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SCB Economic Intelligence Center

EIC's Outlook on the US New Stimulus and its Implication on Economic and Financial Conditions

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Key summary

- **Last week, the US House of Representatives passed the additional stimulus package worth USD 1.9 trillion, and the draft bill is now pending approval from the Senate. EIC views that the Democrats could finally roll out this massive relief bill within the first quarter this year via a Budget Reconciliation, but they might need to pull out some elements (such as minimum wage hikes) and cut down some spending plans (such as financial aids to local governments). In the end, the stimulus size approved by the Senate would be around USD 1.5-1.9 trillion.**
- **In our view, this additional relief plan will help bolster the US economic rebound this year while risks of overheating economy or surging inflation remain low in the short term, given that the current US labor market has not yet returned to its pre-pandemic level and that most of the additional measures are one-off. Nonetheless, even though short-term inflation risks are somewhat manageable, there remain risks that inflation might overshoot in the medium term due to fundamental changes. These are risks that should not be overlooked as they may induce fluctuation in financial markets.**
- **The new stimulus bill has fuelled both inflation expectation and market anticipation that Fed might scale back its monetary easing earlier than expected. These could result in rising long-term US treasury yields and become an upward pressure on the weakening US dollar. Therefore, EIC has revised our forecast on the 10-year Thai government bond yields up to 1.9-2.0% (from 1.5-1.6%) by the end of 2021 and maintained our Thai baht forecast within a range of 29.5-30.5 THB/USD.**

In this issue, we will go through a series of analyses on the US new stimulus pushed by President-elect Joe Biden: will this massive bill overheat the US economy? And how would it affect the US treasury yields, the US dollar, the Thai government bond yields, and Thai baht?

What will the New Stimulus Look Like?

In EIC's view, Democrats will finally roll out the additional USD-1.9-trillion stimulus within the first quarter this year, using the legislative tool called a Budget Reconciliation.

Normally, President Biden is able to choose between the two legislative procedures to pass the bill:

1) **Budget Reconciliation** Under this special rule, the bill will only need a simple majority (50 votes) to get past the Senate, and Democrats already hold enough seats for that. However, wielding the budget reconciliation also comes at a cost. For instance, given a number of lawmaking procedures and strict rules, some elements that have no direct impact on federal spending might be excluded from the bill (such as minimum wage hike and social welfare policy).
2) **Normal Vote** The bill must have at least 60 Senate hands to come up for a final vote. So if the Democrats decide to pass the bill through a normal voting rule, they are very likely to scale down stimulus size to get more supports from the Republicans. But one of the perks is that minimum wage hikes will not be crossed off.

At long last, President Joe Biden decided to fast-track the new stimulus bill through a Budget Reconciliation, given a meager chance for the Democrats to achieve 60 votes as the Republicans are openly against this massive spending. The USD-1.9-million draft bill went under an amendment by the House of Representatives on February 26 and finally got a green light from the Senate on March 6, 2021. This time, to get past the Senate was somewhat challenging. While it requires at least all Senate Democrats on board to pass the relief plan, some Senate Democrats appeared to oppose the House's version of the bill. The most controversial element in the House's version is the minimum wage hikes from USD 7.25 to 15 per day. Some senators claimed that this provision is not relevant to direct federal spending and should be excluded under a Budget Reconciliation rule. So, in the end, the Senate's version took off the minimum wage hikes and replaced them with the student loan tax relief — allowing any student loan forgiveness from now become tax-free until 2026.

On March 10, 2021, the Senate's version of the bill is sent back to the House of Representatives for a final vote before submitted to President Biden's desk. Once signed, the bill will be enforced as the US laws. Listed below are key stimulus measures we expect to be sent out in the first quarter of 2021

1. One-time stimulus check of USD 1,400 per person
2. Financial aids to state and local governments to prevent further layoffs
3. Extending the unemployment welfare programs to September 6, 2021 (from March 14, 2021) and top up a federal weekly boost to USD 300 per individual
4. Reopening schools and universities
5. Public healthcare schemes such as vaccination and virus diagnostic test

Will the New Stimulus Packages Overheat the US Economy?

