INSTITUTE OF INTERNATIONAL MONETARY RESEARCH

Analysis and insight into trends in money and banking, and their impact on the world's leading economies

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The Biden fiscal package:

How much does it matter? And how will it affect the US and global economies?

A presentation by Professor Tim Congdon CBE,

Chairman of the Institute of International Monetary Research,

in March 2021

A report in the Financial Times *on 17th March*

US to leave EU trailing in race to recover after pandemic

Wide variations in rescue packages and speed of vaccinations to affect bounceback

The Congressional Budget Office’s projections

- *Deficits*. At an estimated 10.3 percent of gross domestic product (GDP), the deficit in 2021 would be the second largest since 1945, exceeded only by the 14.9 percent shortfall recorded last year.

What do the Keynesians claim about fiscal policy?

- Fiscal policy – changes in government spending and taxation to influence the growth of demand (and so employment) – is far more powerful than monetary policy, which – according to some extreme Keynesians – can be downplayed or even ignored.
- Because of its power, a correlation should be expected between 'stimulatory fiscal policy' (i.e., an increase in the cyclically-adjusted budget deficit) and growth relative to trend. **When the budget deficit increases, the growth rates of demand and output are more likely to be an above-trend rate, i.e., the 'output gap' should become more positive.**

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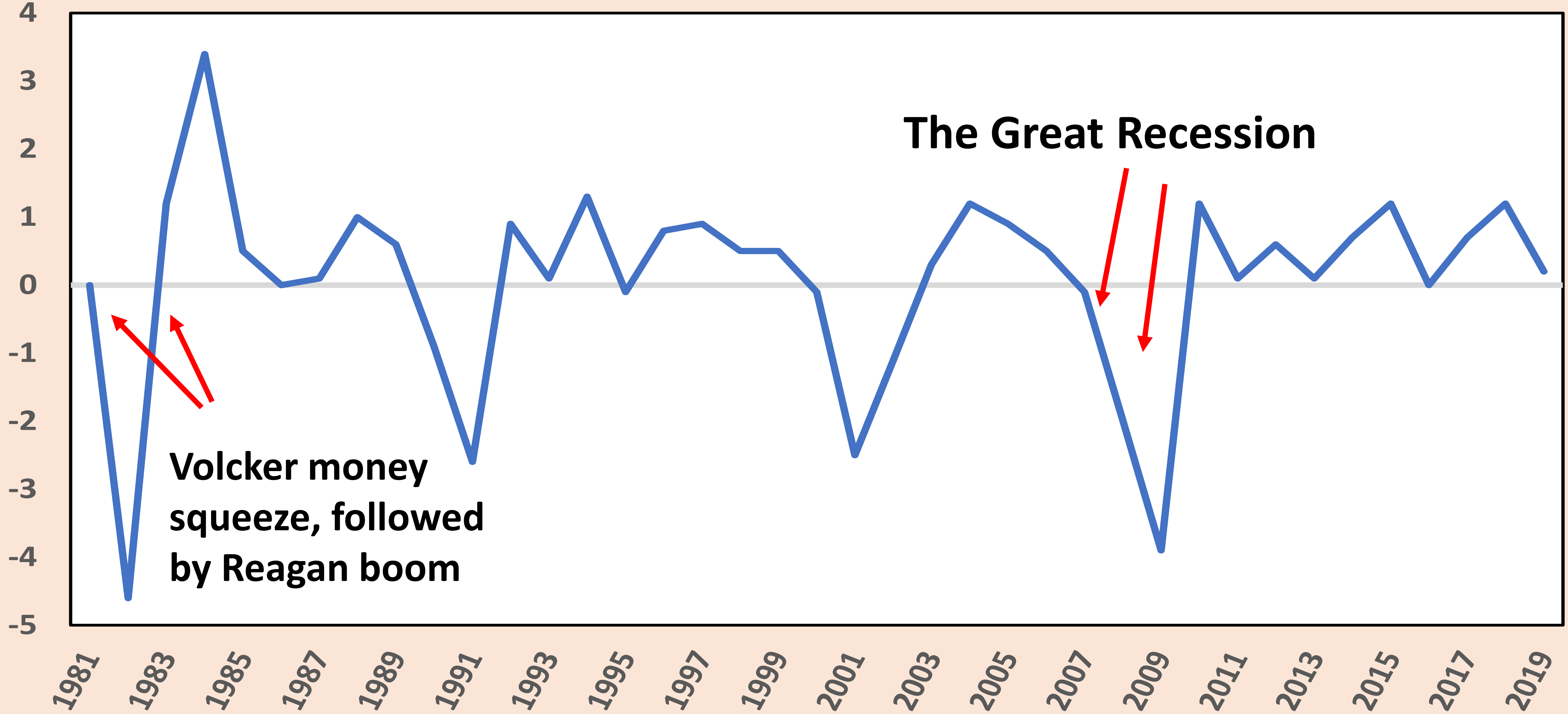
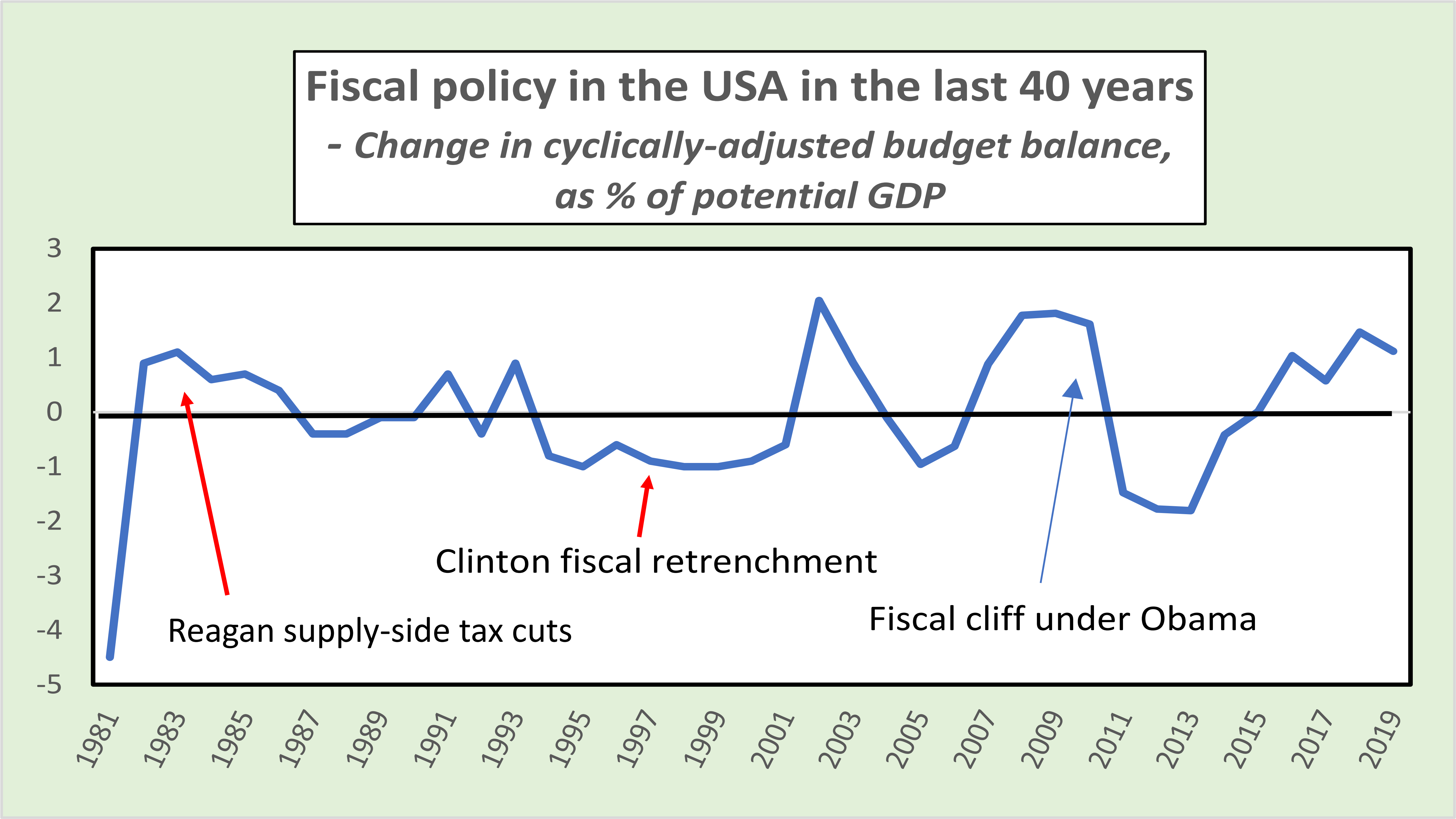
- **But is this actually true, when we check what happens in the real world?**

