Monetary Policy: Theory & Practice Assignment 1 : Biden's stimulus plan and inflation worries

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As a response to the COVID-19 pandemic which caused a severe surge in the unemployment rate in the US, new $1.9 trillion fiscal stimulus is prepared by Joe Biden administration, which is supposed to be split into different categories including $1400 stimulus checks (25%), aid to unemployed (19%) and others (Krugman, 2021). Summed up with the previous fiscal perk of $900 billion, which took place in December'20, this makes up $2.8 trillion, which is significantly higher than any of the rough estimates of the output gap in the US (4.2% or $900 billion, according to Blanchard (2021)).

On the one hand, stimulus is needed for the US economy, which suffered a peak of unemployment (14.8% in April 2020) and a second shift in the GDP's potential level trajectory after GFC of 2008, which is clearly seen from the FRED (2021) statistics. On the other hand, excessive fiscal support may lead to the 'overheating' of the US economy and its transition to the inflationary zone. This is exactly what Blanchard (2021) is concerned about, underlining that inflation burst provoked by consumer spending of stimulus checks and government purchases might force Federal Reserve to tighten its monetary policy by increasing interest rates, which, in turn, will probably cause economic downturn. Of course, final result heavily depends on multiple factors like consumers' marginal propensity to consume (MPC), their propensity to save after the pandemic, and many others. However, even modest approximations of these variables show that the Biden's stimulus will be excessive (Blanchard, 2021).

Still, there are economists like Gagnon (2021) who state that this fiscal move will have only short-term (several years) influence on inflation and compare it to the economic activity and inflation growth during the Koran War in early 1950s. In addition, Krugman (2021) states that insufficient stimulus 'today' will cause sorrowful economic opportunities (investment in infrastructure, etc.) 'tomorrow'. This side of the debate supposes that the possibility of inflation surge is overestimated and there are little hurdles to worry about, given modern attentiveness of the Fed.

In my opinion, things are much more complex than proponents of the Biden's current fiscal policy think. Firstly, final outcome strongly depends on the fiscal multipliers, which is clearly shown by Blanchard (2021). MPC is not a constant for sure and differs significantly within the social layers of people with different income levels and life conditions (MPC

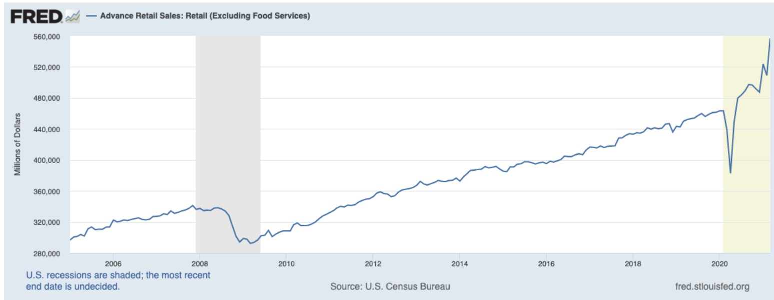

Figure 1: Advance Retail Sales: Retail (Excluding Food Services).
Source: Federal Reserve Bank of St. Louis

probably has a mixture distribution). Thus, precise econometric models and latest data are needed to make a good forecast of GDP and inflation levels after the introduction of fiscal stimulus. Secondly, US economy already shows signs of 'overheating', which can be tracked in advance retail sales data (FRED, 2021) (Figure 1).

If this proxy of economic activity in US is robust, there is a reason to have inflation worries. To my mind, one way forward could be splitting initial $1.9 trillion stimulus into smaller, not necessarily equal, tranches and distribute them across broader time horizon (5-10 years) in combination with punctual inflation targeting policy of the Fed.

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