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The Biden Economy Risks a Speeding Ticket

By N. Gregory Mankiw

You are driving down a highway you've never been on before, eager to get to your destination. You're in a hurry but also want to avoid a ticket.

One problem: You don't know the speed limit. How hard do you push on the accelerator?

That is roughly the question facing the Biden administration and Congress as they debate the size of the next round of fiscal stimulus. They want to reach full employment as soon as possible. But if the economy accelerates too much, they risk a speeding penalty in the form of excessive inflation.

One thing a driver might do is recall similar highways she has been on before. If fiscal policymakers do that, some might decide against further stimulus. According to the Committee for a Responsible Federal Budget, the fiscal packages already in place, measured as a percentage of gross domestic product, are about a quarter larger than those enacted during the Great Recession of 2008. And they are being carried out much faster.

Another thing a driver might do is look at other drivers on the road. Again, by that standard, there is no clear need for more stimulus. According to Moody's Analytics, the fiscal packages passed in the United States in 2020 were, as a percentage of G.D.P., about as large as those in Japan and Australia and notably larger than those in Canada, France, Germany and Britain.

But maybe those other drivers are also wondering what the speed limit is. And maybe they aren't in as much of a hurry. Why not go faster than everyone else? After all, a rapidly moving economy benefits many people, especially those on the fringes of the labor force.

But there are still limits to how fast the economy can go. The economy's speed limit is called potential G.D.P. It measures the level of production of a maximally employed labor force. This occurs not when unemployment is zero but when it reaches a low, sustainable level. When the economy's production exceeds its potential, inflationary pressures start to build.

The U.S. economy is now operating below potential, but the question is by how much? The Congressional Budget Office publishes estimates of potential G.D.P. They’re not perfect, but they’re the best we have.

According to the office’s numbers, G.D.P. in the fourth quarter of 2020 was 3 percent below its potential. In dollar terms, that gap amounts to $666 billion at an annual rate.

How much fiscal stimulus is needed to close that gap? Because money spent by the government circulates through the economy and is often spent again, $1 of government spending can yield more than $1 of gross domestic product. A common estimate of this effect, known as the Keynesian multiplier, is 1.5, which means bringing the economy back to potential requires $444 billion of stimulus.

Fortunately, a lot of stimulus is already in place. The most recent coronavirus relief bill, signed into law at the end of December, was for about $900 billion. Its effects have not yet shown up in G.D.P. data.

On top of that is the pent-up demand from the pandemic. When people started avoiding restaurants, travel and inessential shopping last spring, the personal saving rate soared, and it has since only partly returned to normal. Much of that extra saving is sitting in liquid assets, ready for people to spend when it is safe to do so.

All of this is to say fiscal policymakers may have already pushed on the accelerator hard enough to bring the economy close to its speed limit by year’s end, when widespread vaccination is likely to have released much of that pent-up demand. Another $1.9 trillion, as President Biden has proposed, could push the economy well beyond the limit.

To be sure, some new federal spending may be needed for public health and for those experiencing hardship. But even spending that is targeted at disaster relief expands the demand for goods and services.

Beyond these necessary expenditures, there is not a strong case for more fiscal stimulus in general. The $1,400 checks for most Americans in the Biden proposal are going to many people who don’t need them. That item alone costs $422 billion.

Advocates for greater fiscal stimulus point out that estimates of potential G.D.P. are highly imprecise. Moreover, they say, when the economy exceeded potential in late 2019, there was hardly a whiff of inflation, so why worry now?

They are right about the imprecision, but some portents of inflation did appear in 2019. For the year that ended in the first quarter of 2020, the employment cost index for wages and salaries in private industry grew 3.2 percent, the fastest rate in more than a decade. Had that acceleration continued uninterrupted by the pandemic, businesses would have eventually passed rising labor costs on to consumers as higher prices.

In addition, while crossing a speed limit doesn't always lead to a ticket, racing past it often does. In 2019, G.D.P. exceeded its estimated potential by less than 1 percent, so inflationary pressures, if any, were weak. By contrast, when President Lyndon Johnson's "guns and butter" policy stoked inflation in the mid-1960s, output exceeded potential by about 5 percent. Mr. Biden's proposed stimulus could bring us back to that range.

Stimulus proponents argue that the Federal Reserve can deal with inflation by raising interest rates, which would slow spending. True, but it would be a mistake to put too much faith in the prescience and skill of central bankers.

When inflation got out of hand starting in the 1960s, it took until President Jimmy Carter's appointment of Paul Volcker as Fed chairman in 1979 to get things back under control. The cost of the disinflation was a recession in 1982, at the time the deepest economic downturn since the Great Depression of the 1930s.

Put differently, speeding is dangerous. The result can be not just a ticket but a crash.