship. It also announced a move to an average inflation targeting regime. Specifically, the Federal Open Market Committee announced that "*In order to anchor longer-term inflation expectations at this level, the Committee seeks to achieve inflation that averages 2 percent over time, and therefore judges that, following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time*."

This announcement may have some impact on the conduct of US monetary policy over the next few years. If inflationary pressures emerge and push inflation over 2%, this new formulation of policy means the Fed will be willing to allow this to occur without any reaction at first unless it views the inflation rate as likely to move above 2% for an extended period.

The ECB is still conducting its own strategic review of its monetary policy. A move to greater clarity on its definition of price stability would be welcome as would be a similar statement on the importance of meeting an average inflation target over a period of time.

[2] The statement is available at https://www.federalreserve.gov/monetarypolicy/guide-to-changes-in-statement-on-longer-run-goals-monetary-policy-strategy.htm.

3. RISK OF US OVERHEATING

The immediate impact of the passing of the ARP will be to support the US economy and help get it back to its pre-pandemic path as the vaccination programme is completed. The Biden administration's budget plans are based on the assumption that the US economy will grow strongly over the next 18 months but inflation will remain contained and next year's unemployment rate will average 4.1%, just above the pre-pandemic level.[3] If this is the outcome, then the impact on the euro area will be a small but welcome boost to GDP. I discuss the potential magnitudes of this boost and the channels through which it will operate, in the next section.

Here, however, I discuss the possibility of a more negative scenario. According to this scenario, as discussed for example by Blanchard (2021) and Summers (2021), the USD 2.8 trillion in fiscal action passed in the CAA and ARP will over-stimulate the economy this year and cause a significant increase in inflation. This would then force the Fed to tighten monetary policy and potentially trigger a recession.

I think the risks of overheating from these fiscal packages are low for a number of reasons.

3.1. Current economic weakness

The US economy is currently still well short of its pre-pandemic course. Figure 2 shows that total non-farm employment in April was 5.4% below its pre-pandemic peak while Figure 3 shows GDP in the first quarter of this year as being 3.5% below the pre-recession trend. These are figures that would normally be associated with a very deep recession. The most recent employment report showed 266,000 jobs were added in April. It would take 31 months of job growth at that pace to recover the 8 million jobs that have been lost since February 2020. Figure 4 also shows that while spending on goods is back on track, spending on some of the major categories of services such as transportation, restaurants and hotels and other recreational services are well below their pre-crisis levels.

These figures suggest that despite the success of the US's vaccination strategy, the mix of formal restrictions on activity and public reluctance to engage in potentially risky activities are still restraining the economy. I would note that the public concern about the risk of COVID infection is still well-grounded. While many people in the US are vaccinated, infection rates among the non-vaccinated remain high.[4]

3.2. Flaws in traditional fiscal stimulus analogies

I am not sure that the traditional multiplier analysis carried out, for example, by Blanchard (2021), is useful when describing the current situation. This analysis can be summarised briefly as follows: Prior to the pandemic, the US economy seemed close to full employment. If output in 2020:Q1 is about 3.5% below its pre-crisis trend, then even with a small fiscal multiplier, a fiscal package worth 11% of GDP is bound to more than close this output gap, pushing output above its long-run non-inflationary level and triggering an increase in inflation.

The problem with this analysis is that it does not fully factor in the impact the pandemic is still having on the economy. The pandemic has induced a wide range of negative effects on the economy, some of which (such as business closures and explicit social distancing restrictions) can be viewed as restrictions on aggregate supply and others (reduced demand for certain kinds of services) can be

[3] These economic forecasts are available at https://www.whitehouse.gov/wp-content/uploads/2021/05/spec_fy22.pdf.

[4] See this story in the Washington Post for details. https://www.washingtonpost.com/health/interactive/2021/covid-rates-unvaccinated-people/.

viewed as restrictions on aggregate demand. This means we cannot assess any fiscal package without factoring in the ongoing restrictions on GDP caused by the pandemic.

We know that these pandemic-related negative effects were very large in 2020. Despite a fiscal package worth 11% of GDP, the US economy declined by 3.5% in 2020. If the public health situation in 2021 was to be similar to that in 2020, then enormous fiscal supports would have been required just to keep the economy in the same place it was at the end of 2020.

Thankfully, due to progress with vaccinations, COVID-related restrictions and COVID-related reductions in demand are easing and a similar level of fiscal action to last year can be consistent with a big turnaround in economic growth. The European Commission (2021) forecasts a 10 percentage point change in US economic growth, from -3.5% in 2020 to +6.6% this year. As I discuss below, I believe this kind of outcome is consistent with both a significant easing of the impact of pandemic-related restrictions and with a positive impact of fiscal policy.

3.3. Low fiscal multipliers

Another reason to be less concerned about overheating is the likelihood that the overall fiscal multiplier from the packages passed is likely to be low. The single largest item in the 2021 fiscal year is the direct payments to households. As can be seen from Figure 5, the three rounds of direct payments have produced large increases in disposable income that have not been matched by corresponding large movements in personal spending. Figure 6 illustrates how the three rounds of payments have generated sharp upward spikes in the personal savings rate.

There is, of course, the possibility that once the pandemic is over, households sitting on a "wall of cash" will go on a spending splurge, leading to a demand-led overheating. The total amount of excess savings over the last year (relative to the scenario where the savings rate had remained at its 2019 level) is about USD 2 trillion. This is almost 10% of 2020's level of GDP, so for sure if a large fraction of these savings were mobilised quickly this year, there could be overheating. It is certainly likely that demand for some of the products people had been missing the most—such as bars, restaurants and tourism—could well end up outstripping supply and raising prices.