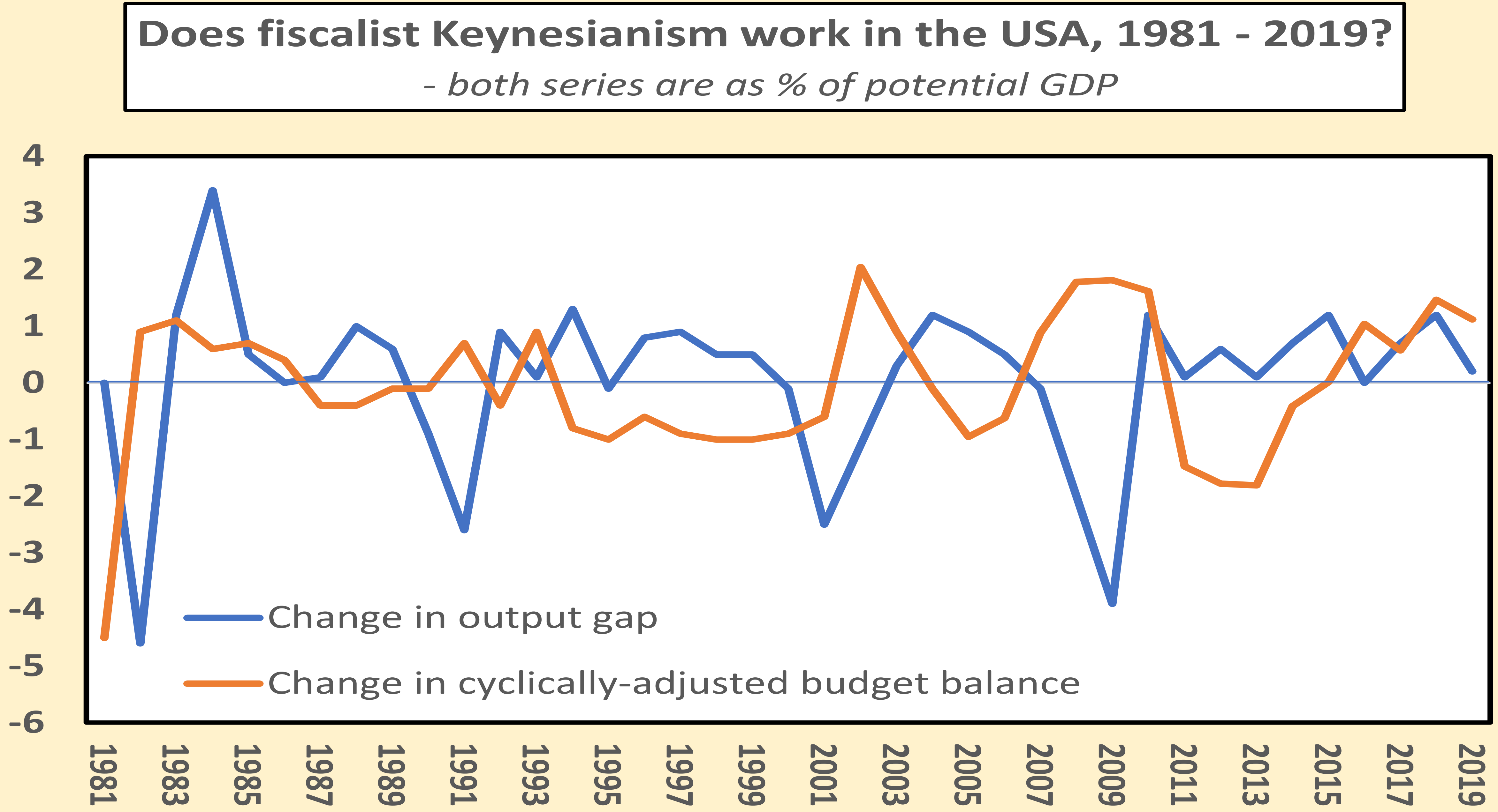
The American business cycle, 1981 - 2019

