COVID Devastated the American Economy

Unemployment Level, millions of jobs

But Our Response Was Aggressive

COVID Money Tracker

Explore the data and track the trillions of dollars of federal spending, tax cuts, loans, grants, and subsidies authorized and disbursed in the wake of the coronavirus pandemic and economic crisis.

Tracking the COVID Response

- **Administrative Actions**: $0.8 trillion
- **Legislative Actions**: $5.2 trillion
- **Federal Reserve Actions**: $4.2 trillion

TRILLIONS OF DOLLARS

Amount Disbursed/Committed

Amount Allowed

$0  $1  $2  $3  $4  $5  $6  $7  $8
Our Response Supported the Economic Recovery

Sources: Congressional Budget Office, CRFB Calculations
But It Was Clearly Too Large

Effect of American Rescue Plan on Output, Billions

* Assumes policy begins in March and covers the final three quarters of 2021.
^ Based on prior multipliers used by the authors not reduced to account for higher inflation, greater savings, or supply constraints.

Sources: Congressional Budget Office, CRFB Calculations.
We Boosted Income Way Above Trend

**Annual Personal Disposable Income, Current Dollars**

- **Base Disposable Personal Income**
- **Base Unemployment**
- **Other COVID Relief**
- **Recovery Rebates**
- **Expanded Unemployment**
- **Paycheck Protection Program**

**Note:** Base Disposable Income includes market income, minus taxes, and regular transfers including Social Security, Medicare, & Medicaid.

Sources: Committee for a Responsible Federal Budget, Bureau of Economic Analysis.
Leading to Economic Overheating

Nominal Personal Consumption Expenditures (PCE) in billions

Sources: Congressional Budget Office, CRFB Calculations.
2021 Inflation Was the Highest in 40 Years

Percent Change, Q4/Q4

- **PCE Price Index**
- **Consumer Price Index (CPI)**

Fed 2% Flexible Average Inflation Target

Sources: Committee for a Responsible Federal Budget, Bureau of Economic Analysis, Bureau of Labor Statistics.
And Inflation Has Risen Further Still

Sources: Committee for a Responsible Federal Budget, Bureau of Labor Statistics.
Inflation Will Remain High in 2022

CPI-U inflation from Q4 of 2021 through Q4 of 2022 under different scenarios

Note: No Inflation assumes CPI remains at April levels, Target Inflation assumes 0.2 percent monthly inflation growth, and Trend Inflation assumes growth continues at the average rate of all months this year.

Sources: Committee for a Responsible Federal Budget, Bureau of Labor Statistics.
Inflation Will Remain High in 2022

PCE inflation from Q4 of 2021 through Q4 of 2022 under different scenarios

Note: No Inflation assumes PCE remains at March levels, Target Inflation assumes 0.2 percent monthly inflation growth, and Trend Inflation assumes growth continues at the average rate of the last three months.

Sources: Committee for a Responsible Federal Budget, Bureau of Labor Statistics
Will High Inflation Persist?

**Yes**
- Low real interest rates
- Delayed inflation (rent, M’care)
- $2.3T of excess savings
- $8T more housing wealth
- Tight labor markets
- Strong state & local finances
- New supply shocks (Ukraine)
- Wage-price spirals
- De-anchoring expectations
- Interest Rate-price spirals

**No**
- Aggressive rate hikes & QT
- Transitory deflation (cars, oil)
- Shrinking balance sheets
- Disappearing stock gains
- Growing labor supply
- ~$2T drop in federal deficits
- Supply chain fixes
- Shift from goods to services
- Anchored LT expectations
- Strong reaction to Fed forward guidance
Deficits Are Falling as COVID Relief Expires

Source: Congressional Budget Office
Interest Rates Are Rising as Fed Tightens

Sources: Federal Reserve, Congressional Budget Office
But People Still Have Plenty to Spend

Excess Savings as Measured by Increase in Savings Above Normal

$2.3 trillion excess savings (Mar. 2020 to Mar. 2022)

Sources: Jason Furman based on Bureau of Economic Analysis, Macrobond.
And Wage-Price Spirals Can Prolong Inflation

Higher Inflation Expectations; Lower Real Interest Rates

Too much money chasing too few goods

Higher Nominal Demand

More money to spend

Price increases

Higher Nominal Wages

Higher Input Costs

COLA raises & higher demand for labor*

Higher labor costs

*Inflation lowers real wages, increasing quantity of labor demanded. This boosts hiring, wages, job switching, etc.
Economists prefer monetary policy over fiscal policy for managing inflation and fighting recessions.

