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Research & Strategy Insights

Keynesians vs. Keynesians

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Key points

- The debate between Lawrence Summers and Paul Krugman on the risks stemming from Biden's fiscal stimulus is all but an obscure academic dispute. The questions they raise are key to the trajectory of long-term interest rates in the US.

Keynesians were fairly united when they were in the policy wilderness, but now that their views are dominant and they can finally seize the levers of macro policy, dissent is emerging. Lawrence Summers is taking issue with Biden's USD1,900bn emergency stimulus. His concerns are twofold: first, that it may be too big and exert enough pressure on capacity to trigger an acceleration in inflation which would ultimately force the Fed into an early and potentially recessionary tightening; second, that it could kill the chances of a medium-term public investment programme which the US needs to lift potential growth. Paul Krugman disputes that closing the output gap faster would necessarily beget inflation, and considers that, even if that happened, it would not necessarily be a bad thing for the Fed.

Your humble servant confesses his admiration for both economists, who both make compelling cases. But taking sides is probably unavoidable in this dispute which may shape the economic debate for some time.

That the Biden's plan, unless it is significantly shrunk to pass Congress, can close the US output gap by the end of 2021 is very plausible. However, this overheating phase is likely to be short, and given the decline in trend inflation over the last 15 years we don't think this can easily trigger a lasting shift in the consumer price regime. For this to happen we continue to think that the institutional set-up of the labor market would have to change. Given the opposition of two moderate democratic Senators to tagging the hike in the minimum wage to 15 dollars to the fiscal bill, such risk is for now probably under control. However, if a lasting acceleration in inflation were to materialize, we think the consequences for the Fed could be quite problematic and that the risk of inappropriate monetary policy, either too tight or too loose, would be significant.

This is why we continue to think that the Biden stimulus is consistent with a further rise in US long-term interest rates. By the middle of this year, it will be difficult to know whether the mechanical rebound in inflation is the signal of something more structural or not. But market focus will be on the Fed. Either the Fed complies with its pledge to accept inflation overshooting and continues to "talk dovish", thus allowing market-based inflation expectations to continue rising; or the Fed gets impatient and starts "talking hawkish", thus making real interest rates rise. In both cases, nominal yields would probably rise.

The doubts of Summers

Lawrence Summers' op ed in the Washington Post **expressing his concerns about Biden's fiscal stimulus came as a surprise but is an important signal**. He took the helm of the Keynesian school with his quite persuasive "secular stagnation" narrative a few years ago, advocating a big push in public investment as the main instrument to re-start innovation and productivity, taking distance from the "neo-Keynesian" synthesis and its focus on monetary policy as the main tool of intervention on aggregate demand. That he – a government official during the Obama administration – would take issue with Biden's USD 1,900 bn stimulus carries weight. Summers has refined his initial Op Ed with a written follow-up as well as in a webinar organized by Princeton University on Friday at which he was opposed to fellow-Keynesian Paul Krugman, who himself took the pen to express his support to Biden's plan. Summers' view can be roughly summarized around two pillars.

First, Summers is concerned that the government ow the central bank's target with only a moderate slowdown in activity and a minor **is doing too much, raising the risk that inflation would flare up**, forcing the Fed into contractionary policy. In his view, the Fed has never been able to find the right dosage when tightening. Fine-tuning a "soft landing" where inflation would return bel rise in unemployment has always eluded the Fed. Monetary tightening is a hammer, not a chisel.

Second, Summers is uncomfortable with the content of the fiscal stimulus, with its focus on short-lived transfers, without any significant contribution to re-starting public investment. This chimes of course with his "secular stagnation" narrative. His concern is that the 2021 fiscal stimulus kills the chances of a comprehensive effort on infrastructure and the green and digital transition, either because the inflationary backlash would force the government into giving up on its medium-term public investment platform, or because Biden would have spent too much political capital on getting his emergency package through. This second pillar mixes traditional macroeconomic issues with some "political economy" concerns.

Making sense of the figures

Let's start with the first pillar. We see two distinct sub-issues there: i) whether Biden's stimulus could really trigger an inflationary shock; ii) what would be the Fed' reaction if that happened.

The inflation risk can be assessed within the neo-Keynesian model. The key mechanism there is the relationship between capacity utilization in the economy and consumer prices. If the central bank is credible and inflation expectations are well-anchored, observed inflation can exceed the central bank's target only if the economy is overheating, i.e. if under-utilisation has been fully absorbed and the output gap is turning positive (actual GDP is then above its potential level). The question then is how the Biden package would speed up absorption.

