Box 3.1

Recent fiscal and monetary policy developments in the US

After taking office in early 2021, the Biden administration proactively introduced a number of fiscal initiatives to provide further relief for those hard-hit by the COVID-19 pandemic, as well as to enhance infrastructure, healthcare system and environmental protection. While the proactive fiscal policy should help fuel economic recovery and enhance long term productivity, there are concerns that they may add to the risk of enlarging the government deficit and debt. On monetary policy, having updated its strategy in August 2020 to provide more room to pursue expansionary policy, the Federal Reserve (Fed) continued to keep interest rates low and maintain asset purchases in 2021, partly contributing to the robust economic performance in the year. However, recent concerns over inflation have led the Fed to alter its super-loose policy stance. This box article provides a brief update on developments of fiscal and monetary policies in the US over the past year, and examines their potential implications.

Fiscal policy

The Biden administration unveiled the US$1.9 trillion (nearly 9% of GDP) American Rescue Plan in January 2021, which was then passed by Congress and signed into law in March. The Plan featured around US$1 trillion in relief for individuals, including US$1,400 per-person stimulus cheques for eligible persons, extended unemployment benefits and enhanced tax credits. The direct relief underpinned strong personal consumption expenditure in the first half of 2021, which grew by 9.5% in real terms on a seasonally adjusted annualised basis. The Plan also included US$350 billion in emergency funding for state and local governments and US$160 billion in direct expenditures to contain the spread of COVID-19 by distributing vaccines and extending COVID testing. According to the Congressional Budget Office (CBO), most of the outlays would be incurred in the first two years (around 60% in 2021 and 30% in 2022).

Following the passage of the American Rescue Plan Act, the Biden administration introduced the American Jobs Plan, an initially US$2 trillion proposal for investment in infrastructure, R&D, manufacturing and workforce development over a number of years. After months of negotiations, the plan was scaled down to about US$1 trillion amid concerns over the cost, and was passed by Congress and signed into law in November 2021 as the Infrastructure Investment and Jobs Act. The final bill included about US$550 billion (about 3% of US GDP) of new federal funding to enhance infrastructure in the US, such as roads, bridges, water, energy transmission and high-speed broadband, while the remainder would be allocated to pre-existing infrastructure programmes such as the highway trust fund. In contrast to the American Rescue Plan, anticipated outlays under the Infrastructure Investment and Jobs Act are spaced out over a longer time frame. The CBO estimated that a cumulative 90% of outlays would take place by 2029.

Parallel to the infrastructure bill, President Biden proposed the US$1.75 trillion Build Back Better Act in October 2021. The proposal focuses on social and climate spending on various items over ten years, including US$555 billion on clean energy and climate investments, US$400 billion on child care and preschool, and US$165 billion on health care. The spending would be partially offset by additional revenue from increases in taxes on corporations and high-income earners. The legislation was passed by the House in November 2021 and sent to the Senate for consideration. As of mid-February 2022, the bill was still under debate and hence details of the final package were not yet clear.

Box 3.1 (Cont'd)

Looking ahead, the fiscal initiatives under the American Rescue Plan have largely expired, and the appetite for additional measures amid rising inflation appears weak, especially in the Senate. Hence, direct fiscal support is likely to abate in 2022. However, the OECD pointed out in December 2021 that earlier stimulus cheques, supplementary unemployment benefit payments and expanded benefit coverage have resulted in significant accumulated savings that will continue to support the recovery.

Monetary policy

In response to the pandemic, the Fed has adopted a highly accommodative monetary policy stance since 2020. In March 2020, the Fed slashed the target range for the federal funds rate to 0.00% to 0.25% and embarked on programme of quantitative easing. In August 2020, the Fed adopted a new monetary policy strategy, expressly noting that following periods when inflation has been running persistently below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time. In December 2020, the Fed said that it would maintain its purchases of Treasury securities and agency mortgage-backed securities at no less than US$120 billion per month.

Supported by the strong fiscal stimulus as well as accommodative monetary policy, the US economy staged a notable rebound in 2021. However, disruptions to supply chains caused by the pandemic became increasingly apparent. This coupled with the surge in demand for goods has led to rising concerns over inflation. The concerns intensified when both core consumer price index (CPI) inflation (excluding food and energy) and core personal consumption expenditure (PCE) inflation exceeded 3% starting from the second quarter of 2021 (***Chart 1a***). Meanwhile, the labour market showed continuous improvement, with the unemployment rate easing from 6.4% at the start of 2021 to 4.6% in October (***Chart 1b***). These developments led the Fed to start to reduce the pace of its asset purchases in November 2021.

