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Fiscal Stimulus, Fed Policy and Inflationary Risk

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The coronavirus pandemic has posed several challenges for all economies, and a common denominator in the response of governments to the crisis has been the expansion of spending, both via transfers to households and people bereft of job opportunities due to the need for social distancing, and via credit and tax breaks for companies and sectors.

In respect of 2022, doubts about labor market recovery after the pandemic, an uneven resumption of activity and growing poverty have fueled support for another round of spending. In the United States, Biden's plan to drive economic recovery entails a budget of 6 trillion dollars. On one hand the plan calls for investment in infrastructure, modernization of the electricity grid and expansion of the social welfare network – a spending program that puts the US on track for a more sustainable and less unequal economy. On the other hand, many people suspect a budget of this magnitude may constitute an excessive fiscal stimulus, especially considering the recovery is already taking place at a fast pace as the vaccine rollout advances.

The latest CPI numbers rang alarm bells. The core CPI (which excludes food and energy) accelerated 0.917% in April month over month, surprising many analysts – the consensus forecast had been 0.3%. Monthly inflation on this measure was the highest since September 1981. The number reflected inflation owing both to production chain breaches and reopening in several broad categories, especially air fares, used cars and hospitality, all associated with the end of lockdown measures and a return to relatively normal mobility.

Although the Fed believes much of this inflation is temporary, with effects limited to the time taken for supply to adjust to demand, there are concerns that production chain disruptions and ongoing price rises will contaminate other prices in the economy, bringing extra pressure to bear on long-term inflation expectations, which have been anchored at levels below 3% for several decades, Figures 1 and 2.

The anchoring of long-term inflation expectations has been one of the factors responsible for the weak correlation between output gap and inflation. In recent decades the inflation rate has remained close to 2% while other indicators of low capacity utilization, such as the unemployment rate, have continued to vary with the business cycle, Figure 3.

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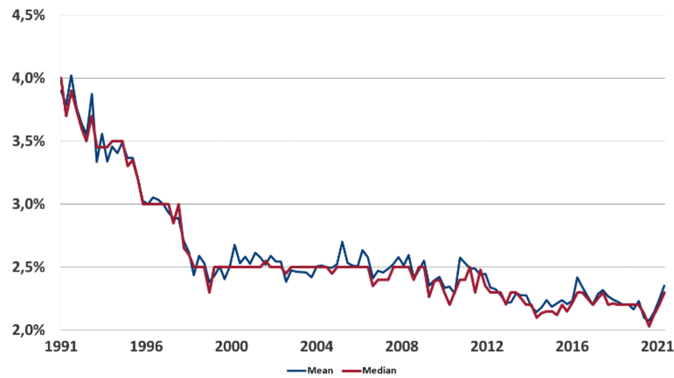
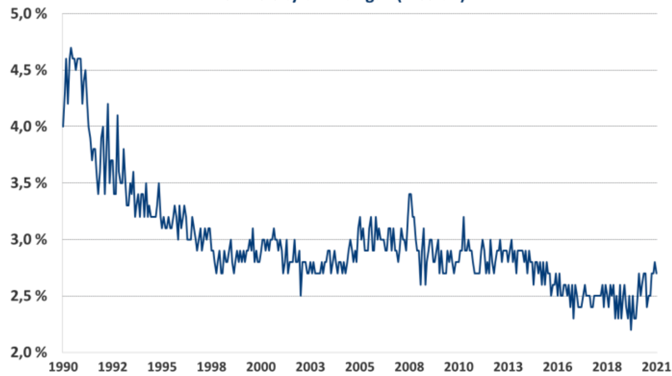
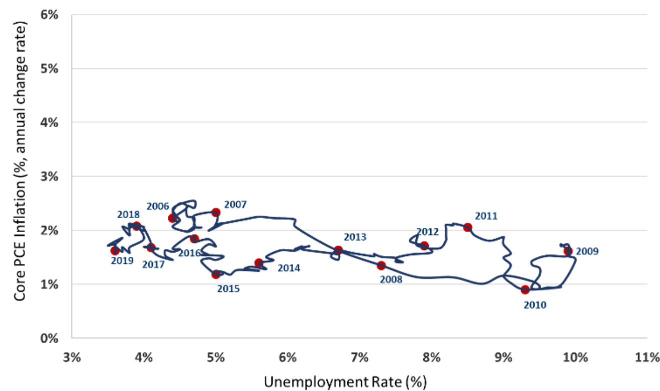


Source: Philadelphia Fed



Source: University of Michigan



Source: Fred St. Louis

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This has not always been the norm. In the 1960s, 1970s and 1980s, inflation rose whenever the unemployment rate fell, pointing to a pickup in capacity utilization and economic reheating. A more restrictive monetary policy (rate hikes) drove unemployment back up, so that the economy ran in circles, as illustrated by Figure 4. It is also important to recall that capacity utilization correlates with other prices in the economy such as the negative association between the unemployment rate and wage inflation, Figure 5, since strong job creation drives wage growth, reflecting the scarcity of labor.

