What to Expect in the Wake of the 2020 U.S. Elections

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The 2020 U.S. elections produced a close, but clear, victory for Democratic nominee Joe Biden in the presidential contest, a surprisingly slim majority for the Democratic party in the House of Representatives, and an even 50-50 split between Republicans and Democrats in the Senate.1 Newly elected Democratic Vice President Kamala Harris holds the deciding vote for party control in the Senate. Thus, the Democratic party now controls the executive branch of the federal government and both Houses of Congress – a huge shift in the balance of political power.

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[1] The Democrats elected 48 members to the 117th U.S. Congress, but two independent Senators caucus with the Democrats in party-control votes, which brings their effective number of Senate seats to 50.

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I. What It Means for U.S. Economic Policy and Policy Making

Where Democrats can maintain strong party unity, they may pass significant legislation with little or no Republican support. For example, as of early February 2020, President Biden appears ready to ditch negotiations with Republicans and rely entirely, or almost entirely, on Democratic votes to enact another round of huge new government spending (Politii 2021). Whether the President's stance is an effort to gain leverage in renewed negotiations or a genuine determination to press ahead without bipartisan support, it's a safe bet the U.S. government will continue to run giant deficits in the near future. The nonpartisan Congressional Budget Office projects U.S. budget deficits equal to 8.6 percent of GDP in 2021 and 6.1 percent in 2022.1 These deficits would push U.S. government debt held by the public to 107 percent of GDP in 2023, the highest in American history. Because these projections don't incorporate the $868 billion Consolidated Appropriations Act, enacted on 27 December 2020, or current Democratic proposals for another $1.9 trillion in fiscal support, actual deficits and debt levels are likely to be a good deal higher than these projections.

I expect President Biden to prevail in his pursuit of more large-scale government spending. Nevertheless, razor-thin Democratic majorities in the Congress will inhibit most major legislative initiatives that lack some measure of bipartisan support. For example, it is unlikely that Democrats can maintain enough unity to enact large tax hikes in 2021 or 2022. I see little appetite among political leaders in Washington for a bipartisan compromise that shrinks future deficits, and little capacity for either party to impose its preferred mix of spending cuts, tax hikes, and growth-enhancing policy reforms. That is another reason to anticipate large deficits for at least the next two years. There will be no near-term reckoning with the unsustainable U.S. fiscal trajectory.

Legislation that sharply curtails reliance on fossil fuels is also unlikely to pass the Congress under the current political configuration. Here, and in many other policy areas, the Biden administration will be tempted to rely on executive orders and regulatory actions to pursue

[1] See Table 2 in CBO (2020a).

domestic policy goals that lack broad, bipartisan support. For the same reason, the administration will turn to international agreements *not endorsed* by the U.S. Congress in efforts to commit the United States to policy goals that don't command a political majority.

Judging by the flurry of executive orders promulgated in the early days of the Biden administration, non-legislative initiatives will indeed be a prominent feature of U.S. policymaking in 2021 and 2022. During the first two weeks after President Biden took office, executive orders pertaining to energy and environmental concerns include the following:

- Cancelling a permit to proceed with the Keystone XL oil pipeline, which has been embroiled in a highly politicized regulatory review process for more than a dozen years (BBC News 2021);
- Rejoining the Paris Climate Accord (Politi and Manson 2021); and
- Freezing new leases and permits for oil and gas development on federal lands (Lee 2021).

New White House guidance to the Office of Management and Budget will also give bureaucrats a freer hand to advance new regulations that do not meet a cost-benefit standard (Henderson 2021; Mulvaney and Grogan 2021). There is high potential for a rapid expansion of new regulations that lack broad-based political support and undermine prosperity.

Given the current configuration of political power, there is an obvious appeal to executive actions aimed at politically contentious issues. While the appeal is clear, so are the drawbacks. Policymaking by executive fiat will not serve President Biden's stated goal of "bringing America together; uniting our people; and uniting our nation" (Biden 2021). And when they lack broad political support, executive actions taken by one administration are easily undone by the next. The result is a highly uncertain policy outlook that inhibits investment, job creation, and regulatory goals (Baker *et al.* 2012; Davis 2017). That neither party has a strong hold on the national electorate raises the reversal risk for executive actions. Legislative enactments are much more durable, especially when they involve some degree of bipartisan support.

II. The Outlook for Fed Monetary Policy

Under its new monetary policy framework, the Fed pledges not to raise its policy rate till it sees clear evidence of a sustained rise in

inflation above its 2% target (FOMC 2020). The new framework reflects several developments and re-assessments: First, U.S. monetary policy consistently undershot its inflation target in recent years, which the Fed attributes to challenges presented by the effective lower bound on the Fed's policy rate. Second, close proximity of the policy rate to its effective lower bound is seen as likely to persist for many years. Hence, the need for a new framework that factors in the implications of the effective lower bound. Third, the search for an operational, stable Phillips Curve that can function as a reliable tool for assessing near-term inflationary pressures has proved elusive, to put it mildly (*e.g.*, Davis 2019). Fourth, and related, the United States enjoyed its lowest unemployment rates in half a century before COVID-19 struck – without the emergence of inflationary pressures. The third and fourth developments undercut arguments for tightening monetary policy in reaction to incipient or anticipated inflationary pressures.

The Fed currently plans to pursue an accommodative monetary policy with near-zero policy rates "until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time." (Board of Governors 2021) The precise operational meaning of this guidance is unclear but, as explained in a recent speech by FOMC member Charles Evans, it may involve near-zero policy rates through 2025 or 2026. If so, we will see low nominal and real interest rates and a flat yield curve for several more years.

