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Global Economic Outlook After COVID-19

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UNIVERSITY of ROCHESTER

The Economic Recovery from Covid

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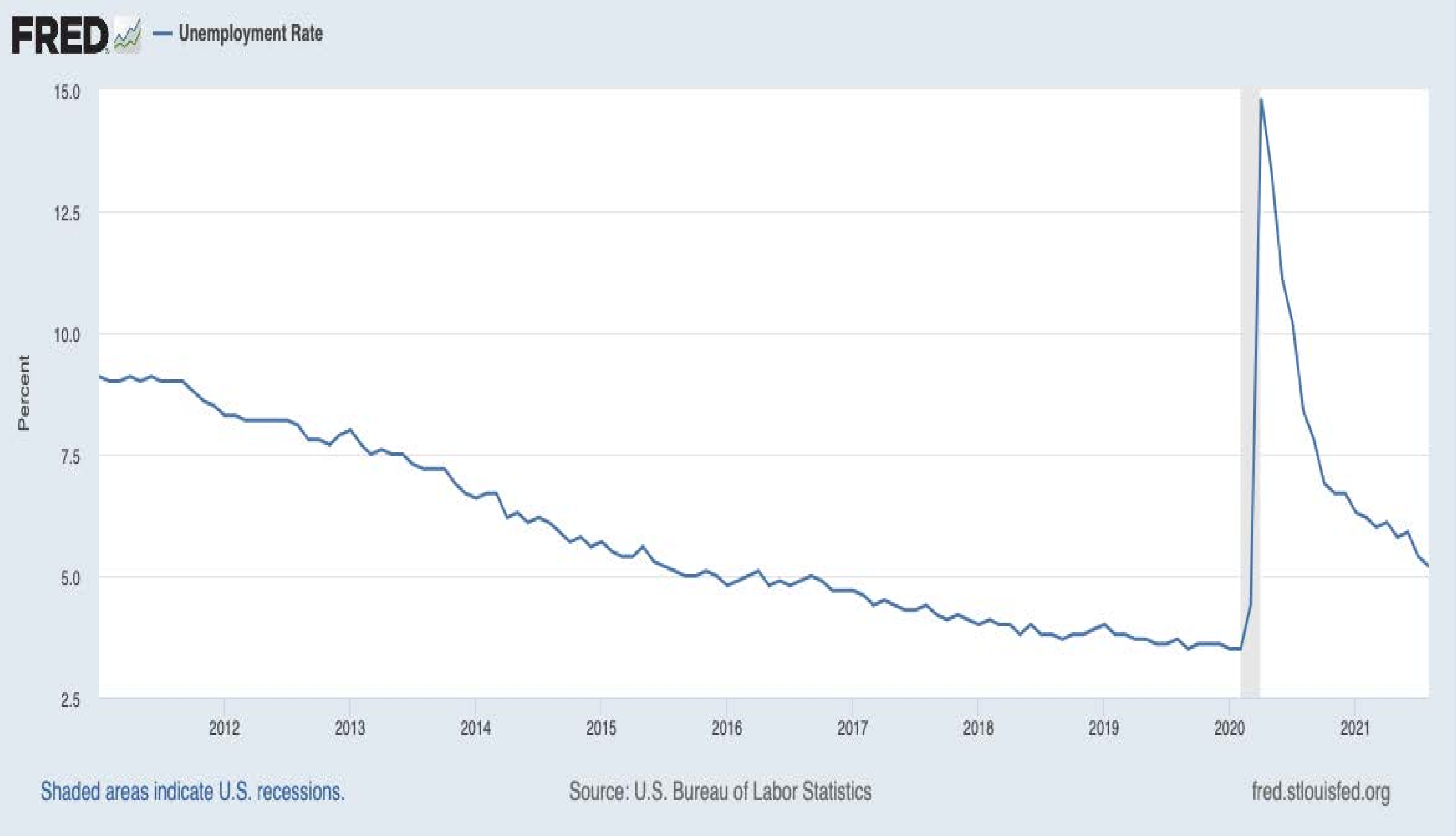
Main Messages

- The recovery has in many ways gone surprisingly well.
- But inflation has been surprisingly high.
- If it stays high, the Federal Reserve might have to raise interest rates sharply …
- And that interest rate hike could threaten the recovery.

