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Should the euro area worry about the US overheating?

One of the lessons of 2020 is that problems which many in the world had stopped worrying about can rear up with sudden force. There is a real risk that the overheating of the U.S. economy becomes one of them.

In pre-pandemic times, a low growth – low inflation scenario had led the mainstream circles of economic policymaking to focus on subdued demand problems, anchoring an environment of low interest rate expectations. The initial policy response to the economic crisis of the COVID-19 reinforced these expectations.

Against an unprecedented shock, there was a pressing need for central banks to anchor accommodative financial conditions with major liquidity injections and low interest rates. Economies steadied and most recently they have even managed to adapt to the restrictions that are still needed to contain the pandemic. A sustained recovery is now in sight as the vaccination campaign gathers speed.

China's case aside, the US is set to be one of the first countries to regain pre-pandemic levels of economic activity. Supported by a comparatively fast vaccination campaign, the Fed's accommodative monetary stance, a major fiscal push and a boost from pent-up demand (real disposable personal income managed to grow by an astonishing 6% in 2020), this could happen as soon as mid-2021.

In this context, the fiscal packages approved at end-2020 and in March 2021 (which together amount to ca. 15% of GDP) have led many to warn about a significant risk of overheating in the US. This alarm has been raised before and proved wrong. The scars of a balance sheet recession and a low money multiplier hampered the inflationary pressures on goods and services of the massive monetary expansion in the Great Recession – while price pressures were more visible among real estate and financial assets.
But this time really could be different: the huge fiscal stimulus has shifted much of the potential impact from the private sector balance sheet onto the public sector and a lot of the cash that the Fed has injected has gone directly into people's pockets through fiscal transfers. While there was no doubt that a locked-down economy needed income support, many voices across the political spectrum are warning that doubling down on a stimulus that will be implemented with a recovery well underway poses significant overheating risks in the US.

A few steps behind, Europe's recovery could benefit from a booming US economy thanks to the positive spillovers on external demand – raising euro area growth and, possibly, nudging up Europe's inflation. The euro depreciation against the dollar would also provide support to European exporters.

At the same time, an overheating US economy could also imply higher interest rates not only in the US but also abroad. Changes in US rates tend to spill over to other economies in a highly synchronous manner. As a matter of fact, Europe has recently imported a bit of the increase in US yields. Overall, positive spillovers from stronger US demand and a weaker euro may outweigh the drag from higher interest rates – more so because the ECB has the firepower and the commitment to keep financial conditions anchored in an accommodative region.

But there are also risks. If a US overheating materializes and inflationary pressures become more persistent, US monetary policy could face an uncomfortable dilemma: stick to the 'low interest rates for long' narrative that has supported markets in the past decade – risking higher inflation and future financial instability – or tighten the policy stance and risk an abrupt readjustment of expectations in financial markets. In any event, no matter the response, global and European financial conditions could be set for a bumpy ride.