- change in output gap, as % of potential output





Fiscal policy in the USA in the last 40 years
- Change in cyclically-adjusted budget balance, as % of potential GDP
3
2
1
0
-1
-2
-3
-4
-5
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013
2015
2017
2019
Reagan supply-side tax cuts
Clinton fiscal retrenchment
Fiscal cliff under Obama


Does fiscalist Keynesianism work in the USA, 1981 - 2019?
- both series are as % of potential GDP
4
3
2
1
0
-1
-2
-3
-4
-5
-6
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013
2015
2017
2019
Change in output gap
Change in cyclically-adjusted budget balance

No clear relationship holds in the USA over the last 40 years between fiscal policy and the economy

- Sometimes – as with the Reagan tax cuts in the early 1980s – increases in the budget deficit are accompanied by above-trend demand growth, in line with the Keynesian textbooks.
- But at other times the relationship between changes in the budget deficit and demand growth is the opposite of that expected by the Keynesians.

- **The Clinton presidency had year after year of deficit reduction, and year after year of trend or above-trend growth in the US economy.**
- The 2013 and 2014 'fiscal cliff' certainly happened – and the growth of domestic final sales was slightly higher in 2014 than in 2013.

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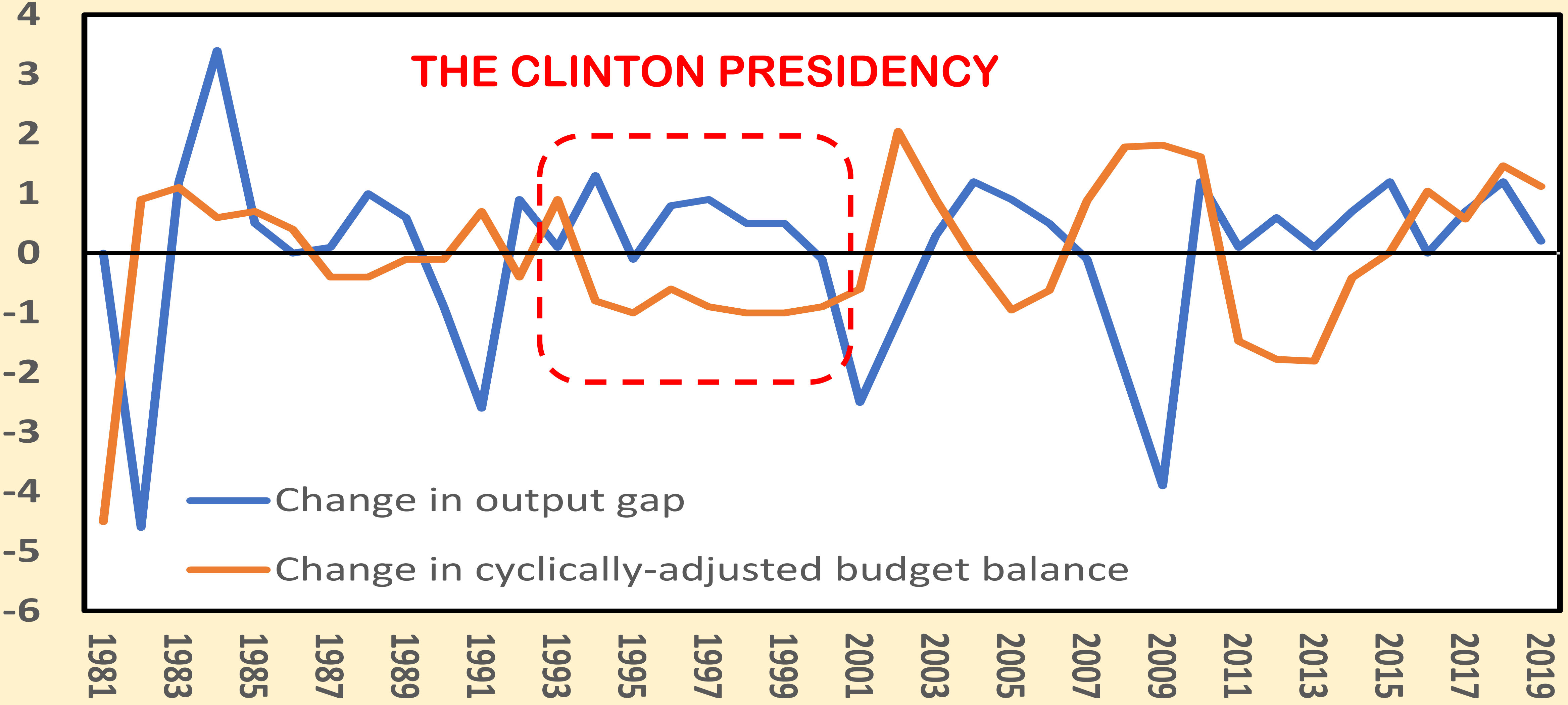

