Rogue One: the Fed and fiscal expansion

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Diario Expansión (España)

Last Wednesday the US Federal Reserve decided to increase the interest rate by 25 bps, as it had last done twelve months ago. This increase reflects the Fed's satisfaction with the performance of the economy and its confidence in its future improvement. In other words it represents a vote of confidence in the fact that the economy is close to full employment and that inflation will soon start to move towards the target 2%.

The Fed is also planning three rate hikes in 2017, one more than in September. This presupposes that economic growth in excess of the potential and an unemployment rate below its long-term equilibrium rate will not generate inflationary pressures.

However, given that the next administration plans strong fiscal expansion, the Fed might find itself forced to deviate from its plans and to opt for a more aggressive reaction.

The short-term impact of fiscal expansion will depend on how much growth it helps generate due to increased and improved use of resources. If the measures adopted are not very effective, there could be strong inflationary pressures. For example, tax cuts for families with low marginal propensity to consume, spending on inefficient industries or protectionist measures that reduce competition. The dilemma for the Fed will be whether to raise interest rates to contain inflation even when the economy is not growing at the pace hoped for. However, it is unlikely that it will allow inflation to increase beyond its objective, knowing as it does that this could be highly counter-productive if it were to damage its credibility. This environment could lead to friction between the Fed and the new administration.

Conversely, if there is substantial idle capacity and the measures adopted have high multipliers, such as expenditure on local and state infrastructure, fiscal expansion could lead to increased economic growth without necessarily generating inflationary pressures. In this case the Fed could raise interest rates unhurriedly and even support expansion in an environment of low interest rates and stable prices.

For the moment, the markets seem to be assuming a combination of both scenarios, i.e. measures from the new administration that will favour both increased growth and higher inflation. This would also be consistent with the fact that although there is some idle capacity, it must be limited.

In the industrial sector, utilised capacity is around five percentage points less than the average for the past 40 years. This implies that it would be feasible to increase manufacturing output by around US$60 billion without encouraging increases in inflation: it would represents just under 0.4% of GDP. Also, labour market indicators suggest that there is an opportunity to increase employment to levels that would favour an increase in GDP of between 0.3% and 0.7%. In this regard, people on part-time contracts who would prefer to work full-time, or people not currently looking for work but who have done so in the past and would like to work again, number between one and two million more than in previous growth cycles. This figure is consistent with a possible increase of two million people aged between 25 and 54 who are not in the labour force relative to levels before the 2008 crisis.

Nonetheless, even if some indicators suggest that there is an opportunity to increase the use of resources, it is difficult to argue that this is the best moment to implement an aggressive fiscal policy. Indeed, now that the economy is approaching full employment, a better option for fiscal policy is prudence, cleaning up and preparing so as to be able to react effectively when the next cycle starts. If this objective is not politically acceptable, then at least the fiscal measures should be aimed at having a medium- and long-term impact so as to boost economic growth through gains in productivity. This would help reach a higher and sustainable rate of economic growth and allow the Fed to go about normalising its monetary policy in a less uncertain environment.