Recently, Biden's stimulus plan has fuelled concerns if its size is too big that it may impact US inflation and financial stability. Former US Treasury Secretary Lawrence Summers warned that Biden's package is too big considering the current output gap[1], so once the stimulus is enacted, the inflation rate may shoot up and affect both the US dollar and financial stability. Besides, since infrastructure and green energy projects — the key elements in Biden's policy — are left out from the USD-1.9-trillion package, this massive spending will likely preclude future federal investment. Former IMF Chief Economist Olivier Blanchard also shared similar concerns with Lawrence Summers. According to Blanchard, if combining the three stimulus packages — USD 900 billion launched in December, USD 1.9 trillion newly proposed, and an additional USD 800 billion for infrastructure projects to be released afterward — the total injection to the US economy will be as high as USD 3.6 trillion, or four times the size of US output gap[2]. And this is a likely risk to an overheating economy.

On the other hand, some economists have their sides with this massive stimulus package, citing that it should help revive the flagging economy rather than fuel the risk of overheating. Janet Yellen, the current US Treasury Secretary, stated that the US needs to 'act big' on relief spending to support the jobless and virus-hit households. She also affirmed that the government has enough policy tools in hand to deal with inflation. Still, Yellen believed risks of inflation spike remain small, and the relief package of USD 1.9 trillion will usher the US economy to full employment within 2022. Minutes from the recent meeting of the Federal Open Market Committee (FOMC) also suggested that the Federal Reserve is more concerned on a consistently low inflation rate than a risk of rapid price rise, whereas the expected burst of inflation following the new stimulus is believed to be transient. Likewise, IMF Managing Director Kristalina Georgieva spoke out in favor of the additional relief package, citing that fiscal spending is necessary in the midst of high uncertainty to provide solace to those who face difficulties from the COVID-19 crisis.

In EIC's view, the additional stimulus will help bolster the US economic recovery this year while the risks of overheating economy or overshooting inflation remain low in the short term because:

1. **The US economy has not yet returned to its pre-pandemic level.** The US economy is likely to get back on track this year, but the labor market says otherwise. The current unemployment rate was at 6.3% and still above its five-year average at 5%. The labor force participation rate also hovered around 61.4%, lower than its five-year average of 62.7%. Besides, the latest inflation rate remained subdued at 1.3%, hanging below its five-year average at 1.5% and ten-year average at 1.5%. Considering that the economy remains behind its true potential with notable signs of labor

[1] Output Gap is a difference between the actual output and potential output

[2] According to Olivier Blanchard, the US output gap should hover around USD 900 billion as of the fourth quarter of 2020

market slack[3], the new relief package should be more of a buttress to the US recovery than fury to overheat the economy.

2. **Most of the additional measures are one-off** such as a stimulus check of USD 1,400 per person and unemployment benefits. For the latter, the disbursement will likely moderate should an economy rebound faster than expected and result in lower unemployment (automatic stabilizer). EIC views that the new stimulus will have its largest economic boost in the second quarter of 2021 and peter out afterward, thus suppressing risks of economic overheating or inflation overshooting.

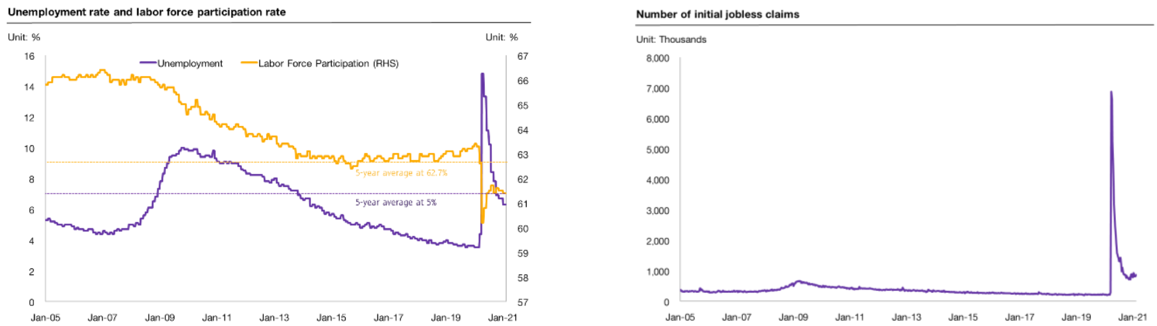
Nonetheless, a possible surge of inflation in the medium to long term is still a critical risk that needs close monitor. There remain other fundamental factors that might magnify effects from the stimulus, sending upward pressure to inflation and thus leading to a fluctuation in the financial market. Here are some factors that might cause inflation to rise faster than expected in the medium to long term:

