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Economics Group

Michael Pugliese, Economist
michael.d.pugliese@wellsfargo.com • (212) 214-5058
Hop Mathews, Economic Analyst
hop.mathews@wellsfargo.com • (704) 383-5312

What's Happening on the Fiscal Front?

Fiscal policy developments have been occurring at a rapid pace. We suspect a <u>sizable</u> fiscal stimulus is in the offing in the United States, but the ultimate scope and design remain incredibly unclear.

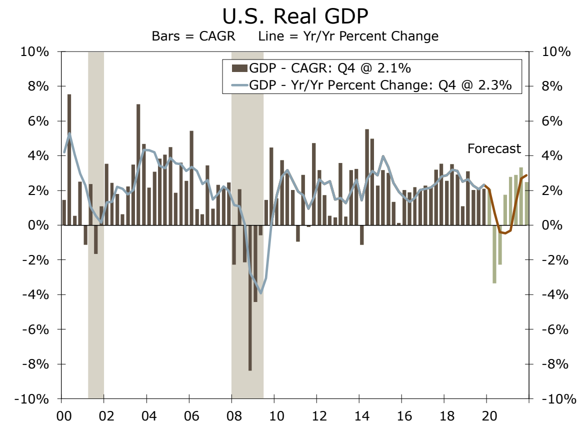
Fiscal Stimulus Coming in Phases

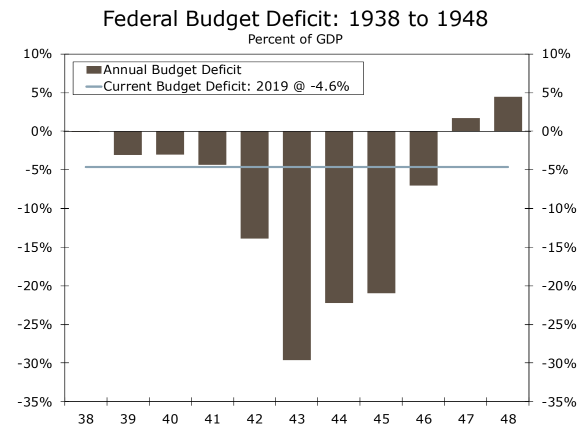
On March 6, Congress passed "Phase I" of its COVID-19 response, authorizing $7.8 billion in new spending towards a variety of policy goals, such as the development of vaccines or the acquisition of medical equipment. Last week, the House of Representatives passed "Phase II" in response to COVID-19. This package included a slew of new measures, including increased Medicaid cost-sharing by the federal government, limited expansion of unemployment and SNAP benefits and an emergency paid sick leave program for certain workers. There is still no official score on the total bill from the Congressional Budget Office, but it is safe to say this bill is more costly than the first. The Joint Committee on Taxation scored the tax credits associated with paid sick leave as costing $105 billion over two years. As of this writing, the bill is awaiting action in the Senate.

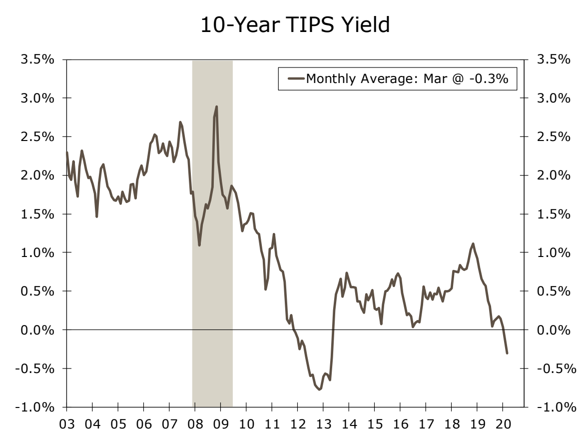
Neither Phase I nor Phase II was a full-blown, macro-oriented fiscal stimulus, at least in our view. As Congress moves to Phase III, we believe sizable stimulus is what comes next. Treasury Secretary Mnuchin has reportedly requested $850 billion to combat the economic effects of the virus. Were this request to be met, it would amount to about 4% of U.S. GDP. For context, the stimulus bill passed in February 2009 was about 5.5% of U.S. GDP. Given how rapidly the economic situation is deteriorating, it would not surprise us if the $850 billion number quickly grows, probably to north of $1 trillion. How this money is spent is still really anyone's guess, as countless ideas are circulating. We suspect that it will ultimately include some of everything; tax cuts; transfer payments to households, businesses and state/local governments; and direct federal consumption and investment, as policymakers attempt to throw the kitchen sink at this.

Just how big could fiscal stimulus get? During the Great Recession, the federal budget deficit peaked around 10% of GDP. Were the federal government to run a similar deficit this year, it would amount to about $2.2 trillion. For some context, we expected the federal budget deficit this year to be about $1 trillion before COVID-19 entered the picture.

But even this 10% of GDP figure probably does not represent the true upper bound on federal borrowing. During World War II, the federal budget deficit peaked at nearly 30% of GDP in 1943, and was more than 20% each year in the 1943-1945 period (middle chart). <u>A federal budget deficit of 30% of GDP today would amount to nearly $7 trillion.</u> Of course, financing these deficits required extraordinary efforts, such as sizable war bond programs directed at the public and direct coordination between the Treasury and the Federal Reserve. And while we doubt the fiscal response will be anything quite that big, we highlight this to remind readers that the federal government possesses significant fiscal ammunition, particularly at a time when real interest rates on Treasury securities remain negative (bottom chart).







Source: Office of Management and Budget, U.S. Depts. of the Treasury and Commerce and Wells Fargo Securities

Wells Fargo Securities Economics Group

Jay H. Bryson, Ph.D.	Acting Chief Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Macro Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Azhar Iqbal	Econometrician	(212) 214-2029	azhar.iqbal@wellsfargo.com
Sarah House	Senior Economist	(704) 410-3282	sarah.house@wellsfargo.com
Charlie Dougherty	Economist	(704) 410-6542	charles.dougherty@wellsfargo.com
Michael Pugliese	Economist	(212) 214-5058	michael.d.pugliese@wellsfargo.com
Shannon Seery	Economic Analyst	(704) 410-1681	shannon.seery@wellsfargo.com
Matthew Honnold	Economic Analyst	(704) 410-3059	matthew.honnold@wellsfargo.com
Jen Licis	Economic Analyst	(704) 410-1309	jennifer.licis@wellsfargo.com
Hop Mathews	Economic Analyst	(704) 383-5312	hop.mathews@wellsfargo.com
Coren Burton	Administrative Assistant	(704) 410-6010	coren.burton@wellsfargo.com

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