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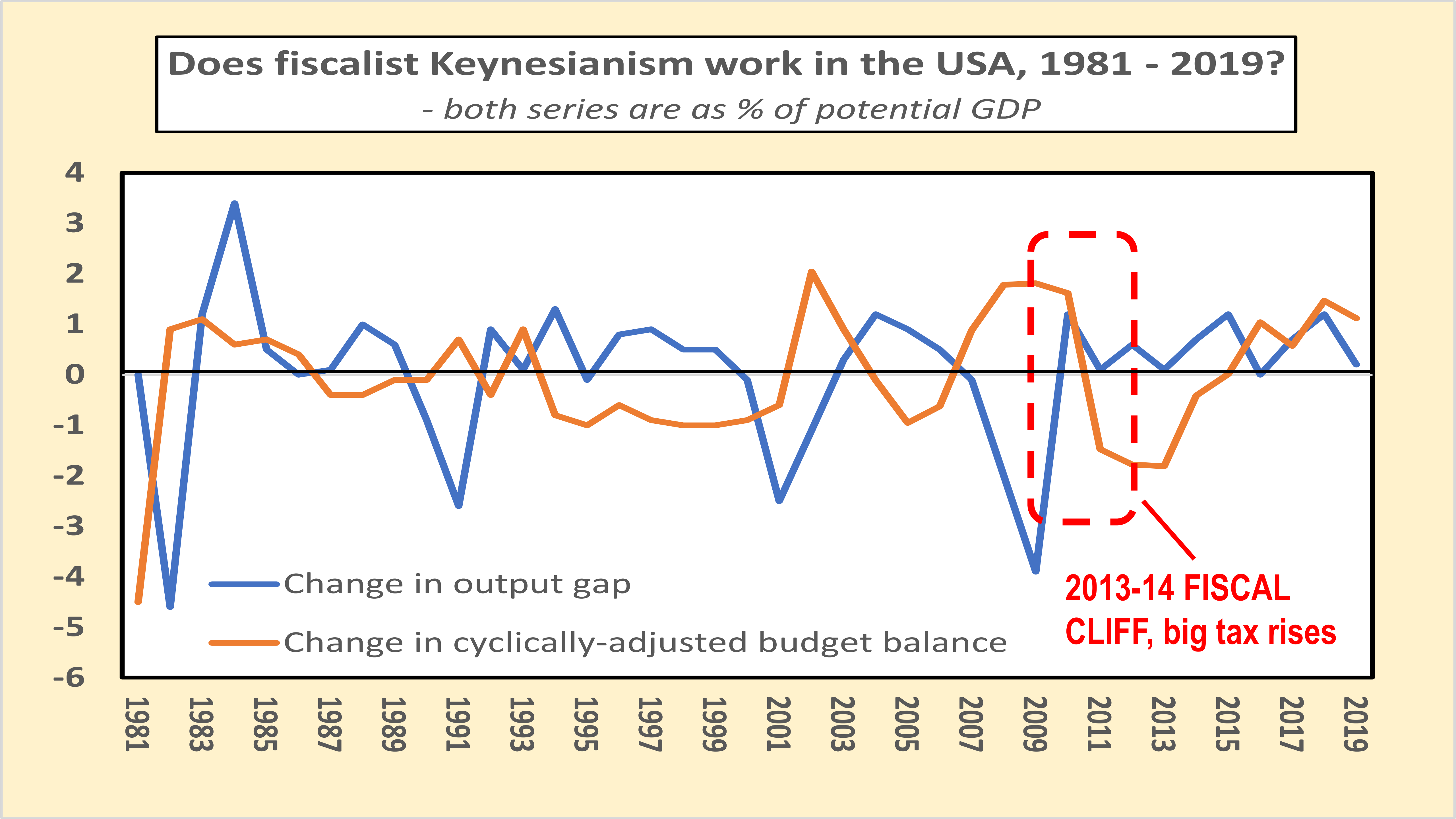
- **The 2013 and 2014 'fiscal cliff' certainly happened – and the growth of domestic final sales was slightly higher in 2014 than in 2013. Obama's 2nd term was just like Clinton's entire Presidency, tight fiscal policy and continuous trend or above-trend growth.**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- both series are as % of potential GDP
4
3
2
1
0
-1
-2
-3
-4
-5
-6
Change in output gap
Change in cyclically-adjusted budget balance
2013-14 FISCAL
CLIFF, big tax rises
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013
2015
2017
2019