That said, it is worth putting this "wall of cash" in context. The savings of the last year and the rebound in equity prices have pushed the ratio of net worth to disposable income of US households up to about 7.5 at the end of 2020 (see Figure 7). However, increases of similar magnitudes have taken place in recent years prior to the pandemic, mainly triggered by rising financial asset values (see Figure 8) and these have not triggered inflationary consumer spending. Even accepting that the psychological approach of households to stimulus payments may be different to those of other financial asset gains, it is fair to ask whether the ratio of net worth to disposable income being 7.5 rather than 7.4 is going to have a major impact on spending plans.

Some of the other areas of major spending also seem likely to have small multipliers. Critics have argued that the level of support provided to state and local governments is excessive relative to their current needs but, if so, it seems unlikely state and local governments are going to go on spending sprees or implement large tax cuts based on a once-off windfall, so the impact on the economy is likely to be modest.

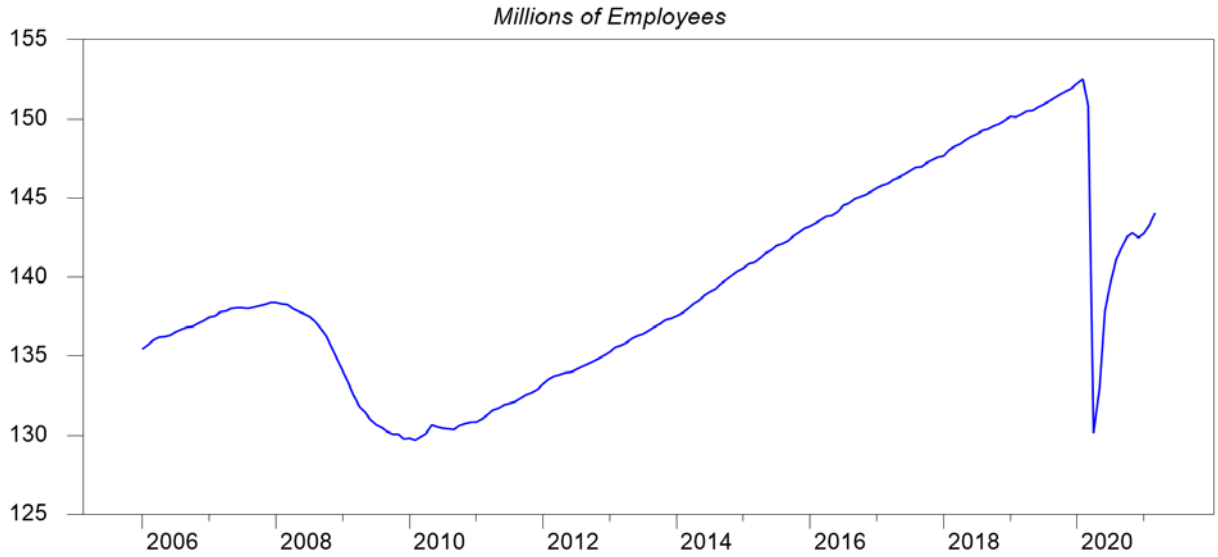
The unemployment insurance provisions of the ARP may also be larger than is needed but if the economy does better than expected and unemployment falls faster, then the amount of this money that is actually spent will be lower than planned. Some have flagged the concern that the additional USD 300 a week in unemployment insurance payments being provided by the federal government is holding back the economy because some people are better off claiming these benefits than working.

However, these supplementary benefits expire in September and if states decide they are hindering the re-opening of the economy, they can opt out of the programme. Already, 24 states with Republican-controlled legislatures have already opted out of the programme.[5] This is largely a political rather than an economic decision—pandemic-related problems are still causing high unemployment rates in many of these states—but it is an option that all states could take if the programme is seen as causing overheating problems.

Finally, programmes to assist small businesses are more akin to "disaster relief" than to traditional stimulus. These funds are being spent to maintain the existing wage levels of employees at firms affected by the pandemic and thus are directly countering the negative impact of the pandemic rather than providing additional stimulus which could boost output above pre-crisis levels. These programmes are also likely to cost less if the economic recovery is indeed faster than currently anticipated by the Biden administration.

These four items—direct payments to households, state and local government supports, unemployment insurance and small business supports—account for the vast majority of the fiscal impetus in 2021 from the three packages that have been passed. Together, I would be surprised if they were associated with a large multiplier or generated economic overheating.

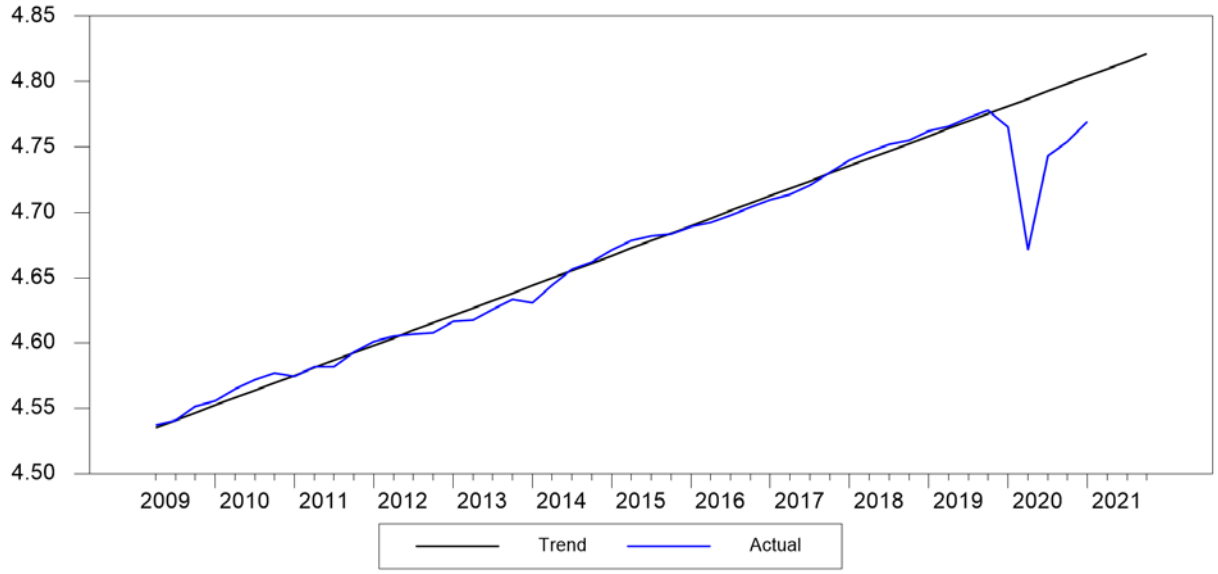
Figure 2: Total non-farm employment in the United States