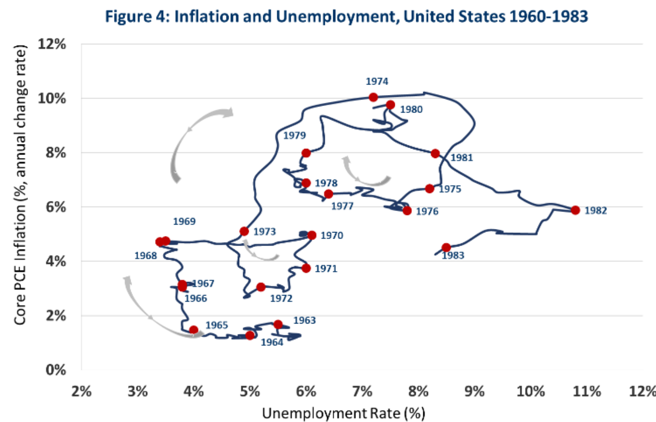

Figure 4: Inflation and Unemployment, United States 1960-1983

Source: Fred St. Louis

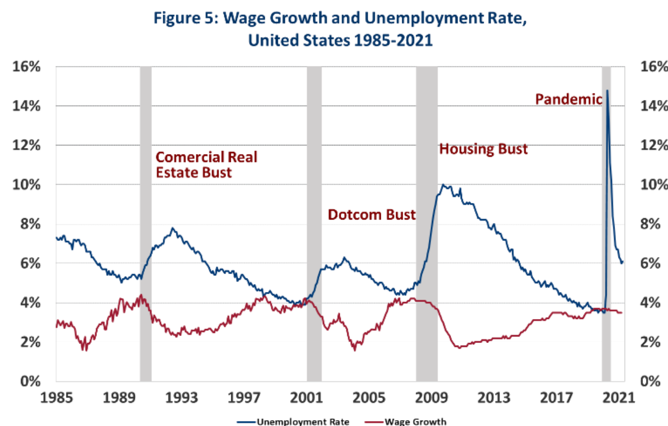

Figure 5: Wage Growth and Unemployment Rate, United States 1985-2021

Source: Fred St. Louis and Atlanta Fed

The apparent absence of this link between inflation and capacity utilization in the US in recent years does not reflect a structural (or immutable) relationship between them. On the contrary, it is directly attributable to the Fed's reaction function and evidences how well its language and actions can anchor long-term inflation expectations during the business cycle.

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Complicating the scenario still further, during the pandemic the Fed changed its inflation target to an average of 2% over time, keeping policy stimulatory until full employment is reached and tolerating higher inflation for a while, as long as expectations remain anchored on 2%.

While the unemployment rate has not yet returned to pre-pandemic levels, some other indicators point to a more solid labor market recovery, including the proportion of firms that are reporting difficulties in hiring and filling vacancies. And recent inflation numbers may change perceptions regarding long-term expectations. Developments in the next few months will be decisive for the trajectory of US inflation, and a possible rise in US interest rates poses even more challenges for emerging-market economies, which are lagging in terms of both vaccine rollout and economic recovery.

Our projections for inflation in 2021 and 2022 are 5.4% and 3.6% respectively, close to the top of the target band for the years in question. Given this prospect of high inflation, the Central Bank of Brazil's Monetary Policy Committee (Copom) is expected to continue raising its policy rate (Selic). We project 5.5% p.a. for the Selic at end-2021 and 6.5% at end-2022. Economic activity is showing signs of a more vigorous resumption, including the recent announcement of positive first-quarter GDP growth and improving tax revenues. In light of the latter, we project a debt-to-GDP ratio of 85% in 2021 and 85.5% in 2022.

ECONOMIC FORECASTS	2016	2017	2018	2019	2020	2021F	2022F
GDP Growth (%)	-3,3%	1,3%	1,3%	1,1%	-4,1%	5,2%	2,5%
Inflation (%)	6,3%	2,9%	3,7%	4,3%	4,5%	5,4%	3,6%
Unemployment Rate, SA (eoy, %)	12,6%	12,4%	12,2%	11,7%	13,9%	13,0%	13,0%
Policy Rate (eoy, %)	13,8%	7,0%	6,5%	4,5%	2,0%	5,5%	6,5%
External Accounts							
Trade Balance (US$ bn)	48	67	53	48	51	70	46
Current Account Balance (US$ bn)	-23	-10	-42	-51	-13	3	-15
Current Account Balance (% of GDP)	-1,3%	-0,7%	-2,2%	-2,8%	-0,9%	0,2%	-0,9%
Fiscal Policy							
Fiscal Primary Balance (% of GDP)	-2,5%	-1,7%	-1,7%	-1,2%	-10,0%	-2,5%	-1,4%
Government Gross Debt (% of GDP)	69,4%	73,7%	75,3%	74,3%	88,8%	85,0%	85,8%

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