The Recovery So Far

Unemployment Rate

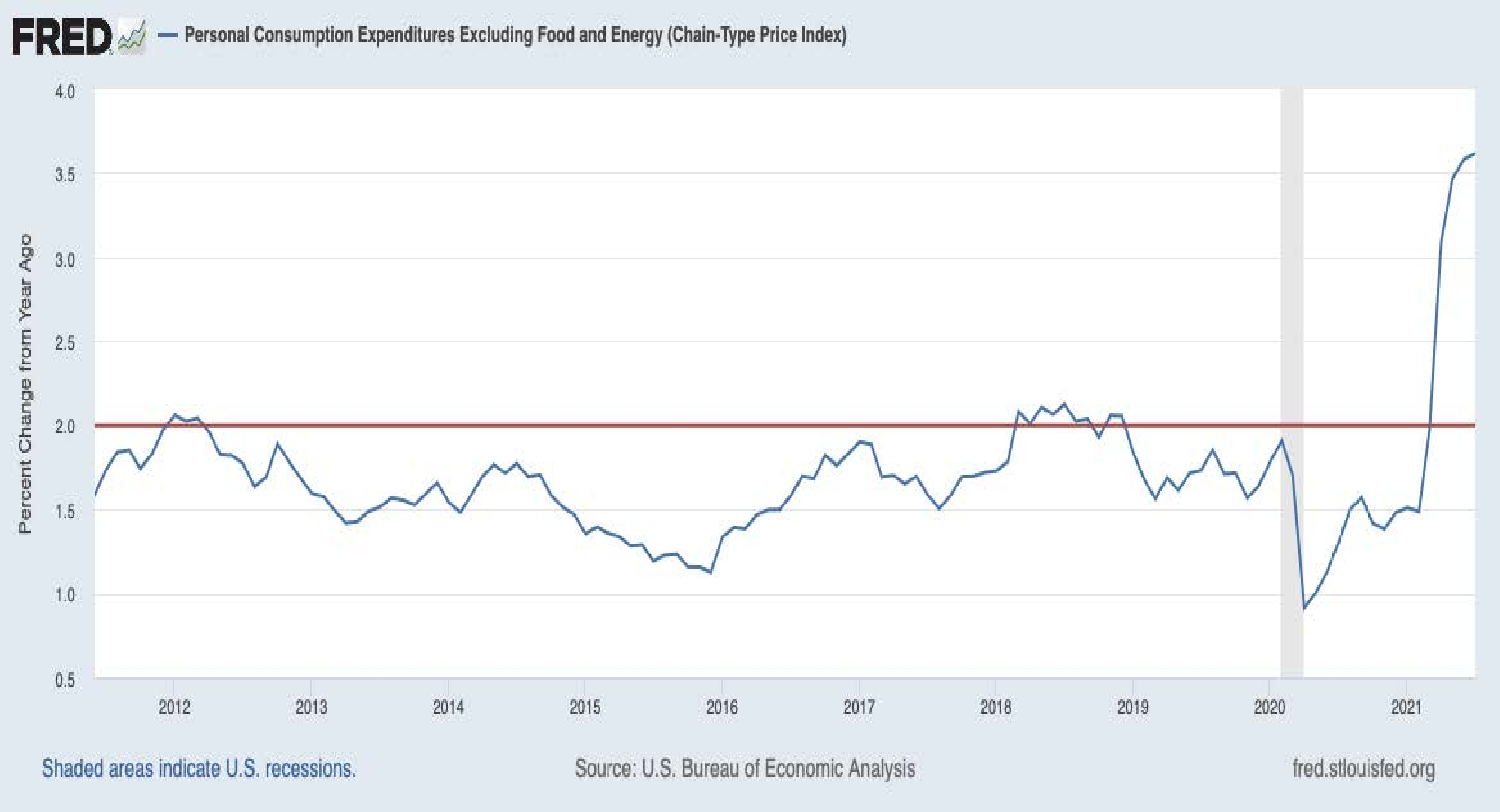


The Inflation Surprise

Inflation during the Recovery

- The Federal Reserve makes monetary policy for the US.
- It aims to keep inflation (that is, the annual rate of price increases) at 2%.
- As of **June 2020**, the Fed expected that inflation would be **1.5%** at the end of 2021 (**well below target**).

What Happened?



Surprise!

- In the last recovery (2010s), inflation never rose much above 2%.
- In this recovery, (core PCE) inflation has spiked up **to 3.5%.**
- It has not been this high in **over 30 years.**

Why is Inflation So High?

- Some of the (many) possible drivers …
  - bottlenecks in supply chains
  - Super-heated increase in demand for a few goods.
- **Most of these factors seem transitory.**

The Big Questions for the Recovery

Inflation and the Fed

- Will inflation stay this high in 2022?

- If so, will the Fed feel compelled to raise interest rates rapidly (to cool off price growth)?

  – And how would such a rate hike affect unemployment/growth?