Before getting into the complicated business of finding the right parameters for the future trajectory of US GDP, a first issue is to get the starting point right. According to the latest projections of the Congressional Budget Office, in Q4 2020 the output gap stood at -3.0% (i.e. actual GDP was 3% below potential GDP). Output gaps are not observed. They are estimated with many assumptions and should be handled with care. However, a cross-check with directly observed indicators which should be good proxy for the state of under-utilisation – in Exhibit 1 we use the employment rate – confirms the message. **The level of capacity under-utilisation in the US economy at the end of last year is similar to where it was upon exiting from the Great Recession of 2008-2009.**

Then, under a no-change scenario, i.e. without the Biden package, the CBO expects the output gap to close only at the beginning of 2025. This is in line with past recessions. In 1990, 2001 and 2008 the US economy took about 4-5 years to plug its output gap. Edelberg and Sheiner, two economists with the Brookings Institution produced a very thorough analysis of the impact of the Biden package, according to which *"by late 2021, we would likely see the economy operating above its maximum sustainable level. That positive output gap would likely put upward pressure on inflation".* **The package would thus accelerate the normalization of the US economy very significantly relative to the usual pattern**. They are however very candid about the considerable uncertainty surrounding their computations. As usual, the choice of the multiplier – by how much an extra dollar of fiscal spending lifts GDP – is key, and theirs looks quite high to us at 1.2, even if they discuss it in detail and take the precaution of assessing each component of the Biden package separately.

Exhibit 1 **– Back to 2010**

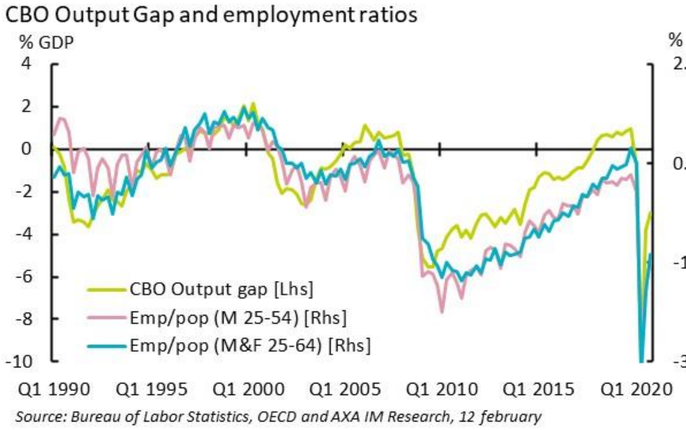
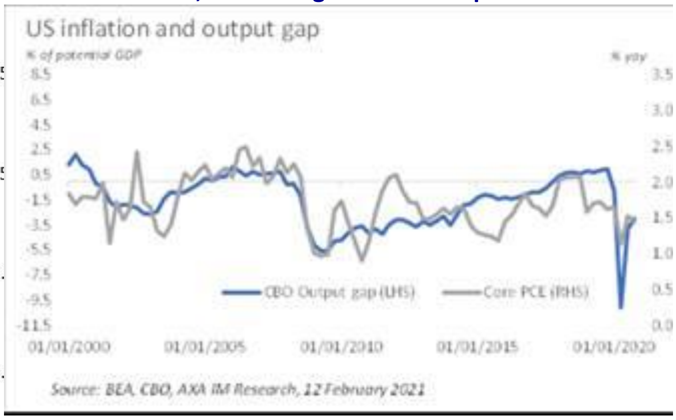


Exhibit 2 - **Decent, but not tight relationship**



Rather than coming up with our own multiplier, we prefer to think about this "in reverse". Assuming the economy would completely stall without the Biden package (which is very unlikely unless one posits the continuation of the pandemic-related restrictions for the whole year), **a multiplier of only 0.5 on the USD1,900bn programme would suffice to close the output gap by the end of this year**. Indeed, the distance between Q4 2020 GDP and where potential GDP should be in Q4 2021 at the 1.8% growth rate assumed by CBO would stand at USD 950bn. 0.5 would be at the low end of available estimates for multipliers, and again, the assumption for GDP growth we use here in the absence of stimulus is probably too low. **We therefore consider it likely that, indeed, the additional fiscal stimulus as it is currently structured would bring the economy to "overheating" territory towards the end of this year.**

Interestingly, in his rebuke of Summers, Krugman did not directly dispute this point. His view however is that i) it is not obvious that closing the output gap would re-start inflation and ii) even if it is, what's the big deal? We think the latter point is far too dismissive and address it in the penultimate section, but the former one is in our view a strong one.