- **Liquidity has significantly increased** thanks to relief measures from the government and the central bank. With the new stimulus bill and Fed's asset purchase program, liquidity in the US market will keep swelling and might result in accelerating prices of goods and services compared to the past.
- **Pent-up demand and excess savings are on the rise.** Since the pandemic started off, a number of virus control measures have undermined the full consumption of some goods and services. Therefore, as lockdown rules are gradually eased, consumption demand could skyrocket, people would ramp up to spend their savings, so prices of goods and services are bound to rise further.
- **Gloomy global trade may hamper the supply of products.** The US-China trade tension will negatively affect the global supply chain and could lead to product shortage in some regions, causing the prices of goods and services to increase.
- **Aging population drives up product prices in some categories.** With a declining share of working-age people in contrast to a growing share of the elderly population, the US production outputs are likely to falter and thus result in escalating prices. On top of that, public healthcare service prices tend to rise in line with a growing elderly population, putting upward pressure on the inflation rate.
- **Impacts of psychological factors on future investment should be softer than expected.** Unlike the aftermath of earlier crises, a great number of firms are likely to resume their investment in business expansion after the COVID-19 pandemic subsides, particularly large firms who adapt well to a new normal of work. On the other hand, the past global financial crisis primarily stemmed from excessive investment in risky assets, thus resulting in sluggish investment worldwide since businesses were reluctant to take high risks after the crisis.

[3] In some cases, 'slack' also refers to a labor market condition where labor supply outstrips the number of jobs available

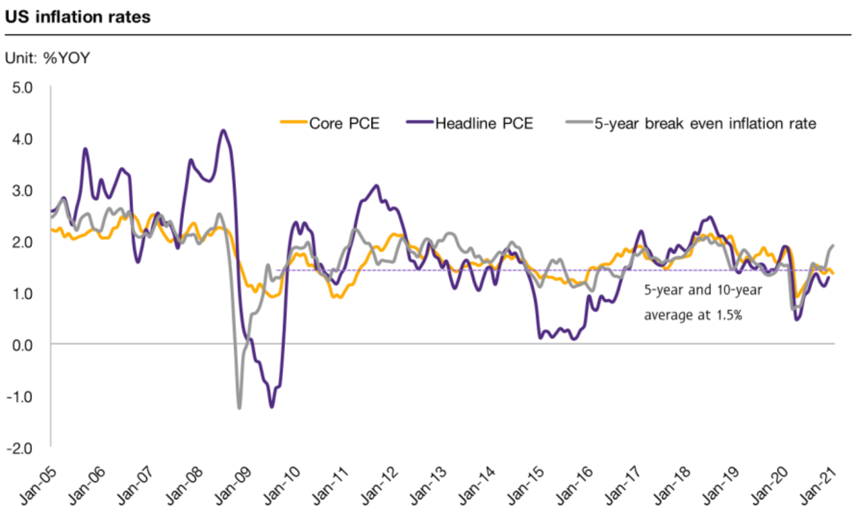
Nonetheless, it is far too early now to say whether Biden's stimulus is too big or otherwise. The bill of USD 1.9 trillion is no less a very massive one compared to the earlier injections and even much larger than the stimulus program back into the financial crisis 2008-2009. So, there remain risks of overheating economy that should not be overlooked. However, an additional stimulus is of paramount importance for the US economy right now to relieve virus-hit households and businesses. Also, Biden had better go too big than too small **when it comes to a relief package. A challenge to the US government is to rule the risks from an additional boost with a close monitor on the inflation rate and key economic indicators in order to get prepared for policy change should any sign of overheating economy spike.**

Figure 1: Unemployment rate and initial jobless claims have been declining but remained above the pre-pandemic level



Source: EIC analysis based on data from CEIC

Figure 2: Latest inflation figure still hovered low compared to the previous average



Source: EIC analysis based on data from CEIC

How will the New Stimulus Affect the US Financial Condition?

