March 23, 2021

**AEI panel. March 24, 2021, on   
“The Biden stimulus, the Federal Reserve, and the everything bubble”**

**Opening remarks of 10-15 minutes, question to panelist Jeffrey Frankel:**

How likely is it that the Biden $1.9 trillion budget stimulus package will lead to an overheating of the US economy and to higher inflation?

1. Bottom line
   1. Very likely, if overheating is defined as GDP **>** potential.
   2. Much less likely, if it is defined as inflation above where the Fed wants it to be.
2. The multiplier logic.
   1. The basic logic in round numbers is simple, laid out dramatically by Summers in his *Washington Post* column Feb. 4.
   2. The Keynesian multiplier can be as high as 1.5 under recent conditions,
      1. in particular, when interest rates stay low.
      2. Of course, the Fed has pledged to keep short-term interest rates near 0 for several years (3, by last week’s dots plot)
   3. Call the multiplier 1.0,
      1. since most of Biden’s ARP is transfers, of which some will be saved,
      2. and since long-term interest rates may rise (the 10-year T-bond rate has already risen to 1.7%, up from 0.9% at the beginning of the year).
   4. 1.0 x $1.9 trillion = $1.9 trillion = 9 % of GDP
   5. GDP at the end of last year is estimated [by BEA and CBO] to be to be about 3 % below potential.
   6. **So a 9% boost would leave GDP an estimated 6% above potential** [=9%-3%].
3. Major counterargument: We may be underestimating potential.
   1. True, inflation did not rise much in 2018-19, when official estimates put output 1% above potential and unemployment fell as low as 3 ½ %.
   2. But I think a better explanation of that is a relatively flat Phillips curve.
   3. After all, inflation also didn’t *fall* very much during 2010-2014, even though output was still below potential.
4. Bottom line:
   1. Yes, likely that GDP will go abovepotential.
   2. But no, inflation next year is not likely to rise above where the Fed wants it.
5. To be sure, there are other possible downsides to such big fiscal expansion.
   1. Unsustainable national debt, if we allow for interest rates to rise. At least outside the US.
   2. If Fed succeeds in keeping interest rates low, it may prolong the “everything bubble.”
   3. The trade deficit will rise, which could exacerbate protectionism.
   4. Much depends on *how* the money is spent.
6. Biden is making sure that the country doesn’t **repeat the “mistake of 2009,”**
   1. when Obama’s $0.8 trillion stimulus was too little and too short-lived.
   2. I’m not sure that the mistake was Obama’s, since $ 800 b was the most he could get passed, given Republican opposition.
   3. But Biden is making sure that the country doesn’t repeat the mistake.