Source: Author's calculations based on data from the Bureau of Labour Statistics Employment Situation release.

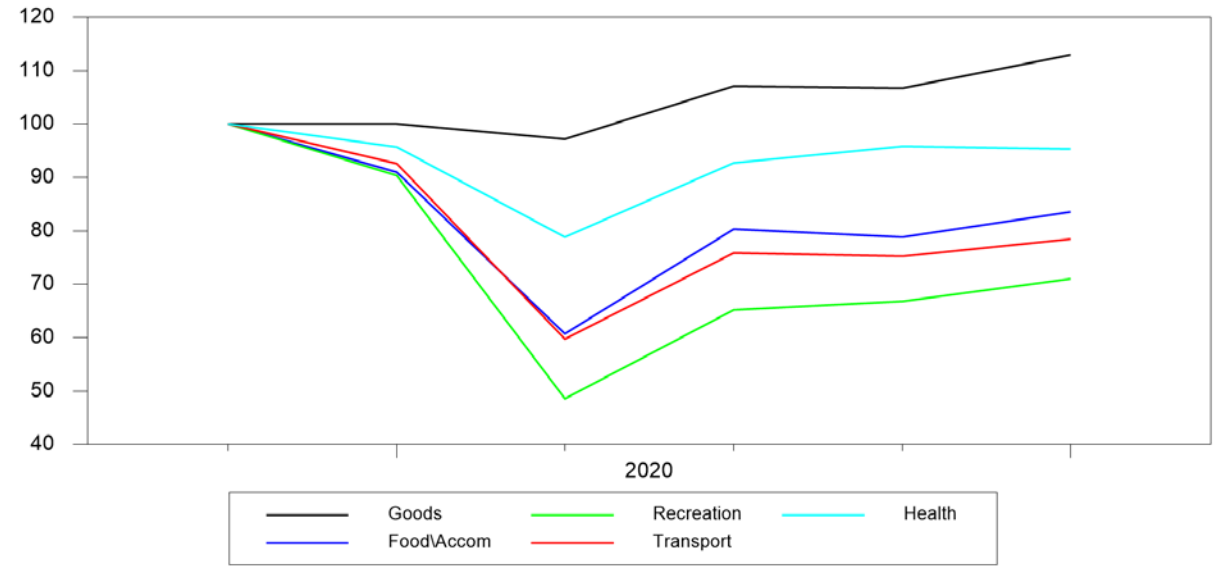
[5] See details here https://tcf.org/content/commentary/fact-sheet-whats-stake-states-cancel-federal-unemployment-benefits/.

Figure 3: Log of US real GDP and its pre-crisis trend



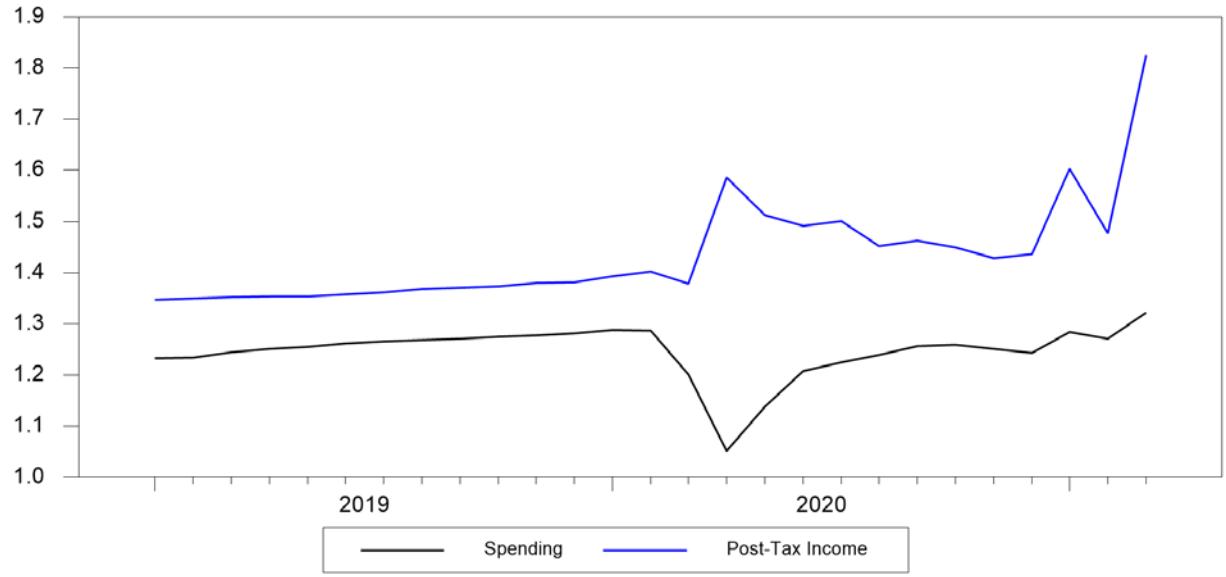
Source: Author's calculations based on data from the US National Income and Product Accounts published by the Bureau of Economic Analysis, US Department of Commerce.

