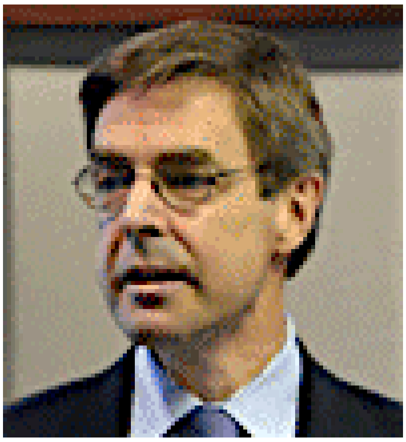
An Imperfect Demand Stimulus

By George A. (Sandy) Mackenzie *Thu, Mar 26, 2020*

While the Great Depression of the 1930s saw a massive contraction in demand, the current crisis entails a massive shock to the economy's supply side, writes our guest columnist, the founding editor of The Journal of Retirement. He sees flaws in the Senate's assistance package.



What is happening today may be likened to a hurricane or a tornado, but one that affects every city, town and county in the country, as well as the rest of the world, at the same time. Because so many workers simply cannot report to work, the economy's effective capacity will shrink drastically for a time, in the same way that the ability of a small island's economy to produce is devastated temporarily by a hurricane.

Unlike a small island economy, however, there can be no prospect of external aid. Even if the textbook Keynesian response would work in more normal times, it cannot offset this decline.

However, aggregate demand could still fall well short even of the economy's reduced capacity. Laid-off workers, especially those living paycheck to paycheck, will have to cut back drastically on their spending on those goods and services that the economy is still capable of producing. Declines in income will be particularly severe for gig workers, and workers in the hospitality and retail sectors. Even households that are spared lay-offs and are not (or have stopped) hoarding will be trying to economize, or will be cutting expenditure on what is no longer available, like a drink at their local bar. The increased efforts to save by many households will not automatically be offset by an increase in business investment, except perhaps for some involuntary inventory accumulation, which will be reversed as inventories mount.

Many workers, especially teachers and other civil servants in government and education, will continue to receive a paycheck even if they are unable to work from home. Some of the households that are financially strapped may benefit from transfers from their parents and grandparents, which will partly mitigate their plight. Households that remain in a comfortable position may also increase their charitable contributions. Nonetheless, millions and millions of workers will find themselves virtually without resources unless the government steps in.

This truly grim economic outlook has led some commentators to argue that the economic suffering entailed by concerted and strong action to control the virus may outweigh the pain and suffering of those who end up sick or who die. Comparisons with the Great Depression, which lasted for a decade, are made, but are surely exaggerated. This writer believes that if strong public action can stop the spread of COVID-19 before many months have passed, even a huge increase in unemployment can be reversed.

What should be done?

In this writer's view, *economic policy should be geared to preventing a further fall in aggregate demand* below the economy's reduced capacity level, and to helping those households with the lowest and least secure incomes, including one-person households. In addition to assisting hospitals and medical workers obtain the supplies they so desperately need, assistance from the federal, state and local governments to businesses and to households is urgently needed, in the form of loans, grants and transfers.

The news media report that the Senate has agreed on a $2 trillion dollar package. The components of this package (which fall short of $2 trillion) are reported to be:

- $130 billion to hospitals
- $250 billion for direct payments to households and individuals, apparently in the form of direct mail-outs
- $250 billion in increased unemployment insurance benefits accompanied by a broadening of its application
- $350 billion in loans to small businesses
- $150 billion for state and local governments, which are starting to run short of tax revenue to pay their furloughed employees
- $500 billion for distressed corporations and municipalities, with requirements to ensure that these payments will go to support their workforce

As of today, the bill has left the Senate and gone to the House, where it must be approved before going to the White House for the President's signature.

In the writer's view, the package that is ultimately passed should be judged by three criteria: (1) how well targeted it is; (2) how quickly it acts; and (3) its administrative feasibility. On those counts, how does the latest version stack up?

- Loans to business, even when the lender enjoys a guarantee, are not well targeted. Their impact on employment is indirect and uncertain, unless there is a way of requiring recipients to keep their workers on the payroll. They may also take some

time to implement. Direct investment and loans by the government, which are probably feasible only for large corporations, may be better targeted, but only if they are accompanied by an effective employment requirement. This is probably not feasible for hundreds and thousands of small businesses. That said, if such a policy can be made to work for them, all the better.
- Enhanced unemployment insurance (increased by $600 per week for four months) is well targeted, although its decentralized administration at the state level makes it more complex. Nonetheless, the infrastructure is established—it doesn’t have to be started up from scratch.
- A direct mail-out of checks to households is quick and easy to do. The Senate bill makes the mail-out decline with income and be phased out when adjusted gross income (AGI) reported to the IRS in 2018 reaches $99,000 for singles and $198,000 for couples. The maximum benefit for singles is $1,200, payable if their AGI is $75,000 or less and $2,400 for couples with an AGI of $150,000 or less. An additional $500 is paid for each child (also subject to a phase-out). A mail-out is undoubtedly appealing politically. Making payments decline with income is desirable, but the policy does not distinguish between households with secure and those with insecure incomes. Many payments will be going to households that do not really need them, because many households have reasonably secure incomes, and a lower cut-off point could finance larger payments to low-income households.
- Enforcing a moratorium on evictions of tenants and foreclosures of households behind in their mortgage payments, as some commentators have proposed, might also help. Ideally, it should be should be targeted at low-income households. The feasibility of this is uncertain. Outright forgiveness of student debt is poorly targeted, especially if it is a permanent policy. A temporary moratorium on loan servicing makes more sense, although even this measure will benefit a large number of students and their families who are not in desperate need.

An emphasis on payments to persons, not business entities, is the best policy, and an increase in unemployment insurance with a concomitant relaxation of its terms is probably the best single policy of this sort. Loans with guarantees in place for the lender, direct loans by the federal government, and ownership positions in very large employers could be justified provided their terms make them effective in preventing large-scale lay-offs. Of course, assistance to hospitals is vital.

The writer is not in a position to put a number on the size of the total package, but it should be large. The initial package may have to be followed up by another, given the uncertain duration of the drop in the economy’s ability to supply the normal amount of goods and services and the possibility that demand falls even below that level. Any stimulus package will take some time to implement.

Conceivably, and unbelievable though it might seem, a very large package or series of packages might actually push demand beyond what the economy can now supply. In the writer's opinion, the resulting increase in the price level and in the rate of inflation would not be a large price to pay to prevent a true calamity. Inflation is very low now, and the price level is in fact likely to drop—i.e. the *rate* of inflation will probably become negative for a time, given the inevitable drop in demand before any stimulus takes hold. We are not on the verge of hyperinflation.