US economy: overheating after the freeze?

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The $ 1.9 trillion spending package (or roughly 9% of GDP) that the Biden administration wants to push through causes a lot of ink to flow among economists because it may give birth to economic overheating. We review here the main stumbling blocks of the debate and the variables that have to be monitored with regard to the labor market.

Overheating: the key question of potential GDP and multiplier effects

The world of economists has been in turmoil since an op-ed written by Larry Summers, former Treasury secretary to Bill Clinton, in the *Washington Post* on February 4[1]. In it, he indicates that the $ 1900 bn spending package that the Biden administration wants to pass as early as March via a budget reconciliation procedure (for which a simple majority is required in the Senate) could lead the US economy to "overheat" in the second half of 2021. Details of the package are currently being worked out in committees of the House of Representatives and of the Senate.

Summers's fear, even as he praises the progressive nature of the Biden plan, is that it would be oversized. According to the latest CBO projections, real GDP in the US would be $ 250 bn below its potential[2] at the end of 2021 in the absence of this Biden plan. For Summers, the $ 1900 bn spending package would therefore push economic activity far beyond its potential, which would create two risks:

- *"There is a chance that macroeconomic stimulus on a scale closer to World War II levels than normal recession levels will set off inflationary pressures of a kind we have not seen in a generation",*
- It could hamper the ability of the Biden administration to make significant public investments afterwards (eg green investments).

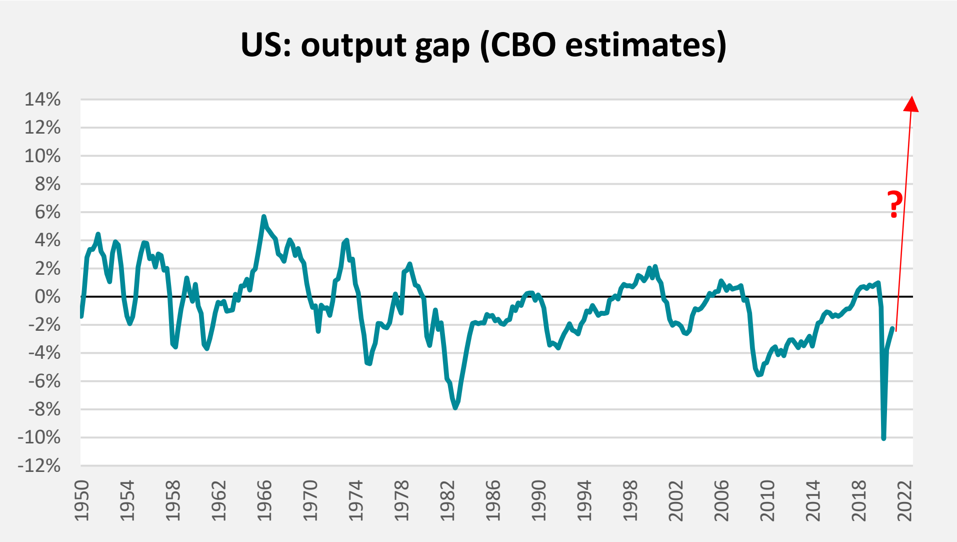
Former IMF chief economist Olivier Blanchard quickly made it known that he shared Summers' fears[3], adding that activity in 2021 would also be stimulated by the massive excess savings

[1] https://www.washingtonpost.com/opinions/2021/02/04/larry-summers-biden-covid-stimulus/

[2] The CBO defines potential GDP as the maximum output that can be achieved over a prolonged period without straining productive capacity and thus increasing the risk that inflation will rise above the Federal Reserve's goal.