Figure 4: Real personal consumption expenditures for selected components, 2019:Q4 to 2021:Q1



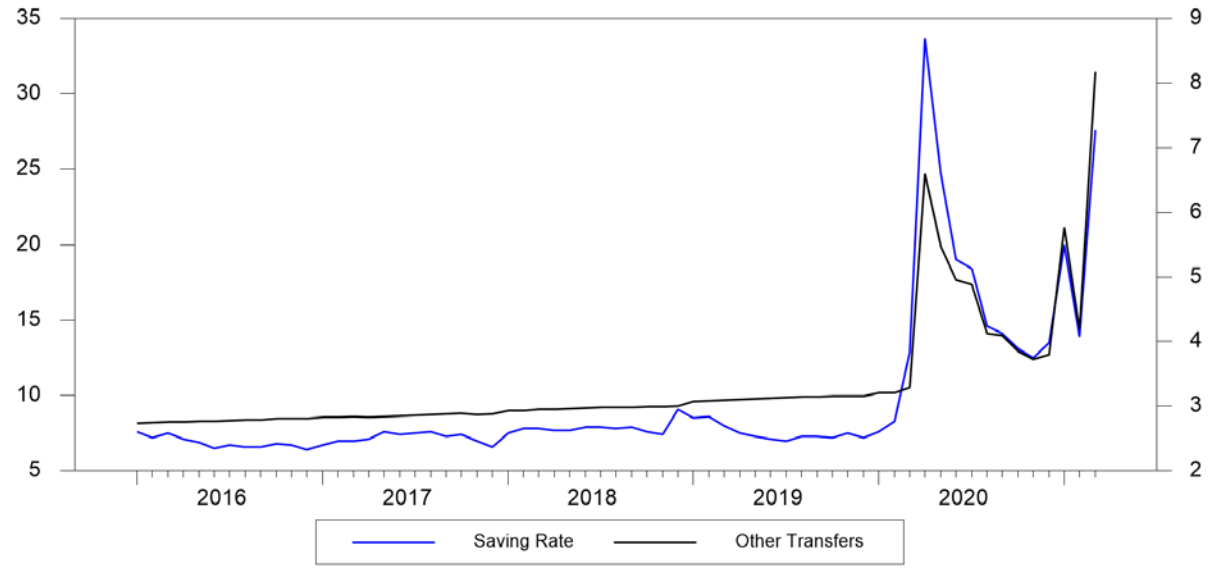
Source: Author's calculations based on data from the US National Income and Product Accounts published by the Bureau of Economic Analysis, US Department of Commerce

Figure 5: Personal spending and post-tax income (in USD trillions)



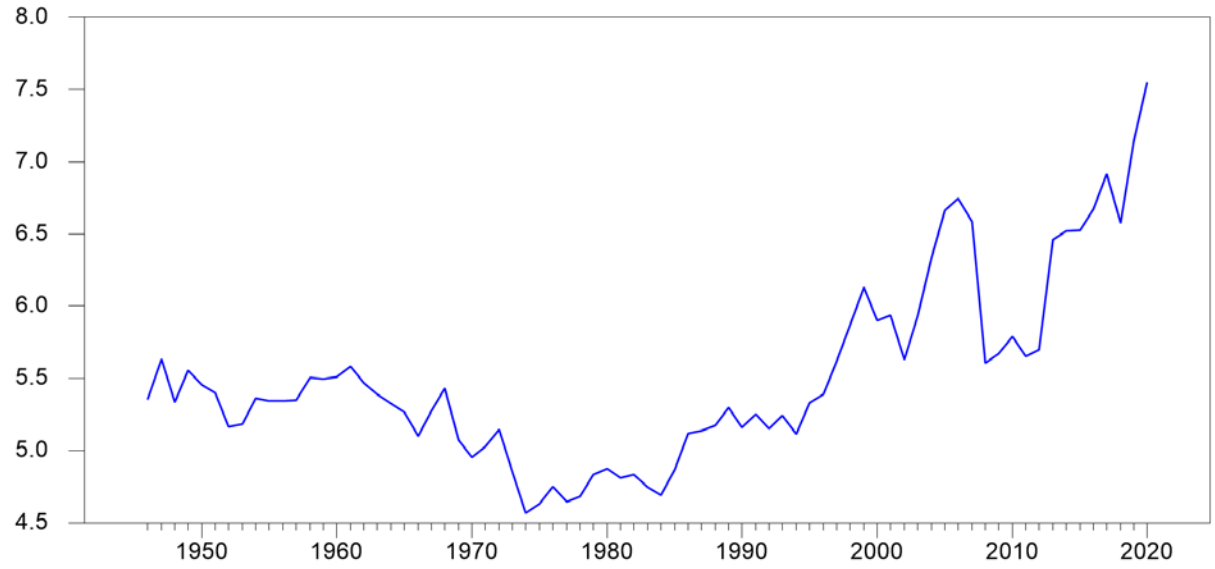
Source: Author's calculations based on data from the US National Income and Product Accounts published by the Bureau of Economic Analysis, US Department of Commerce.