The massive stimulus bill will send a long-term treasury yield shoot up and thus become an upward pressure on the US dollar. When the Democrats proposed the USD-1.9-trillion package on January 14, 2021, the 10-year Treasury yield jumped by 28 bps while the US dollar index settled around 90.3 after weakening through much of last year. This relief package will have consequences on Treasury bond yields and the US dollar through the following channels:

1. **The higher expectation on the US economic rebound.** According to the Bloomberg survey, before the massive bill was announced, market participants anticipated a 4.1% US economic growth in 2021, but now the forecasted figure rose significantly to 4.9%. The survey showed that the market grew more upbeat about the US rally while other major economies saw a contrast. For the Eurozone and Japan, growth forecasts were down from 4.2% and 2.7% at the beginning of 2021 to 4.2% and 2.6%, respectively, after a stringent lockdown was reimposed to tackle virus resurgence. For that reason, the US Treasury yields went up on the back of lower demand for the US Treasury bonds (regarded as a safe haven). Meanwhile, the greenback held steady after weakening through much of 2020, in consistent with the short dollar positions which recently gained a firm footing.
2. **Rising inflation expectation.** Since the start of 2021, inflation expectations in the US market have been on the rise. This is evident in the 5y5y breakeven inflation climbing 31 bps to 2.29% (as of February 19, 2021), in line with the household 3-year inflation expectation, which ascended to 3.03% in January 2021 — from 2.90% in the previous month. Given a higher inflation expectation, the inflation risk premium will likely increase and cause a sharp rise in Treasury yields.
3. **The market expectation that Fed tapering could come earlier than expected.** EIC expects the Federal Reserve to keep its policy rate on hold until 2024 as it has replaced the previous monetary policy approach with an Average Inflation Targeting (AIT). Under this new framework, Fed will not make an abrupt change to tighten the monetary policy if inflation of any month rises close to or reaches 2% but mainly seek to achieve an average annual inflation rate at 2%. Still, both US economic rebound and inflation are likely to pick up pace, and these could fuel market expectation that Fed might wind back monetary easing by lowering its asset purchase any time soon. Based on the Bloomberg survey during January 15-20, 2021, 88% of respondents expected that the Fed's next move would be tapering rather than scaling up its asset purchase, and 50% believed the Fed would kick-start its tapering within the next 7 to 12 months. Recently, a surge in treasury yields has evoked fears of another Taper Tantrum, which took place back on May 22, 2013. The market was unprepared at that time when Fed announced it would scale back asset purchases. The announcement came as a surprise and thus sent 10-year Treasury yields surging 11 bps in only a day and 85 bps within three months.

Nonetheless, the severity of impacts from rising long-term Treasury yields on financial condition will also relies on other following factors:

1. **Investor Confidence in the Economy: Positive sentiment on outlook will result in lower impacts on financial condition.** *Reasons behind a Treasury yield ascent can come from both changes of investor sentiment on economic condition and changes of monetary or fiscal policy direction.* *EIC found that impacts on financial condition could be worse if a surge in Treasury yields comes solely from monetary policy shifts while the economic outlook remains subdued.* Back to the Taper Tantrum in 2013, we saw a rising US dollar, capital flights from emerging markets, global stock market slumps, and weakening Asian currencies. Those were different from the year 2015, when financial conditions tightened only slightly. For 2016, Treasury yields went up following a lower uncertainty from the US election and Fed rate hikes, which sent both the greenback the US stock market rally. But since the global economic outlook also improved during late 2016, capital outflows from emerging markets were somewhat limited (Table 1).
2. **Outlook on Global Economy: Glooming global outlook could depress investor confidence.** For example, when the Taper Tantrum took place in May 2013, China's economy had already been on a substantial slowdown. The dim outlook worsened investor confidence over the emerging markets and led to a massive capital flight back to the US. As a result, the Emerging Markets Index saw a slump, regional currencies lost against the greenback, and global financial conditions were severely hit. Nonetheless, the outcomes were different in 2015 and 2016, when the US Treasury yields have been surging but investor sentiment on China's outlook was in good shape, we found that the global financial condition worsened only slightly. Also, the Global stock market index remained on the rise whilst capital outflows from emerging markets were lower than the taper tantrum in 2013.

Table 1: Variation of financial assets during major events

Table of comparing the changes of financial assets during major events

	Taper tantrum (Early May to the end of June 2013)	Bund tantrum (Early April to the end of May 2015)	US election (Early Nov to end of Dec 2016)
10-year US government bond yield (bps)	81.4	19.83	61.88
US Dollar index (%)	1.7%	-1.5%	3.8%
Asia currencies index (%)	-2.2%	-0.1%	-2.8%
S&P500 (%)	0.5%	1.9%	5.3%
MSCI world (%)	-3.7%	2.3%	2.6%
EM portfolio flow (USD bln)	-24.6*	47.5	-10.1