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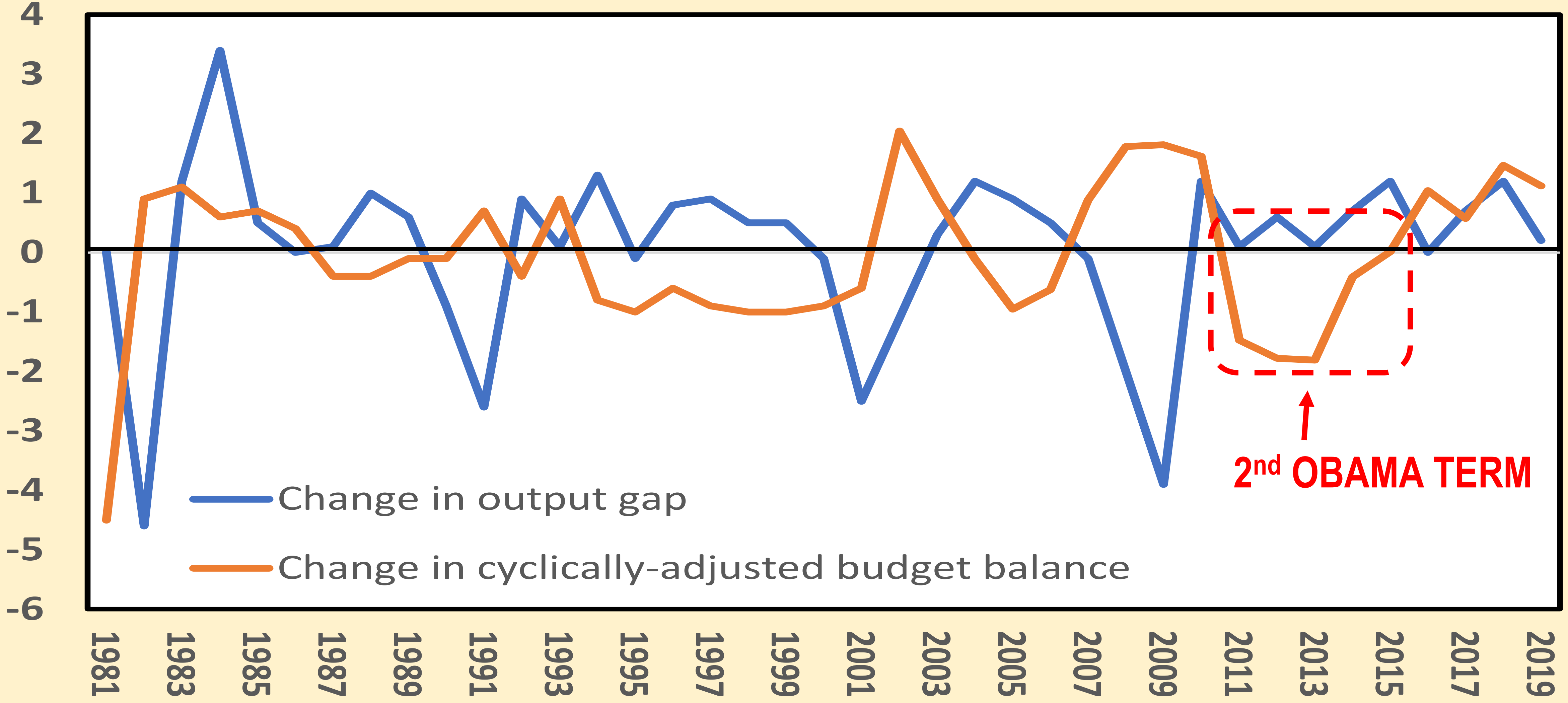

Why does fiscal Keynesianism fail? 1.