GOVERNMENT SPENDING AND FINANCE

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Government Spending

One way economists look at the economy is to examine who buys our goods and services:

- Total expenditures within the economy can be divided among the various groups who are spending: Consumers, Businesses, Government, and Foreigners
- If the government consumes more of the output within the economy, then given our overall productive capacity, spending by these other groups must be reduced
- In principle, an optimal level of government spending should be at that level where our collective valuation of the benefits of the spending by the government equals the value of those things that other groups would have to forego

Government Spending

Now one area where most economists and political scientists point to where government spending is likely to be valued most highly by our citizens is on infrastructure.

- In this sense, the President’s proposal to spend over a trillion dollars on new infrastructure seems quite reasonable
- But before we get too giddy, take a look at the details of specific things that are in the “Infrastructure Bill”—In addition to roads, bridges, and internet connectivity, there are a number of items of good old-fashioned pork
- In addition to the “bi-partisan infrastructure bill” there is another multi-trillion “Democrat-only” spending bill with even more pork

Government Spending

- Although most of the debate has been at a fairly high level of abstraction about the benefits of various government spending proposals, the critical aspect missing from these discussions is what the rest of the economy (consumers and businesses) are going to give up – have “crowded out” – by this unprecedented level of government spending

Government Financing

Ultimately, the government can pay for its expenditures in three basic ways:

(1) Taxes, (2) Borrowing, and (3) Printing Money

- Personal taxes reduce what economists refer to as “disposable income” thus reducing the resources consumers have to spend
- Borrowing by the government competes with borrowing by individuals and businesses – more borrowing by the government “crowds out” private borrowing (A high priority of the current Congress is increasing the debt ceiling)
- Printing money essentially involves the Federal Reserve buying government bonds

The Growth in the Money Supply

When the Federal Reserve purchases Government Bonds, it injects additional reserves into the banking system

- Because banks only have to hold a fraction of their deposits as reserves, primarily in the form of banks' deposits with the Federal Reserve, an increase in reserves leads to a larger increase in the money supply
- An increase in reserves by $1 leads to a greater than $1 increase in the money supply – this is what economists refer to as the money multiplier

The Growth in the Money Supply

- Increases in the money supply generally lead to increases in prices – inflation
- Higher inflationary expectations have some profound consequences
  - Long-term contracts – employment contracts, building contracts, supply agreements, etc. – anticipating higher future prices will lead to higher current prices (or the inclusion of escalator clauses)
  - Higher inflation expectations reduce the anticipated value of loan repayments and thus lenders demand higher promises interest rates on loans
- If interest rates increase, banks face higher costs of holding excess reserves, this increases the money multiplier, further increasing the money supply
- For those thinking that can't happen here, I have two words: Jimmy Carter

Taxes

I fully expect that the Biden administration will raise taxes: Personal income taxes, Corporate profits taxes, Estate taxes – to name the big targets

- Last week Democrats announced that they were going to raise tax rates on people with income over $400,000 and propose a new "soak the rich" tax – a 3% surtax on individual income above $5 million
- House Democrats are looking at a 26.5% corporate tax rate, up from 21%.
- Biden has promised to raise the estate tax

Taxes

Let me start with the corporate profits tax.

- Most economists who study public finance think that this is a bad tax – it distorts incentives and leads to a misallocation of resources in the economy
- One implication is that it makes US businesses less competitive in the global economy and discourages domestic investment
- Economists continually debate who pays this tax.
  - Corporations can't pay taxes anymore than cars can pay taxes, or land can pay taxes or cows can pay taxes – ultimately, it's people who pay
  - Some economists argue that this tax is paid by stockholders, some argue it's the customers, some argue that it's the employees
  - In an interesting way, this explains its political popularity – if it's not clear who pays it, it's harder to form an effective coalition to object to it

Taxes

Taxing billionaires is a frequent populist proposal, one that they forecast will raise billions of additional tax revenue

- These forecasts are virtually always wrong
- The very wealthy regularly hire tax experts to devise ways to reduce their clients' tax bills
- And extremely wealthy individuals are among the most mobile people on the planet – people that other countries would love to count as citizens

Taxes

The Estate Tax is an odd tax – those assets that accumulate in one's estate typically have already been taxed, this provision taxes them yet again

- When my first child was born, the exclusion amount for the estate tax was $600,000 – an amount likely to be exceeded by my wife and myself.
- After it was raised several times, it currently is $10 million
  - If it stays at this level, I have no worries
  - But I expect that this exclusion amount will be lowered
  - The exclusion amount is currently at $10 million – It's not clear whether he will propose $1 million or $5 million or something between
  - He has suggested eliminating the "step-up" in basis in the current code


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