Note: *use only June data

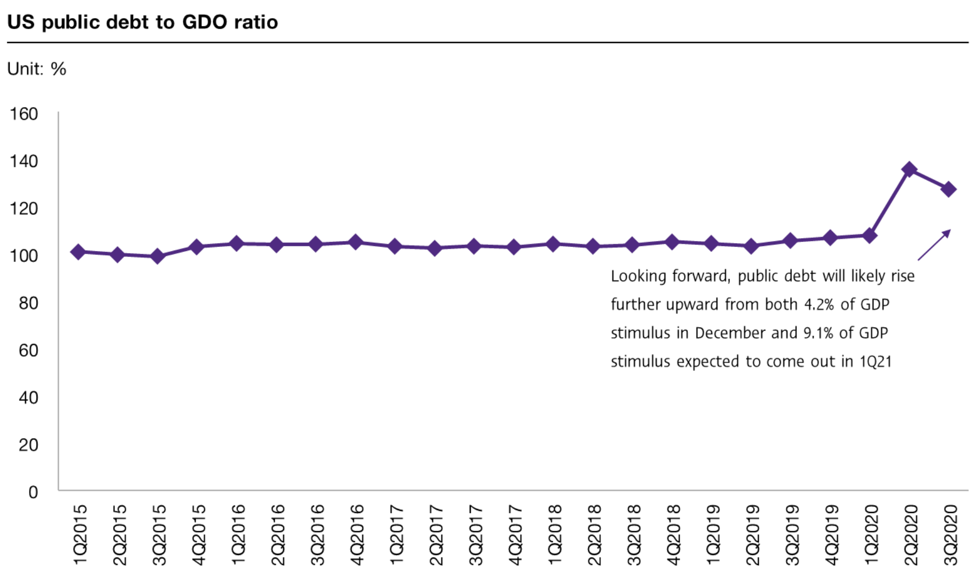
Source: EIC analysis based on data from Bloomberg and IIF

For that reason, EIC revised up our forecast on the 10-year Thai government bond yields to 2.1-2.2% (from 1.5-1.6%) at the end of 2021, as the long-term US treasury yields tend to rise further while the Thai economy gradually picks up pace. On Thai baht outlook, we revised our forecast that the baht will weaken — compared to the end of last year — to a range of 30-31 THB/USD (from 29.5-30.5 THB/USD) by the end of 2021, as the US dollar looks to continue rally whilst the Thai economic recovery has fallen behind its peers and current account only saw a small surplus (see more in Outlook for Thai government bond yields and Thai baht 2021).

The New Stimulus Impacts on the US Economy in a Long Term

Apart from the risks of overheating economy, the massive stimulus also sparks concerns over rising federal debt. As the latest figure shows, the US public debt was as high as 127.3% of GDP and will likely shoot up further if the government enacts the additional stimulus package. This might fuel risks to the US economic growth ahead since a soaring public debt will push more tax burden to households and businesses and result in higher yields of Treasury bonds and debentures. Such circumstances could deter business sentiment, pressure on overall production capacity and wage, and thus hinder economic growth in the long term.

Figure 3: The US public debt rose in response to a massive stimulus in 2020



Source: EIC analysis based on data from Fed St.Louis

Nevertheless, despite a high public debt, EIC views that impact from the new stimulus will be limited because:

1. **Interest rates will likely remain persistently low.** Low interest rates mean that US federal debt's interest burden also stays as low at 1.7% GDP (close to the level back in the financial crisis 2008, albeit the current public debt is nearly twice in size). With low interest payments, tax burden and

risk of debt default will only see a slight increase and unlikely to be much pressure on private investment ahead.

2. **Large infrastructure investment is on the way, as Biden promised.** Building infrastructure has played a significant part in Biden's campaign. Among his key projects in the pipeline are green energy and 5G technology, which will enhance manufacturing capacity and benefit the US economy in the long term, unlike a usual income compensation that aims only for a short-term boost to private consumption and employment.

Given that adding more debt now does not add much to the interest burden and that the government can pump investment to restructure the US economy as promised, then this big debt bill will not exert that much impact on the US fiscal sustainability. **At the end of the day, the massive stimulus may not be a bad decision, especially when households and businesses are grappling with crisis and scars from the COVID-19 pandemic. Still, fiscal risks and sustainability are key issues that should be closely monitored.** These cover both risks of the fiscal cliff and a possible surge in public debt if a revenue collection (with Biden's tax hikes) appears to be lower than expected.

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