[3] https://twitter.com/ojblanchard1/status/1358122330329927680

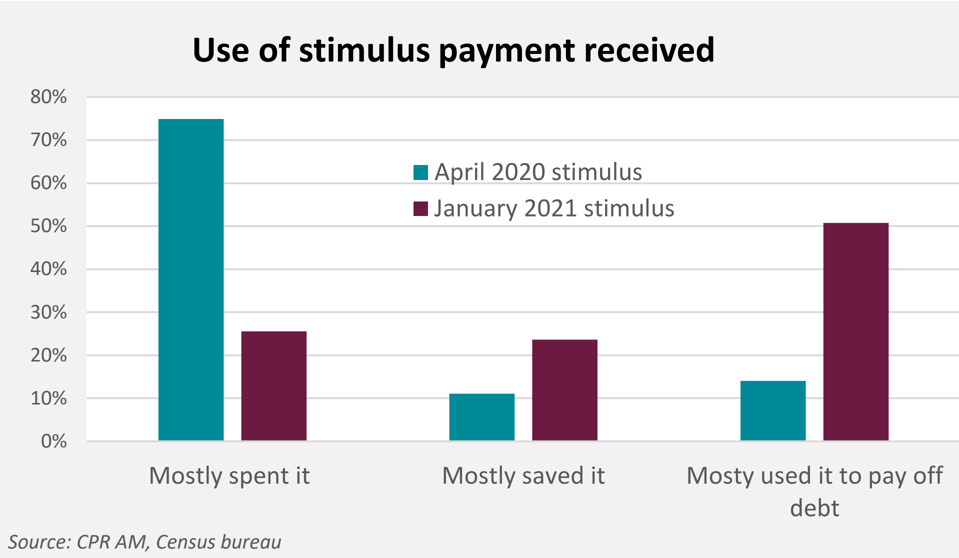
accumulated by households in 2020 ($ 1600 bn more saved by households compared to 2019). For Blanchard, assuming a multiplier effect of 1 for the Biden plan and assuming that half of the 2020 excess savings is spent in 2021, GDP could be 14% above its potential. To have an idea of the scale of the matter, just consider that the output gap, that is to say the deviation of the GDP from its potential, has been at most 6% since 1950 ... For Blanchard: "*It would take the unemployment rate very close to zero. This would not be overheating; it would be starting a fire.*"



Source: CPR AM, Datastream.

Summers and Blanchard therefore argue for a more limited spending package, but they both acknowledge that there is considerable uncertainty, both on the estimate of potential GDP[4] and on the effect the plan will have on the economy. It could be that the potential GDP is higher than what is generally estimated today but also that a significant part of the Biden plan, for example direct payments to households or the unemployment benefit supplement, would be saved. After all, a *Census Bureau* survey indicates that $ 600 checks paid directly to households in January 2021 (as part of the $ 900 bn plan adopted in December) would have been "mostly spent" in 26% of cases, "mostly saved" in 24% of cases (the share is higher for wealthier households) and "mainly used to repay debts" in 50% of cases[5]. By assuming multiplier effects much lower than what Blanchard suggests and more in line with what has been observed historically, Wendy Elderberg and Louise Sheiner[6], two economists from the Brookings Institution, estimate that the output gap could reach at most +2.4%, which would still be the highest level for half a century. That said, their simulations do not take into account a possible use of the excess savings accumulated in 2020.

[4] In a note from 2016, the ECB acknowledged that the different methodologies resulted in output gap estimates ranging from -6 to -1% ... ("How large is the output gap in the euro area").
[5] By the way, it is remarkable that the results of this survey are very different from those carried out after the checks were sent in April 2020, in which three quarters of the recipients indicated having used the money received to consume.
[6] https://www.brookings.edu/blog/up-front/2021/01/28/the-macroeconomic-implications-of-bidens-1-9-trillion-fiscal-package/



Paul Krugman is on a different line than Summers and Blanchard[7]. He defends the large size of the Biden plan because for him it is necessary to incur all the expenses necessary to win the "war" against the virus, even if it means taking the risk of accelerating inflation. Krugman does not deny the fact that the Biden plan could lead to a significant overheating of the US economy (that is to say an activity so strong that unemployment would drop very sharply) but he downplays the risk of an acceleration of inflation in large part because the Phillips curve, which links the rate of inflation and the rate of unemployment, has become very flat in recent decades[8].

In fact, the topics of potential GDP and of multiplier effects of government spending, and even that of the Phillips curve, are among those that economists are generally very humble about. Recall, for example, that Blanchard himself wrote in 2013 that the IMF, of which he was chief economist, had underestimated the multiplier effects when the institution recommended plans for fiscal consolidation during the euro zone crisis[9].

Ultimately, despite all the uncertainties about the economy's reaction to the Biden plan, the magnitude of the latter means that we cannot rule out the risk of an acceleration in inflation in the second part of 2021. Summers says moreover quite rightly: “*Stimulus measures of the magnitude contemplated are steps into the unknown.*” Jason Furman, an economist close to Biden, says much the same thing: "*If there's no risk of overheating, then we're doing too little*."