The Phillips curve is not dead, but it's wounded

Let's go back to why monetary policy has lost its shine. From a technical point of view, it's obvious: central banks are "up against the zero limit" for policy rates, so that additional stimulus is possible but complicated (quantitative easing is an imperfect substitute to rate cuts). But why have they got there? Essentially because even under decent cyclical conditions and an easy monetary stance, inflation was stubbornly below target. The question Krugman is asking boils down to "why should it change just now". Exhibit 2 suggests that in the US the relationship between the output gap and inflation is decent but cannot be considered as tight, and crucially that **the output gap had been in positive territory for two years before the pandemic while inflation – measured here with the core PCE favoured by the Fed – fell again below 2%.**

The Phillips curve – linking inflation to capacity utilization – has been refined a long time ago by taking into account lagged observed inflation as a proxy for inflation expectations. A robust result of the econometric literature is that over the last 15 years, the impact of lagged inflation on current consumer prices has been rising. In other words, adaptative behaviour is rife in developed economies. Low current inflation begets low inflation expectations, feeding back into current price setting mechanics, e.g. via wage bargaining.

A key issue to consider here is for how long the economy would overheat. Edelberg and Sheiner's results point to a large positive output gap by the end of 2021/beginning of 2022, but this would be quite short-lived, since most of the measures contained in the plan are either one-offs (the "cheques" to individuals) or time-limited and dependent on the cycle. For instance, by construction if the economy improves very fast, the federal unemployment benefits top-up will not spend the entirety of its envelope. In the Brookings' economists trajectory, *"with the $1.9 trillion package, we project that real GDP would grow robustly in 2021, contract slightly in the middle of 2022, and then grow modestly in 2023"*. For the acceleration in inflation in 2021 – which will occur anyway given the disappearance of some one-offs from last year – to last, we suspect cyclical conditions, and in particular the speed of the decline in unemployment, would need to stay in overheating territory for longer than what the Brookings' economists estimate. Adaptative expectations are slow to move.

What comes next

However, in Biden's plan his USD 1,900 bn package would not be the end of fiscal activism. It would be followed by the investment plan which Summers has been calling for, which we have quantified in a previous Macrocast at about 2% of GDP every year. Could this create expectations of a quasi-permanent fiscal support which over time would send the economy into a new inflation regime?

Biden's investment programme is however quite different in nature from the emergency stimulus. First of all, it is supposed to be fully offset by higher tax. This would suggest that it would trigger some multiplying effect on the US economy, since this US administration is planning to raise tax on the wealthiest only, who have a lower propensity to spend, but the aggregate multiplier would probably be quite low. Second, in the medium run the investment programme is likely to lift potential growth, thus blunting the inflationary effect the investment splurge would have through aggregate demand.

We think the main risk to price stability would not come from the medium-term fiscal plan but from Biden's wage policy. We have argued before that given how our economies have been accustomed for more than 30 years to low inflation, it would probably take a change in our institutional set-up to decisively take the inflation regime up. Just before the festive break we argued that some aspects of Joe Biden's strategy, in particular his proximity to the labour movement and his general fondness for the pre-Clinton Democratic framework, with its focus on blue-collars, could over time bring about a "paradigm shift" towards a more regulated labour market, conducive to significant pay increases. From that point of view, **the temptation to tag onto the stimulus bill the rise in the federal minimum wage to USD15 per hour (a campaign promise of Biden) is a concern for u**s. This could be the signal which would finally re-ignite cost-push inflation in the US. **That risk however seems to be kept in check. Indeed, two moderate democratic Senators, Manchin and Sinema, have explicitly criticized this idea**. Manchin has been broadly supportive of the stimulus so far, and he expressed his interest in a small hike in the minimum wage (to USD11) but as things stand today, it seems that the US administration won't be in position to trigger a substantial shock on low skilled pay. Again, we remain on the lookout on this theme given Biden's overall policy preference, but this issue may not be for immediate consumption yet.

The ghost of Feds past

In a nutshell, we are not overly concerned over the risk of a lasting inflationary flare-up. However, if this risk were to materialize, we would not share Krugman's relaxed approach about the consequences it would have on monetary policy and, down the road, on economic stability in the US.