Chart 1a : Inflation rate shot up

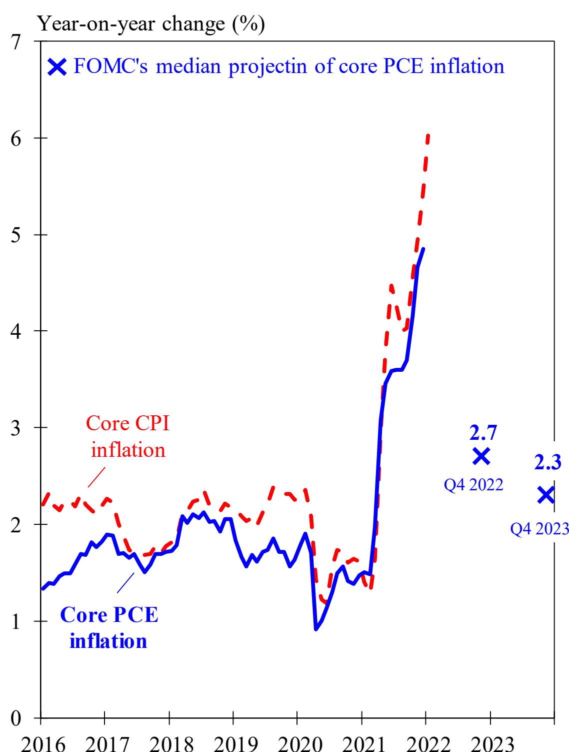
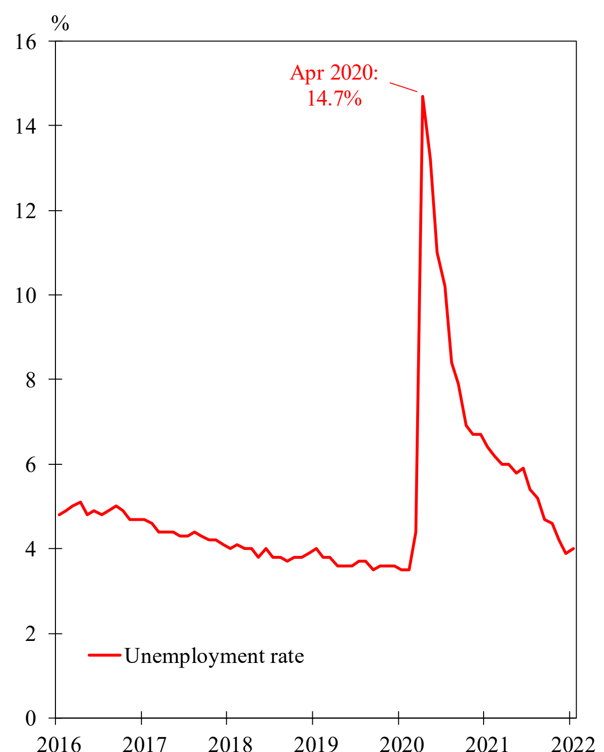


Chart 1b : Unemployment rate declined noticeably



Source: US Bureau of Labour Statistics, Bureau of Economic Analysis and Federal Reserve.

Box 3.1 (Cont'd)

By November 2021, the unemployment rate fell further to 4.2%, while core PCE inflation hit 4.7%, the highest since 1989. At its meeting in December, the Federal Open Market Committee (FOMC) noted that inflation was more persistent and widespread than previously anticipated, and revised its forecast of core PCE inflation for Q4 2022 and Q4 2023 to 2.7% and 2.3%, up from 2.3% and 2.2% as projected in September[1]. Against this backdrop, the Fed decided to reduce its asset purchases at a faster pace, with a view to bringing them to a close by March 2022. At its meeting in January, the Fed noted that it will soon be appropriate to raise the target range for the federal funds rate. On the other hand, while the Fed has not made decisions regarding the specific timing, pace, or other details on how it will shrink its balance sheet, it stated that this will occur after the process of raising interest rates has begun. As of mid-February, markets expect US interest rates to rise by at least 150 basis points over the course of 2022.

Potential implications

While an acceleration of the Fed's tapering and forthcoming interest rate increases may help contain inflation, it may also hurt economic sentiment and thus economic growth. It may also magnify the prevailing uncertainties brought by the evolving COVID-19 pandemic, as tensions could arise between keeping prices under control and providing support to the economy. In January 2022, Fed Chair Jerome Powell warned that, as entrenched inflation could jeopardise the economic expansion, the Fed would have to act to ensure that inflation did not become an even more serious problem. On the other hand, monetary policy tightening by the Fed may also cause volatility in financial markets. Emerging market economies with weak fundamentals may face higher risks of currency depreciation and capital outflows. In the longer term, higher interest rates will increase debt service burdens, creating the need for fiscal consolidation.

On fiscal policy, though accumulated savings from past initiatives are still likely to provide some support in the near term, the effect will dissipate gradually over time. In the longer term, infrastructure investment and certain kinds of social spending may bode well for the US' potential output. For example, enhanced infrastructure may help boost productivity, while improved child care services, if enacted, may help boost labour force participation. However, it will take time for supply-side effects to materialise. Moreover, increases in fiscal spending will also put upward pressure on the government deficit and debt in the longer term. According to the latest CBO projection, federal budget deficit will rise from US$980 billion (4.6% of GDP) in 2019 (before the pandemic), to about US$1.86 trillion (5.5% of GDP) in 2031, while the federal debt held by the public will rise from 79% of GDP in 2019 to 106% of GDP in 2031, surpassing its historical high in 1946. This projection has not yet taken into account the effects of the Infrastructure Investment and Jobs Act and Build Back Better Act. Should government debt continue to rise, it may cause further volatility in financial markets. It would also complicate efforts to fight inflation, as monetary tightening would increase the government's debt servicing costs.

In 2022, the US administration and the Fed will have to thread the needle between continuing to fight the pandemic and keeping inflation under control. After that, fiscal consolidation in an era of higher interest rates will pose a continuing challenge. As the performance of the US economy and its policy responses carry significant implications for the global and local economy, the Government will closely monitor the developments.

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(1) In February 2022, the private sector forecast that core PCE inflation will be 3.9% and 2.3% in 2022 and 2023 respectively.