Figure 6: Personal savings rate (left scale) and "Other Transfers" (in USD billons, right scale)



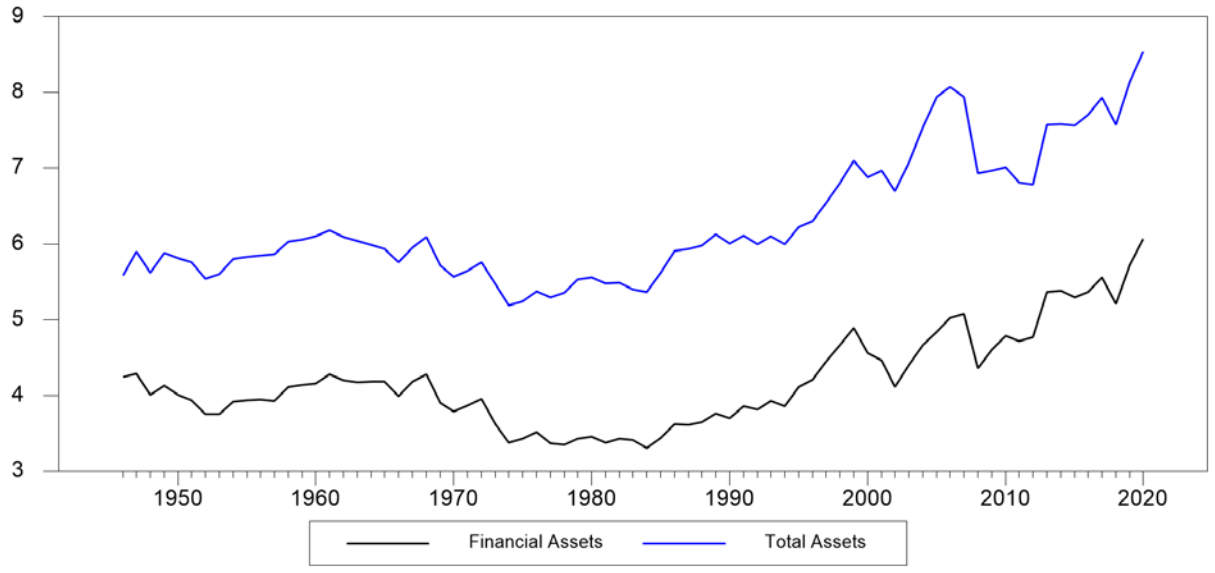
Source: Author's calculations based on data from the US National Income and Product Accounts published by the Bureau of Economic Analysis, US Department of Commerce.

Figure 7: Ratio of net worth to disposable income for US households



Source: Author's calculations based on Z1 Statistical Release from the Federal Reserve Board.

Figure 8: Ratio of total assets and nonfinancial assets to disposable income for US households



Source: Author's calculations based on Z1 Statistical Release from the Federal Reserve Board.

3.4. An illustrative scenario

Here, I provide a simple summary to illustrate how COVID-related effects and fiscal packages may have combined to influence the US economy in 2020 and how they will do so in 2021.

Based on the reasoning above, I expect the "multiplier" effect of the fiscal packages in 2020 and 2021 to be relatively low. Here, I will use the figure of 0.8, which means the positive impact of the fiscal packages on GDP will have been 8.8% in both 2020 and 2021, but the general point being made here isn't dependent on this specific figure. For this multiplier estimate of 0.8, given the actual GDP growth rate of minus 3.5%, you can "back out" that without fiscal intervention, US GDP would have declined by about 12% in 2020. Given the scale of the shutdown inflicted on whole swathes of the economy, this seems a reasonable magnitude.

Similarly, assuming a similar calculation for the fiscal impact this year, the Commission's forecasted growth rate of 6.6%—which means the economy is back on its pre-crisis trend but not overheating—is consistent with a negative impact of COVID-19 on the economy in 2021 of about 6%, just under half the negative effect in 2021. This seems consistent with the data showing an increase in economic activity but with employment still a long way below its previous peaks.

I conclude that fiscal packages have played and continue to play an important role in combatting the negative economic effects of the pandemic and getting the economy back on track and they can do this without triggering a significant over-heating of the economy. While the US fiscal programmes have perhaps been inefficiently designed, they are likely to see the US economy in much better shape by later this year than the euro area, which has seen a far smaller level of fiscal action.

Table 4: An illustrative scenario for COVID-19 restrictions and fiscal policy effects on GDP

	2019	2020	2021
COVID-19 impact on GDP	0	-12.3%	-5.9%
GDP with no fiscal action (index)	100	87.7	94.1
Growth with no fiscal action		-12.3%	7.2%
Fiscal impact		8.8%	8.8%
GDP with fiscal action (index)	100	96.5	102.9
Growth with fiscal action		-3.5%	6.6%

Sources: Author's calculations of potential negative effects of pandemic restrictions and positive effects of fiscal policy.