Krugman's starting point is that some acceleration in consumer prices is precisely what the Fed wants to see. And indeed, this is why the US central bank has launched its Average Inflation Targeting strategy last summer. Yet, Krugman takes another step: higher inflation would allow the Fed to rebuild some policy space (i.e. moving policy rates up) after allowing for the promised overshooting. Yes, of course this would allow monetary policy to regain some capacity to fine-tune the cycle in the future, relieving fiscal policy, but conflicting stances (in this case, dovish fiscal and hawkish monetary) do not look particularly attractive.

This is where debt accumulation needs to be taken into account. After allowing some overshooting, presumably the Fed would have to be quite aggressive with its tightening to avoid a permanent shift upward in inflation expectations. The effect of such a rise in policy rates, triggering an increase in market real interest rates coming on top of higher inflation expectations to push nominal long-term yields significantly higher, could be more detrimental than usual to corporate willingness to spend given their higher level of leverage post-pandemic, which would be likely to grow further during an inflation overshooting phase given the Fed's inaction on financial conditions. Beyond the possibility to trigger a larger-than-needed contraction in economic activity, the Fed could well also take into consideration financial stability concerns – for instance a systemic default risk – and hesitate to normalize monetary policy fast enough.

There is at least one historical precedent of such "hesitation" in a context of divergent policy stance: the Fed's reaction to Lyndon B. Johnson's fiscal push in the second half of the 1960s. The US budget deficit was rising because of the cost of the Vietnam war and Johnson's massive increase in social programmes under his "big society" platform. Fed chairman William Martin initially responded with a monetary tightening in 1965, but gradually the central bank moved towards an accommodative stance, allowing inflation to creep higher (4.5% in 1966 and 5.75% in 1969, up from an average at only 1.5% between 1952 and 1965. A 2016 paper by the Richmond Fed goes into some details about the policy conflict and suggests that this episode was the root cause of the more spectacular policy rout of the Fed in the 1970s culminating in 2-digit inflation.

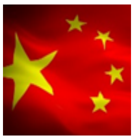
There is a symmetric policy risk to "hesitation": time inconsistency. Inflation reacts to the output gap with a lag, which itself is often the lagged product of policy action. The Fed could "lose patience" and forget about its promise to look through an inflation overshooting amid strong but transitory positive signals on both inflation and the real economy, and engage in tightening exactly at the time the impact of the fiscal push would fade. This would create one of those situations described by Summers where the central bank would have been unable to deliver a "soft landing" of the economy.

Political economy and market interest rates

This discussion of monetary policy is key for us, because it explains why we think US long-term interest rates still have some space to rise (1.5% by year-end for the 10 year yield was increasingly consensual in sell-side research a few weeks ago and we see it creeping towards 1.75%) . Indeed, **while we elaborated on why we think that the risk of a lasting upward shift in inflation is limited, we also think that in the coming months the market debate will be increasingly focused on the possible materialization of such risk**, between the US administration pushing for a large stimulus – even if we still think Biden will have to shrink it to get it through Congress – and the Fed maintaining a very dovish communication, as it is in a way "trapped" in its Average Inflation Targeting strategy. A variant of this debate would emerge if the hawks within the FOMC were to get more vocal and the market would start pricing in "early tapering". In the first case, nominal yields would move up pushed by inflation expectations. In the second case, it's the pressure from higher real rates which would lift the curve A few months of stronger inflation prints, on account of the reversal of the one-offs from last year, would be another ingredient in this "higher yields" brew.

If we are right and ultimately the fiscal stimulus has too short a life-span to trigger a lasting upward shift in the inflation regime, then towards the end of the year/beginning of 2022, yields could fall back after a flare-up in the summer, but even with the help of foreign investors – attracted by the interest rate differential with the rest of the world – we think the trough in long-term yields is firmly behind us (unless a catastrophe occurs on the pandemic front and the expected rebound in 2H 2021 fails). The genie won't be fully put back in the bottle.