Various explanations:

1. The deficit has to be financed – and some methods of financing cause an offsetting reduction in private borrowing and/or expenditure. **('Crowding out',** an argument sometimes used by Milton Friedman of University of Chicago).
2. The deficit does not add to national wealth, because government bonds are not net wealth, i.e., extra government spending implies higher taxes in future to pay for interest on the debt, and people realize this and allow for it. (**The neo-Ricardian doctrine** associated with Robert Barro at Harvard.)

A report in the Financial Times *on 15th March*

FINANCIAL TIMES

Stimulus cash:

US retail investors expected to spend big portion of cheques on stocks

Why does fiscal Keynesianism fail? 2.

Money can be spent on *already-existing* assets. Transactions in assets are separate from transactions in the income-expenditure-output flow.

If someone uses a 'stimulus cheque' to help in ordering a new car, that boosts expenditure and output in the current year, as the car has still to be made. But, if he or she buys a second-hand car, that car has already been manufactured. *There is no addition to current year 'aggregate demand' or national output.* By the same logic, if Americans 'spend a big portion of cheques on stocks', *there is no addition to current year 'aggregate demand' or national output* from that first-round decision.

Crucial question of how the deficit is financed

- If deficit is financed by the issue of bonds to non-banks, quantity of money does not rise…and neither do equilibrium national income and expenditure.

In recent decades US budget deficits have been mostly financed by the issue of bonds and their sale outside the banking system. That explains why the Clinton fiscal contraction and the 2013 'fiscal cliff' had effects so different from those expected by economists who believe the Keynesian textbooks.

- If the deficit is financed from the banking system (i.e., either the Federal Reserve or the commercial banks), the quantity of money rises…and, roughly speaking, equilibrium national income and expenditure also rise…and much of the time they rise more or less equi-proportionally.

In the Second World War, and again today the deficit is being financed mostly from banks, the quantity of money is rising rapidly…..

The financing of the deficit: the TGA drawdown

- A complication is that in 2020 the US government issued some Treasury bills and raised funds, but then did not spend the money. It let a large balance accumulate in the 'Treasury General Account' (i.e., the government's bank balance) at the Federal Reserve.
- Plans are for the TGA to be 'drawn down', i.e., spent, in 2021. That will add to the bank deposits (or money) held by the non-bank private sector.
- The TGA was over $1,500b. at the start of 2021. **An official announcement has been made that it is to be reduced to $500b. by the middle of the year. A $1,000 increase in bank deposits held by the non-bank private sector would add about 4% to the quantity of money.**
- The big banks don't want the cash deposits, as – bizarrely – they have to hold capital against cash, beyond a certain figure. The cash will go to the smaller banks…..

Conclusions - 1.: still rather fast US money growth ahead in 2021

- US budget deficit will be about **10% of US GDP in 2021**, compared with 15% in 2020.
- **The still very large deficit will be financed mostly at the short end, from the Federal Reserve and the commercial banks, and will lead – by itself - to rather high money growth.**
- An imponderable is the strength of bank credit to the private sector. If that regains strength in 2021, it will put further upward pressure on money growth.
- **US policy-makers are indifferent to money growth patterns and believe that the coming increase in inflation will be temporary.**

Conclusions - 2.: stronger US recovery in 2021 due to excessive money growth

- US recovery in 2021 will be stronger than that in the European Union, but that will be **due, above all, to**

- **Faster rollout of the vaccination programme, and**
- **Faster growth of the quantity of money in the USA than in the Eurozone.**

- The historical record shows that **fiscal policy by itself is ineffective**. But no one disputes that – if a large budget deficit is monetised and that leads to high money growth – the results will include buoyant asset markets and a period of above-trend demand and output growth.
- Unhappily, **high money growth also causes inflation**.