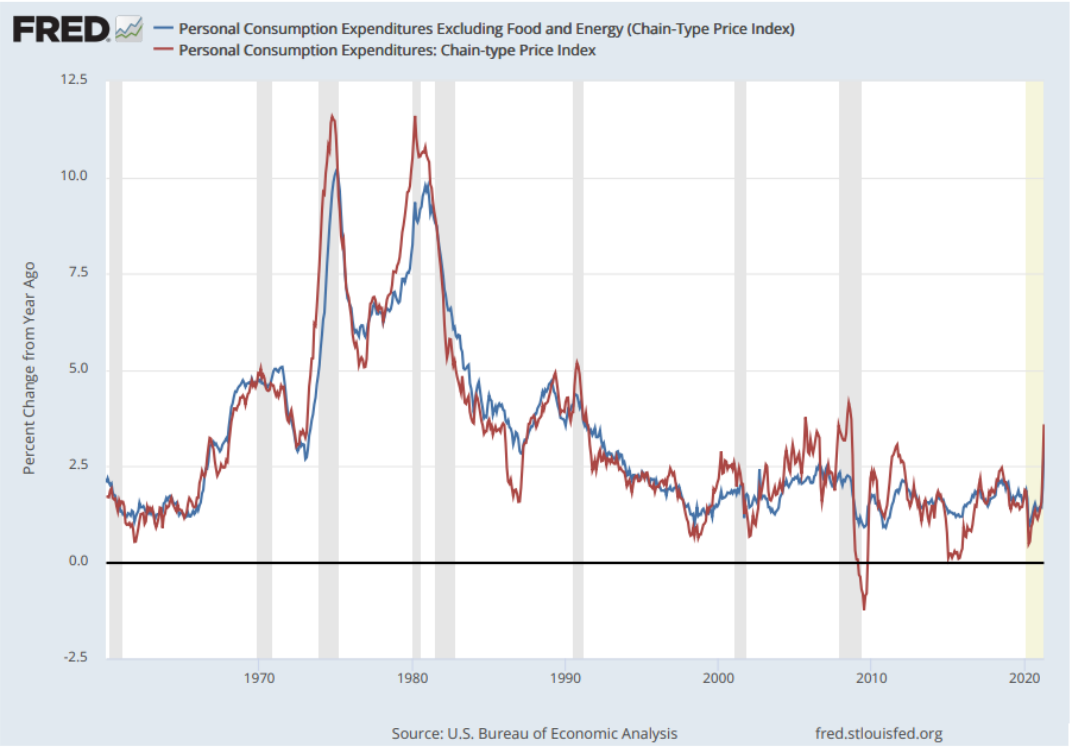
3.5. Short-run inflation developments and longer-run expectations

In recent weeks, the concern about US economic recovery generating inflation has not been purely theoretical. US consumer price inflation, as measured by the personal consumption expenditure (PCE) deflator jumped to 3.6% in April.

A closer examination of the data, however, suggests this is likely to be a temporary development. There have been a number of volatile price movements for some items. In some cases, this has stemmed from shortages due to the unusual patterns in global trade over the past year, which has led to a shortage of containers in some locations. Another example has been used cars, which have seen a surge in demand as people return to work but are still wary of using public transport. The Dallas Fed's "trimmed mean" measure of core inflation, which removes the most volatile price changes from each month, remained almost unchanged at 1.8% in April.[6]

On balance, then, it seems likely the current upward jump in inflation will be a temporary one. For what it's worth, both investors and economic forecasters tend to agree with this assessment. Looking at those who have money at stake, the inflation rate implied by yields on Treasury Inflation-Protected Securities (TIPS) plunged in the early days of the pandemic but has recovered over the past year. The estimated 10-year rate is now above 2%, though no higher than it has been on multiple occasions over the past decade (see Figure 10). The Philadelphia Fed's Survey of Professional Forecasters show forecasting economists have a long-run inflation forecast similar to the TIPS market forecast.

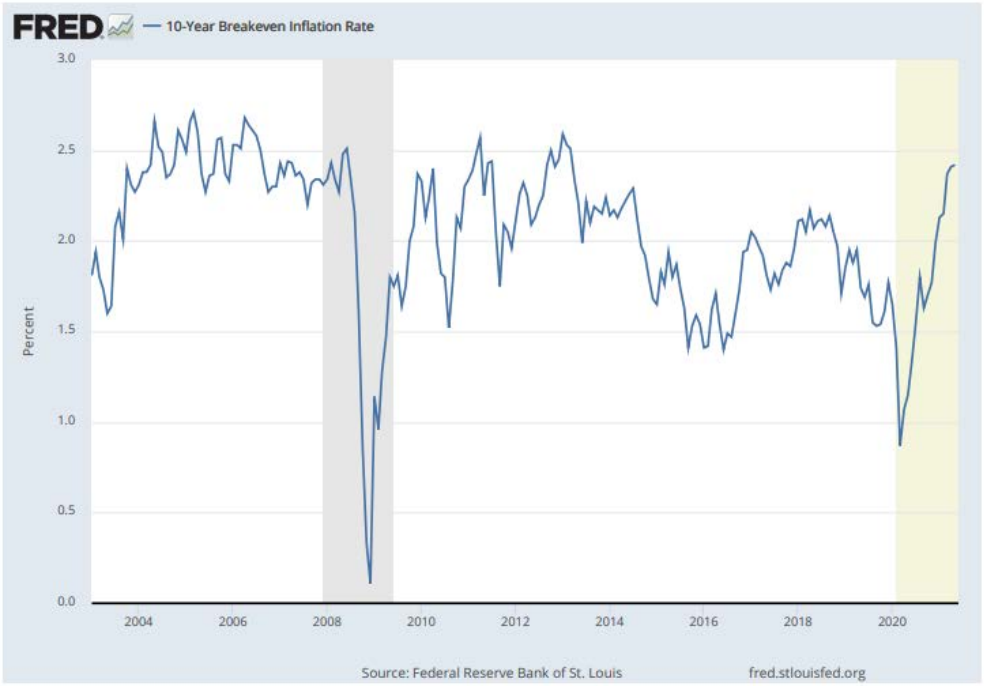
Figure 9: Personal consumption expenditure inflation for all expenditures (red) and for expenditures excluding food and energy



Source: Federal Reserve Bank of Saint Louis.