This gets us back to Summers' political economy point on the content of the fiscal programmes. We think there are two reasons which may make it more difficult than expected to get the investment programme Summers is calling for to defeat "secular stagnation". First, between the impact of the economy reopening, giving way to a spectacular recovery in 2H 2021, and the effect of the emergency stimulus, the macro situation may look a bit "too good" at the beginning of next to convince a majority of the Senate to support another fiscal splurge, however necessary it may be from a potential growth point of view. Second, the proponents of the big public investment plan are losing one of their key arguments: the fact that the US should seize the opportunity of historically low interest rates to take on debt which, in the long-run, may be self-financing.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Trump impeachment trial starts. 67 Senate needed for conviction seen as unlikely, although Mitch McConnell suggested a "conscience vote" • $1.9tn stimulus could be delivered by reconciliation, more broad-based doubts emerge • CPI inflation edged higher to 1.4%, in part on gasoline, core CPI dropped to 1.4% from 1.6% • Jobless claims revised higher, latest week 793k • Consumer sentiment remained lacklustre proving virus cases	• FOMC minutes, likely the key channel of communication for balance sheet changes, but taper talk "premature" for now. • Retail sales for January will give first clues to scale of consumer spend expected in Q1 • Industrial production for January to add to Q1 GDP outlook • Philadelphia and Empire State manufacturing surveys for February • Continuing decline in new virus cases
	• Germany extended the lockdown by four weeks to 7 March and set a tougher new target for easing (7-day incidence of 35 vs 50 before) • Italian 5SM members voted to support a government by Mario Draghi • IP dropped by 0.8%mom in France, remained unchanged in Germany	• February Flash PMIs to remain broadly unchanged • Final January inflation data and second estimate of EA Q4 GDP • Official vote of confidence on Mario Draghi government to take place on Tuesday
	• Q4 GDP +1.0%, better than expected. GDP for 2020 -9.9% overall – worst since 1709. Q1 2021 expected at -3.5%, +4.6% for 2021 as a whole. • Cases continue to fall back, 1st dose vaccinations rose to 13.5mn, delivering >2mn/week to 10/2 • RICS housing survey (Jan) saw sharp drop in new buyer & seller activity pre-Stamp Duty reversion	• Retail sales (Jan), we expect -3.7%mom based on -1.3%yoy total BRC survey • Last public finances release (for Jan) before the 3 March Budget • Preliminary PMIs for February following sharp falls in January • Continued virus cases retreat and vaccines
	• Bank lending is flat at 6.1%yoy • The February IPSOS-Thomson Reuters household confidence survey surprised on the upside at 35.8 from 34.8. • Jan Economy Watchers poll fell to 31.2 from 35.5	• Private consumption, capex and exports have probably bolstered Q4 GDP growth • Jan trade should be robust but distorted by some frontloadings before the Chinese NY • After reaching a through in Dec (-1.2%yoy), CPI should improve slightly to -0.9%.
	• Strong aggregate financing in January – rising yoy and similar to post-lockdown March boost. • CPI fell to -0.3%yoy from +0.2%, despite PPI inflation rising to +0.3% from -0.4%. • Lunar New Year, welcome year of the Ox	• Lunar New Year holiday continues • 1yr Medium-term lending rate expected to be left unchanged at 2.95%
	• Preliminary Q4 GDP yoy fell 3.4% for Malaysia and 2.2% in Indonesia. 2020 GDP at -3.1% growth for Poland at -2.8% implying Q4 contraction. • Central banks on hold in India, Philippines, Russia and Peru, while Banxico cut O/N rate by 25bps to 4% on the back of large output gap. • Ecuador first round of presidential election voting appears very tight rising odds for street protests.	• CB meetings: Indonesia, Turkey, Taiwan • Jan CPI in Poland, Saudi Arabia, South Africa, Angola, Israel, Nigeria • Q4/2020 preliminary GDP: Colombia, Thailand, Hungary, Singapore, Peru

Upcoming events		
	US:	Tue: Empire State survey (Feb), TIC data (Feb), Weds: Retail sales (Jan), PPI inflation (Jan), Thu: Philly Fed index (Feb), jobless claims, housing starts (Jan), Fri: PMIs (Feb, p), Existing home sales
	Euro Area:	Mon: EZ IP (Dec), Tue: EZ GDP (Q4), Ecofin meeting, Ge ZEW survey (Feb), Fr unemployment (Q4), Thu: EZ consumer confidence (Feb, p), Fri: Ez, Ge, Fr PMIs (Feb, p)
	UK:	Wed: CPI and PPI inflation (Jan), Fri: Retail sales (Jan), public finances (Jan), CBI Industrial Survey (Q1), PMIs (Feb, p)
	Japan:	Mon: IP (Dec, f), Tue: trade (Jan), machine orders (Dec), Weds: CPI inflation (Jan), Fri: PMI (Feb, p)
	China:	This week: 1yr lending facility rate (Jan)

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