What is the situation in the labor market?

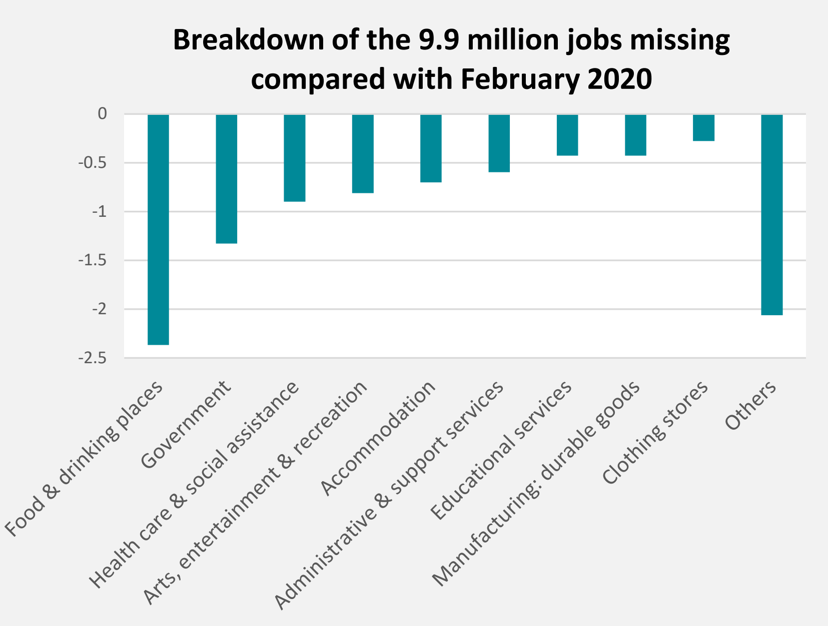
Surprisingly, current debates about the possible future overheating of the US economy do not mention the current state of the job market. However, a possible acceleration in inflation would come from such an improvement in the labor market that companies seeking to recruit (to cope with excess demand) would offer higher wages and pass this on to prices. For this reason, it is useful to know where the job market is.

[7] https://www.nytimes.com/2021/02/07/opinion/covid-biden-economy-stimulus.html
[8] https://paulkrugman.substack.com/p/stagflation-revisited
[9] Blanchard O. et D. Leigh, 2013, « Growth forecast errors and fiscal multipliers », *IMF working paper*.

In the United States, the shutdown of the economy in March / April (in the majority of states, lockdown measures were only put in place during the month of April) destroyed 23.4 million jobs. But as early as May and the lifting of health restrictions, a good part of those who had been placed on temporary layoff ("furloughed") could come back to their previous job**. In January 2021, 55% of the jobs lost in March / April had been re-created and 9.9 million were still missing compared to February 2020. The breakdown of the missing jobs shows that they are concentrated in the sectors the most affected by the crisis:**

- A quarter of the missing jobs come from bars and restaurants (2.4 million fewer jobs compared to February, or 20% of jobs in the sector),
- 1.3 million comes from government jobs,
- 0.8 million comes from the arts, leisure and entertainment sector (or about a third of jobs in the sector),
- 0.7 million comes from the hotel industry (or about a third of jobs in the sector),
- 0.4 million comes from education services (or 11% of jobs in the sector).