Furman & Elmendorf (2008) explain why for recessions:

- Monetary policy can adjust much more quickly
- Monetary policy can best judge timing and magnitude of needed intervention (economists > politicians)
- Fiscal policy is more likely to do long-term harm

Similar arguments apply for inflation – we want interest rate hikes, not tax hikes and spending cuts, to be the main tool for fighting inflation.
So What Is the Federal Reserve’s Plan?

The Plan:
1. Steadily raise interest rates to ~neutral rate (2.5-3.0)
2. Allow balance sheet to shrink by attrition
3. If #1 and #2 don’t work, raise rates further

The Problem:
- Raise rates too little, inflation persists
- Raise rates too much, recession emerges
- Raise rates just right, you might get both (stagflation)
Soft Landings Are Hard to Navigate

Federal Funds Rate

Red to indicate hard landing recession after interest rate rise
Blue to indicate soft landing after interest rate rise

Sources: Committee for a Responsible Federal Budget, Federal Reserve.
Economists recognize role for fiscal policy in recessions

Furman & Elmendorf (2008) explain why for recessions:

- Fiscal policy can reduce uncertainty of total thrust provided to the economy
- Fiscal policy is helpful when interest rates are constrained by the zero lower bound or policymakers want to support employment at a higher rate
- Fiscal policy has shorter outside lag – can work faster
- Fiscal policy may be needed when monetary policy is proving ineffective
We *should* recognize role for fiscal policy in inflation

When it comes to fighting inflation, we argue:

- Fiscal policy can reduce uncertainty of total thrust provided to the economy, anchoring expectations
- Fiscal policy is helpful when trying to avoid raising interest rates well above the neutral rate
- Fiscal policy and monetary policy together can spread and thus limit the “pain” from inflation fighting
- Fiscal policy can cut the cost of higher interest rates

Fiscal policy should *assist*, not replace, Fed policy
How Fiscal Policy Can Help Fight Inflation

- **Do No Harm** – End COVID relief, offset new legislation

- **Lower Health Care Costs to Reduce Prices** – Reduce excessive Medicare payments, lower drug costs

- **Cut Deficits to Reduce Demand** – raise taxes, cut and cap spending, impose user fees, increase premiums

- **Promote Work to Boost Supply** – repeal earnings test, improve work requirements, EITC for older workers, vocational rehab, etc.

- **Support Savings** – Savers’ match, “inflation bonds”

- **Enact Other Anti-Inflation Reforms** – energy, trade, government procurement, regulations, etc.
Project increase in prices from one year of ongoing student debt forbearance, sequester relief, and enhanced FMAP payments, in basis points

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<th>Without Fed Response</th>
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<td>90% Price Pass Through</td>
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<td>33% Price Pass Through</td>
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Source: Committee for a Responsible Federal Budget.
Lower Health Care Costs

- Enact Drug Pricing Reforms
- Reduce Provider Payments (Site-Neutral, Post-Acute)
- End Excess Medicare Advantage Payments
- Reform Cost-Sharing Rules
- Raise Premiums (Means-Tested?)
- Restore “Cost-Sharing Reduction” Payments
- Restrict Medicaid Provider Tax Loopholes
- Limit Health Care Tax Preferences
Do Whatever Else You Can

- Cap discretionary spending, cut mandatory spending
- Raise revenue, especially from upper middle class
- Pursue mechanical price reductions – lower procurement/infrastructure costs, cut tariffs
- Boost supply where you can, don’t expect much
- Support savings where you can, don’t expect much
- Don’t worry (too much) about multipliers, we need the deficit reduction regardless
The National Debt is Headed to Record Levels

Note: “Alternative Fiscal Scenario” assumes extension of individual tax cuts in the TCJA, extension of expiring tax credits in the ARP, extension of various tax extenders, and discretionary spending growing at the rate of GDP. Sources: Congressional Budget Office and Committee for a Responsible Federal Budget.
And Inflation is Higher Here than in Europe

Graph from Jason Furman

Note: Pre-pandemic trend based on log-linear regression of Jan-2018 to Dec-2019. HICP (EA, France, Germany, US) and UK CPI seasonally adjusted using Macrobond.
Illustrating a Wage-Price Spiral

- Higher Nominal Demand
  - Monetary Stimulus
  - Fiscal & Monetary Stimulus

- Higher Input Costs
  - Higher Nominal Wages
  - Lower Real Wages

- Higher Inflation
  - Too much money for too few goods
  - Labor needed to produce goods & services
  - Price Hikes
  - More money to spend
  - Cost of living raises
  - Most costs are labor costs
  - Labor needed to produce goods & services

- Lower Real Interest Rates, Higher Inflation Expectations

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