[6] This measure can be found at https://www.dallasfed.org/research/pce/.

Figure 10: 10-year "breakeven" inflation rate implied by Treasury Inflation-Protected Securities



Source: Federal Reserve Bank of Saint Louis.

4. THE IMPACT ON THE EURO AREA

Here, I will briefly discuss the impact on the euro area this year of US macroeconomic policies under the baseline scenario described above. I will also discuss some implications for Europe should the less benign scenario of US overheating and potential monetary tightening occur.

4.1. The baseline scenario

Exports to the US have only accounted for about 4% of EU GDP in recent years there is relatively little room for expansionary policy to have an impact on the euro area economy through direct trade linkages. However, the US fiscal packages are large enough to provide a decent boost to global GDP and thus increase export demand for European products throughout the world.

The OECD (2021) have estimated that in 2021 the ARP will boost US GDP by 3.8%, world GDP by 1.2% and euro area GDP by 0.5%. The European Commission (2021) project a smaller increase in US GDP of 3% as a result of fiscal policy and thus a correspondingly smaller impact on euro area GDP of 0.3%.

These figures can largely be explained via direct trade effects. With non-EU exports being about 30% of EU GDP, a pro-rata increase in these exports in line with an increase in world GDP of 1.2% would point to the ARP boosting EU GDP by about 0.36%. In addition, the OECD and European Commission expect some boost to exports from the impact the fiscal stimulus will have in strengthening the dollar relative to the euro.

I think these figures could be underestimates of the total impact of US fiscal measures on Europe in 2021 for three reasons.

First, by focusing only on the USD 1.9 trillion in the ARP, the OECD calculations understate the full amount of discretionary fiscal action being taken in the US in 2021 due to the CARES act, the CAA and the ARP. The calculations above suggest the combined amount of fiscal action this year is about USD 2.5 trillion.

Second, the fiscal multipliers used by the OECD and European Commission seem on the low side. For example, the OECD estimates that a fiscal package of 8.5% of US GDP will raise output by 3.8%, implying an average multiplier of 0.45. In his discussion of possible multiplier values for the ARP, Blanchard (2021) reports a multiplier of 0.4 as the lowest value among the range of options he considers possible. While there are good reasons to believe, as argued above, that the multiplier for current fiscal packages are low, they are probably higher than 0.45.

Third, looking at trade and exchange rate linkages misses out on the potential role that sentiment plays in generating businesses cycles. International economies tend to display more co-movement than can be explained purely by trade or financial linkages. This suggests an important role for sentiment. In this case, the fact that the US is pursuing an aggressive fiscal policy may make firms and households in the rest of the world more optimistic. In particular, if firms feel the global economy is recovering, they may be more welling to move ahead with investment plans that had been deferred during the pandemic.

4.2. The US overheating scenario

In the scenario in which US fiscal policy leads to an overheating economy, there are a number of possible consequences for the euro area, ranging from mild to highly unwelcome.

First, there could be a direct effect on inflation if a US boom triggers higher prices of globally-traded products. A certain amount of upward pricing pressure might actually be welcomed by the ECB, which has failed to reach its 2% inflation target over the past few years. The May reading for HICP inflation

saw a jump up to exactly 2% but core inflation remains below 1% and the jump in the overall inflation rate seems likely to be temporary (see Figure 11). However, should the US expansion trigger a sustained global increase in traded goods prices, it may force the ECB to tighten monetary policy sooner than it is currently intending.

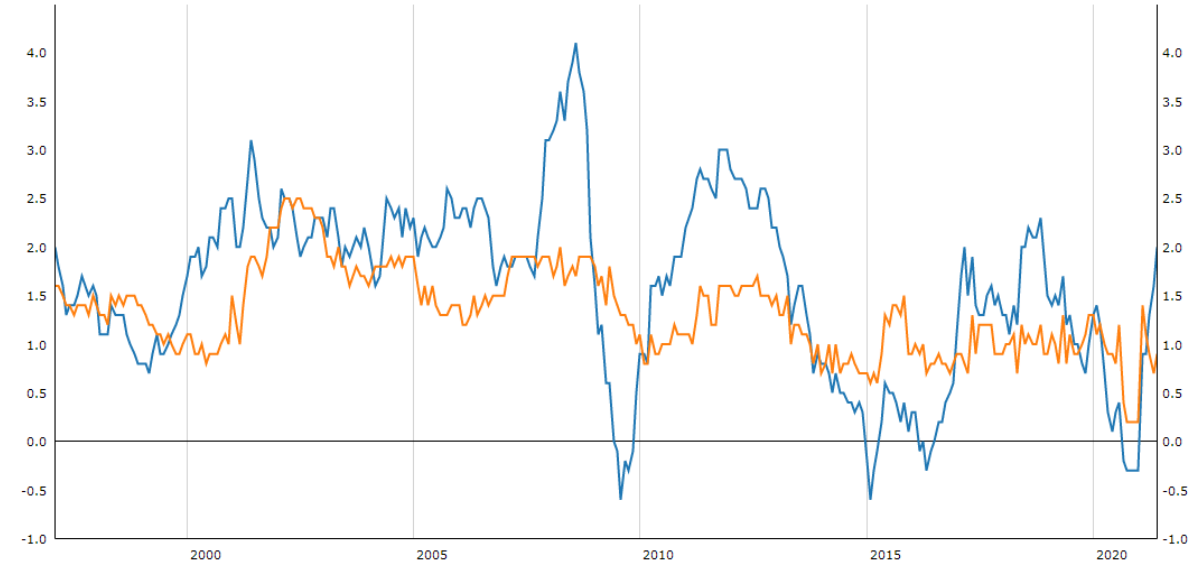
Second, a big rise in US long-term interest rates triggered by a sharp and unexpected tightening of monetary policy could place upward pressure on long-term rates in the euro area leading to a potentially unwelcome increase in financing costs for households, business and governments.