While that scenario is plausible, there is another plausible scenario in which inflation rises sharply enough in 2021 or 2022 to prompt the Fed to tighten monetary policy abruptly. How might such a scenario come about? First, a successful vaccine rollout that drastically curtails virus infection and reproduction rates, triggering a period of rapid output and employment growth. Second, a large burst of private spending as consumer-facing businesses re-open and return to normal operating practices. The U.S. personal savings rate shot upwards from 7.5 percent in 2019 to 16.2 percent in 2020, its highest level in the past sixty years. Clearly, there is potential for an unusual spending boom fueled by strong household balance sheets and pent-up demand for consumer goods and services that were squashed during the pandemic. Third, a successful Democratic effort to legislate another massive near-term increase in government spending. The $1.9 trillion in additional

spending sought by the Biden Administration is several times larger than the estimated output gap, as stressed by Summers (2021). If all three of these developments materialize in powerful ways, actual and expected inflation rates could rise quickly and sharply. See Bordo and Levy (2021) for a similar warning and some discussion of historical parallels.

The Fed's new framework and its current policy stance raise the likelihood of this scenario and, if it emerges, make it more likely the Fed would be slow to respond. In that event, the Fed may find itself faced with undesirably high inflation rates, unanchored expectations about future inflation, a serious loss of credibility, rising risk premia, and a need to re-evaluate its policy framework yet again. That set of circumstances would spill over to credit conditions around the world -- raising borrowing costs, curtailing business investment, and driving large exchange rate adjustments. It would also involve a sizable increase in the flow cost of servicing U.S. public debt outstanding. The trajectory of U.S. fiscal deficits and debt-GDP ratios could quickly emerge as major economic and political issues.

II. Structural Shifts in the U.S. Economy

The 2020 U.S. elections took place amidst an extraordinary public health and economic crisis. Fortunately, the deployment of effective vaccines for the SARS-COV-2 virus is now underway, and it appears likely that the United States and other advanced economies will bring the pandemic under control in 2021. There is much to say about the pandemic, policy responses, and the economic consequences. Here, I confine my attention to certain structural shifts in the economy triggered by the pandemic.

The COVID-19 shock generated massive shifts in demand across and within industries. Barrero, Bloom, and Davis (2020, 2021a) provide evidence on the near, medium, and longer-term reallocative aspects of these shifts in the US economy. The evidence in their studies and others points to rapid acceleration in the growth of online shopping and delivery, high expected job and sales reallocation rates in the wake of the pandemic, a large upheaval in labor markets, less business travel and greater reliance on virtual meetings, and a huge shift to working from home. Davis *et al.* (2021) provide complementary evidence based on cross-sectional patterns in firm-level equity returns.

There are sound economic reasons to think that pandemic-induced shifts in consumer spending patterns, business practices, and working arrangements will partly stick. Millions of households have tried online shopping and delivery services in the past year. Some find they like it and will continue to value the convenience and (perceived) safety after the pandemic ends.2 Businesses plan for a 30 percent drop in their travel expenditures *after* the pandemic ends, as compared to the pre-pandemic situation (Altig 2020a). After turning to virtual meetings out of necessity, many businesses are likely to see them as an easier, cheaper option to travel and in-person meetings in some circumstances. A persistent drop in business travel has profound implications for the travel and hospitality industries.

These empirical observations point to large benefits of policies and policy reforms that facilitate a speedy reallocation of jobs, workers, and capital to newly productive uses in the wake of the pandemic. Policies that deter or slow reallocation are likely to further lengthen the lag of creation behind destruction, slowing the overall recovery from the pandemic, the lockdown, and the pandemic-induced reallocation shock. Barrero *et al.* (2020) develop this theme at some length. Policies that facilitate productive reallocation can also ease supply constraints and complement the role of fiscal and monetary policy in stabilizing demand. In turn, aggregate demand stabilization and monetary policy actions that ensure the smooth functioning of the financial system help set the stage for a speedier reallocation of jobs, workers, and capital to their most efficient uses.

Worker surveys suggest that employers plan for their full-time employees to supply about 20 percent of workdays from home *after* the pandemic ends, as compared to 5 percent before the pandemic (Barrero *et al.* 2021b). When asked directly, business executives say they expect full-time employees to supply about 15 percent of workdays from home after the pandemic ends (Altig 2020a). Barrero *et al.* (2021b) provide evidence on several mechanism behind a persistent shift to working from home: better-than-expected experiences when working from home during the pandemic, large new investments in physical and human capital that enable working from home, a greatly diminished stigma

[2] For examples of how this shift is playing out in groceries, restaurants and new automobile sales, see Mims (2020c), Naughton (2020) and Mims (2020b), respectively.

associated with working from home, lingering concerns about crowds and contagion risks, and a pandemic-driven surge in technological innovations that support working from home (Bloom *et al.* 2021).

The shift to working from home raises questions about the future of the dense urban core in cities like New York and San Francisco, where a large share of commuters work in skill- and information-intensive jobs that are amenable to working from home (Althoff *et al.* 2020). Barrero *et al.* (2021) estimate that, relative to the pre-pandemic situation, the post-pandemic shift to working from home will lower post-COVID worker expenditures on meals, entertainment, and shopping in central business districts by 5 to 10 percent of taxable sales. This loss of sales tax revenues and a possibly large fall in the property tax base could add materially to the fiscal strains that were already facing many American cities before the pandemic.

In light of these observations, the strength of economic recovery over the medium run in the United States and other countries will turn partly on whether policies facilitate or impede an effective adjustment response to unusual, and unusually large, shifts in the structure of demand and working arrangements.

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