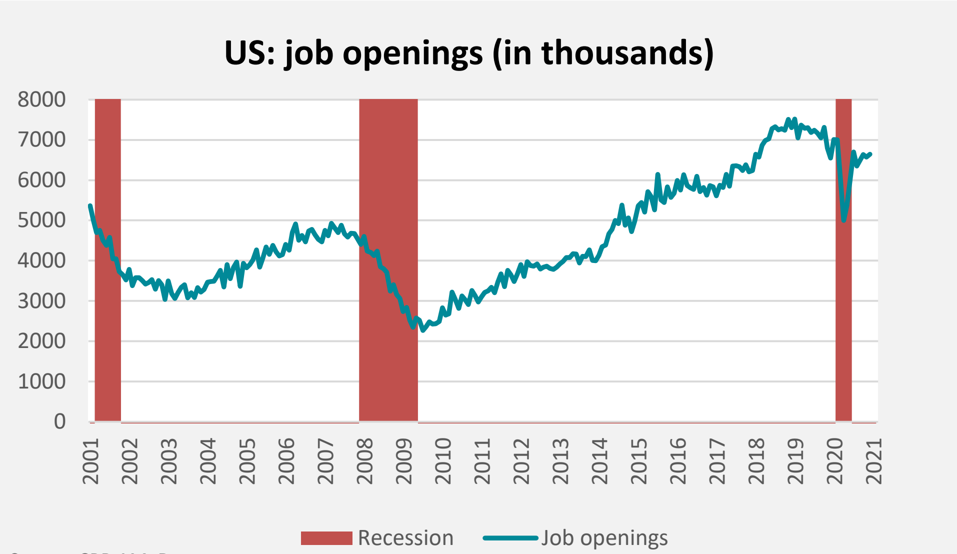
The aid that will be provided to local authorities (states, cities) by the Biden plan should "bring back" quite easily a little over a million jobs. In addition, it is not forbidden to think that job creation should be strong during the year 2021 once the vaccine is rolled out a bit more and once the restrictions on bars, restaurants, gyms, cultural venues and schools will be lifted. Obviously, all the jobs lost in these sectors cannot be found because a number of businesses will have disappeared.



Source: CPR AM, Datastream.

It therefore seems fairly clear that the job losses caused by the crisis are largely concentrated in certain sectors (hotels, restaurants, education, art / leisure / entertainment) and that the other sectors are ultimately not doing so badly. At the January Monetary Policy Committee, Jerome Powell explained that FOMC members were surprised by the significantly weaker than expected impact on the economy of the 2nd and 3rd waves of covid (this summer and since this fall, respectively). Their diagnosis was that outside the affected sectors, the economy had "adapted" to the virus.

In fact, excess demand may exacerbate the tensions already present in some sectors. Indeed, the number of vacant positions has fallen only slightly compared to before the covid crisis and a significant proportion of SMEs indicate that they have difficulty filling one or more positions (this share has probably never been so high at the end of a recession). Even during and after the 2020 recession, US SMEs say their most pressing problem is "quality of work". A fiscal shock of the magnitude of the Biden plan would be exceptional in itself, but it would be even more so if you take into account that US companies already have great difficulty in recruiting.



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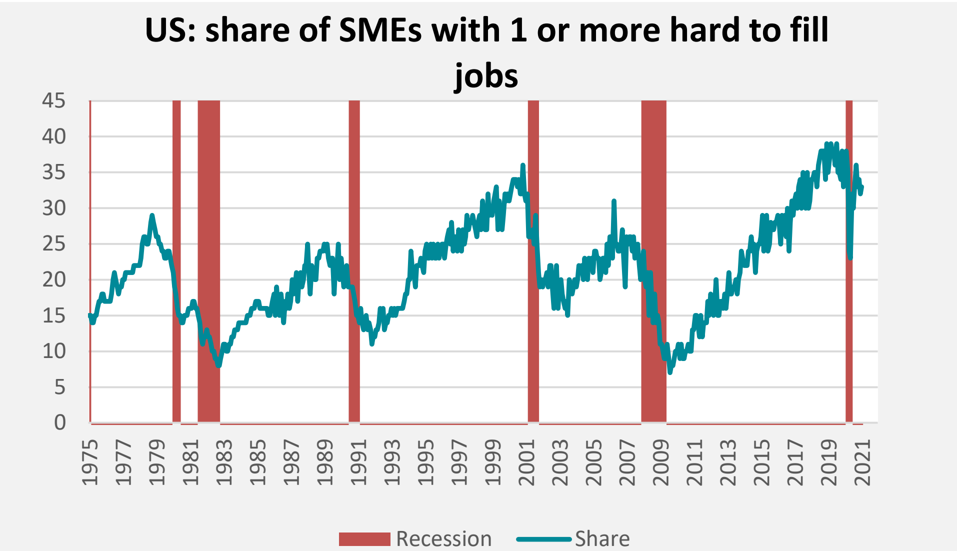

Source: CPR AM, Datastream.

Ultimately, the very likely adoption of the $ 1900 billion Biden plan should mean that the US economy will find itself clearly above its potential at the end of 2021, even if the extent of the overheating is particularly difficult to assess. The current debate seems to obscure the fact that this fiscal shock is occurring in a context where many companies are already having difficulty recruiting skilled staff. However, this will be a crucial element for the development of inflation in the second half of the year.

Published on February 16th 2021

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