Economic Policy During the Pandemic: How Can the Damage be Undone?
by Veronique de Rugy
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There is much that has been said about the terrible damage caused by the health policy response during the pandemic. From global lockdowns to mask and vaccination mandates to school closures, the data suggest that history will not look fondly on government officials and public health officials. Less talked about the damages done by the economic policies implemented during the pandemic. I will focus here on the United States.

Over the course of several Covid Relief bills, Congress and two presidential administrations authorized $5.9 trillion, and disbursed $5.2 trillion through the legislative process. To give you a sense of the scale of this legislative response, that's 27 percent of U.S. GDP, two times the GDP of my native country, France, and 6.5 times the GDP of Switzerland. It is also more than 5 times larger than the stimulus spending by the U.S. government during the Great Recession.

The money was used to stimulate aggregate demand through programs like:

- Loan and Grant Program: $1.56 trillion including $835 billion to the Payroll Protection Program, $500 billion for the Economic Injury Disaster Loans program, $84 in airline bailout, and $28 billion in grants to restaurants.

- State and local funding: $884 billion, including $201 billion for education funding.

- Income Support: $906 billion, including $717 billion in unemployment benefits

- Direct payments to individuals: $869 billion ($1,400, $1,200, $600)

Many of these funds were distributed directly to companies and were little more than cronyism. The more egregious case was the three different airline bailouts, which was mostly for the benefit airline creditors and shareholders. Also problematic was the Payroll Protection Program, the funds of which benefited mostly companies that least needed help. Unsurprisingly, it did not fulfill its promise to prevent business closures.

State and local governments also received funds, despite seeing their tax revenues soar. As Chris Edwards of the Cato Institute notes, "State and local government tax revenues dipped just 3 percent in the second quarter of 2020, and then quickly rebounded. By the third quarter of 2021, tax revenues were up 15 percent from the dip." State governments distributed large amounts of funding to schools, even as many of school stayed closed to the detriment of children.

Individuals often received income-support payments, in addition to individual payments and unemployment benefits. In fact, although the economy was closed, incomes grew during the pandemic as people made more money by not working than by working. Oh, there was also, in addition to this firehose of spending, student-loan waivers and deferrals, as well as moratoria – from both Trump and Biden – on tenant evictions and foreclosures of federally backed and insured mortgages.

In addition, the Federal Reserve allowed $7.1 trillion in Covid response, and disbursed $4.21 trillion, including $2.7 trillion to buy Treasuries.

It is hard to overstate the size of fiscal and monetary stimulus. Unfortunately, this stimulus was the product of an enormous misdiagnosis of the problems that plagued the economy. Even by the standards of Keynesian economics, the $5 trillion injected into the economy was larger than any plausible GDP gap, regardless of the size of the multiplier. Even worse is the fact that the Covid recession was mostly an aggregate *supply* shock, not a collapse of aggregate demand. Sending money to people who either cannot or will not work can have very little impact on output, but have a huge impact on demand.

The result of this excessive deficit spending and massive monetary 'accommodation' was an increase in the federal debt of $6 trillion, or 30 percent of GDP. In turn we Americans are now experiencing the highest rate of inflation of the last four decades.

How can these errors be undone? In a recent testimony before the Senate Banking Committee, I laid out the following path to get out of this mess:

> "First, the Fed needs to fully step back from its expansionary policy. It needs to raise interest rates significantly to tame inflation. With inflation at 7 percent, even the Fed's promise to raise interest rates to about 2 percent leaves the real, after-inflation cost of borrowing at a stunning −5 percent. The rule of thumb is that to tame inflation, the Fed must raise nominal interest rates by more than the inflation rate, so that real interest rates rise. Current Fed policy will only achieve that goal if almost all of today's inflation miraculously melts away on its own.
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> But Congress needs to do its part too. Without fiscal consolidation, the government's interest costs on the debt will rise. Unless fiscal policy tightens to pay those interest costs, raising interest rates just makes deficit-induced inflation worse. As economist Eric Leeper states, "fiscal responses are fundamental, even indispensable to monetary policy impacts on inflation." They are "the difference between a Brazilian-style interest rate and inflation spiral and a successful reigning [sic] in of inflation," he adds.
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> Empirical work confirms that fiscal contraction is a key element to reducing persistent inflation. For instance, legislators implemented fiscal consolidation (by raising revenue—through pro-growth tax and regulatory reforms that increased the tax base—decreasing spending, or both) during each of the four latest victories over inflation: in the late 1940s, after the 1980–1982 Recession, in the late 1980s, and in mid-1990s. Unfortunately, this link between fiscal and monetary expectations is too often overlooked in conventional inflation debates, with fiscal authorities acting as though inflation outcomes are independent of fiscal policy.
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> Also, higher real interest rates would increase household wealth through lower inflation (increasing the real value of wealth) and higher interest receipts (raising household income flows). Thus, although the central bank is aiming to lower inflation, its efforts could backfire by boosting demand for goods and services. Higher levels of debt work to amplify these (demand-driven) inflationary pressures if there are no plans for fiscal consolidation (e.g., tax hikes to offset the wealth effect).
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> Second, Congress needs to get its fiscal house in order above and beyond the need to tame inflation. Perpetual deficits and a looming entitlement crisis will increase the national debt

> and increase political pressure to finance this growing debt with inflation. The good news is everyone knows what types of fiscal adjustments are effective at reducing the US debt-to-GDP ratio. Alberto Alesina and others have shown that fiscal adjustment packages based on spending cuts—preferably reforms to programs that are the drivers of future debt: Social Security and Medicare—rather tax increases are the most effective way to reduce the debt. Such packages are also less likely to cause short-term recessions and, if they do cause short-term recessions, those recessions are mild and short, unlike those caused by adjustments based on tax increases."

Fiscal discipline and strong Fed restraint is what is now needed to tame inflation and restore some fiscal sanity. Unfortunately, there is no sign that our monetary and fiscal overlords are willing to do what must be done. In other words, we are likely in for an unpleasant ride.

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