As shown in Figure 12, long-term interest rates in the US and the euro area have often moved together, partly driven by arbitrage trading by international investors looking for the highest rate of return. However, Figure 12 also shows that the looser monetary policy run by the ECB in recent years has allowed them to get euro area long-term yields well below the corresponding long-term yields in the US. So, if the ECB is not concerned about inflation, it could offset upward international pressure on long-term yields with a combination of forward guidance and asset purchases. Indeed, the ECB could choose to copy the Bank of Japan and engage in "yield curve control" by explicitly pegging long-term yields to specific low values. One potential future problem, however, is that as ECB holdings of sovereign bonds grow to reach ever-higher shares of the total amount of debt outstanding, it increases the possibility that the European Court of Justice could view its policy mix as violating the monetary financing clause (see Whelan [2020] for a discussion of these issues).

Third, a Fed-induced recession in the US would be the most unwelcome of the possible scenarios. In theory, the ECB could attempt to ease monetary policy further but there are limits to what it can do within the toolkit of policies that it is willing to consider. In terms of fiscal policy, the NextGenEU grants will also help to provide some fiscal stimulus in the coming years but the reactivation of the EU's fiscal rules could see this counteracted.

Realistically, there are no modern examples of the US going into recession without there being a substantial negative knock-on effect on other leading economies. In most cases, these economies have also gone into recession. Given the potential global implications, there is a lot at stake in the US authorities hitting the right "landing point" for their economy over the next few years.

Figure 11: Total euro area HICP year-over-year inflation (blue line) and HICP inflation excluding food and energy (orange)



Source: ECB Statistical Warehouse.

Figure 12: 10-year US Treasury yield and 10-year euro area AAA yield

Source: Federal Reserve Bank of Saint Louis and ECB Statistical Warehouse.

REFERENCES

- Autor, D. et al. (2020). "An Evaluation of the Paycheck Protection Program Using Administrative Payroll Microdata". Available at https://economics.mit.edu/files/20094.
- Blanchard, O. (2021). "In Defense of Concerns over the $1.9 Trillion Relief Plan". Peterson Institute. Available at https://www.piie.com/blogs/realtime-economic-issues-watch/defense-concerns-over-19-trillion-relief-plan.
- Congressional Budget Office (2020a). "The Effects of Pandemic-Related Legislation on Output". June 2020. Available at https://www.cbo.gov/system/files/2020-09/56537-pandemic-legislation.pdf.
- Congressional Budget Office (2020b). "H.R. 133, Summary Estimate for Divisions M Through FF Consolidated Appropriations Act, 2021 Public Law 116-260". Available at https://www.cbo.gov/publication/56963.
- Congressional Budget Office (2021). "Estimated Budgetary Effects of H.R. 1319, American Rescue Plan Act of 2021". Available online at https://www.cbo.gov/publication/57056.
- European Central Bank (2021). "The initial fiscal policy responses of euro area countries to the COVID-19 crisis". ECB Economic Bulletin, Issue 1/2021.
- European Commission (2020). "Communication on the 2021 Draft Budgetary Plans: Overall Assessment". Available at https://ec.europa.eu/info/sites/default/files/economy-finance/dbps_overall_assessment.pdf.
- European Commission (2021). "European Economic Forecast, Spring 2021". Available at https://ec.europa.eu/info/sites/default/files/economy-finance/ip149_en.pdf.
- Haagensen, E. (2021). "American Rescue Plan (Biden's $1.9 Trillion Stimulus Package)". Available at https://www.investopedia.com/american-rescue-plan-definition-5095694.
- OECD (2021). "Interim Economic Outlook". Available at https://www.oecd.org/industry/ind/Item_4a_ECO.pdf.
- Probasco, J. (2021). "The Consolidated Appropriations Act of 2021: What's in It, What's Not". Available at https://www.investopedia.com/congress-agrees-on-second-stimulus-here-s-what-s-in-it-and-what-s-not-5093226.
- Sahm, C. (2019). "Direct Stimulus Payments to Individuals". Available at https://www.hamiltonproject.org/assets/files/Sahm_web_20190506.pdf.
- Summers, L. (2021). "The Inflation Risk is Real". Washington Post, May 24. Available at https://www.washingtonpost.com/opinions/2021/05/24/inflation-risk-is-real/.
- Whelan, K. (2020). "Monetary-Fiscal Interactions in the Euro Area: Assessing the Risks". Publication for the committee on Economic and Monetary Affairs, Policy Department for Economic, Scientific and Quality of Life Policies, European Parliament, Luxembourg. Available at https://www.europarl.europa.eu/cmsdata/214968/01.WHELAN_final.pdf.

The US has undertaken much larger discretionary fiscal packages than euro area governments, particularly in 2021. The large 2021 US fiscal package is likely to provide a welcome boost to the euro area economy. There is a risk, however, that US fiscal policy could lead to overheating of the US economy and a possible monetary tightening from the Fed which could trigger a recession. This paper argues this scenario is unlikely to occur but discusses the implications for the ECB if it did.

This paper was provided by the Policy Department for Economic, Scientific and Quality of Life Policies at the request of the committee on Economic and Monetary Affairs (ECON) ahead of the Monetary Dialogue with the ECB President on 21 June 2021.

PE 662.917
IP/A/ECON/2021-19

PDF ISBN 978-92-846-8148-8 | doi:10.2861/603052 | QA-03-21-259-EN-N