Practical challenges of fiscal/monetary response to COVID-19 situation in the USA

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Abstract; The article's main objective was to analyze sentiment, financial markets, and Consumer Price Index (CPI) emotional impact. It narrates and summarizes the changes that have occurred since the onset of the financial crisis and financial recession in 2003. Data document review is the main method used to collect data for the article. The article borrows concepts and theories from the cited sources. As per the article, it is hard for the government to target specific parts of the economy. The mainstream economic limits in the covid-19 era disproved several theoretical pillars of the mainstream economy. According to studies, conventional economic theory holds that people are constantly eager to adapt their requirements and satisfactions to better their balance sheets for increased utility. The demand and supply rules serve as the foundation for modern economics models. It demonstrates how the market continually seeks equilibrium. One of the key tenets of orthodox economics is that since economists are practical by nature, it follows that everyone wants their unique needs to be satisfied. People occasionally judge and make decisions, which is the limitation of contemporary mainstream economics in addressing real-world issues. The key dangers are that these markets could cause the real economy to suffer from risk re-pricing, decreased confidence, falling asset values, and tighter financial conditions. Mainstream economics influences most people's lives aspects. Its majority dealings are at the house level and are deeply flawed in terms of their real-life impact. Individuals commonly follow market trends and predictions, and any shift will undoubtedly impact the individual.

1. Introduction

This article is centered on the limitations and irrationality that mainstream economics possesses in the context of the new crown epidemic. By analyzing traditional economics tools such as CPI, monetary/fiscal policy, unemployment and inflation, etc., the article illustrates the narrow and flawed generality of mainstream economics. It also provides suggestions and approaches by illustrating some of the irrational moves made by the government in reliance on mainstream economic theory. For example, the stagflation was manipulated by President Trump during his administration. Not only did this put the U.S. economy on the brink of collapse, but the negative public sentiment was also particularly high. Therefore, in this article I will carefully and logically develop all the issues mentioned above and hope that my methods and conclusions will be effective in helping some people.

2. Traditional Policy Tools during Crisis

2.1 Fiscal Policy

Authorities often employ fiscal policy as their primary tool to intervene in the economy. However, the impact of fiscal policy changes like tax increases or decreases in expenditure may take time to become apparent, which is one of its significant drawbacks. Tax cuts, for instance, could not immediately lead to increased consumer expenditure. Alternatively, they may wait to see how the tax reduction affects their long-term income and only spend more if they are confident that their income will improve. The inability to focus on specific sectors of the economy is another weakness of budgetary policy[11] (Gregory, 2022). For example, if the government wants more money to be spent on home upgrades, it may reduce taxes on such work. A potential downside to this tax break is that it may encourage frivolous expenditure, which suggests that the government's new budgetary strategy may have a different impact.

2.2 Monetary Policy

Monetary policy changes take a long time to affect the economy as well. It takes time for banks to modify lending rates and for consumers and companies to react. This implies that a monetary policy adjustment may take a year or more. As a result, it is tough to target specific parts of the economy using monetary policy. For example, to stimulate home improvements, the central bank may decrease interest rates[5] (Chowell et al., 2020). This loan rate drop might lead to more lavish spending on holidays and autos. Fiscal and monetary policies may be beneficial, but they have limits. Targeting specific parts of the

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economy may be difficult, and policy changes might take a long time to impact.

2.3 Analysis of the Impact of Policy Change on Consumer Spending

An increase in government expenditure, which is not reliant on any other factor, leads to a rise in aggregate demand for goods and services. In turn, this causes the IS curve to shift outward toward higher prices. As a consequence, the IS-LM model forecasts that an increase in government spending would cause the equilibrium to shift from point E to point B, which will result in an increase in both the rate of interest (from r1 to r2) and the amount of income (from Y1 to Y2). If the central bank decides to raise the interest rates it charges to commercial banks. Those commercial banks will, in turn, increase the interest rates they give to people and companies in the market for borrowing money[1] (Afonso et al., 2019). Consequently, personal loans, auto loans, credit card balances, and mortgages cost more, and borrowers are becoming less eager to take out these types of credit.

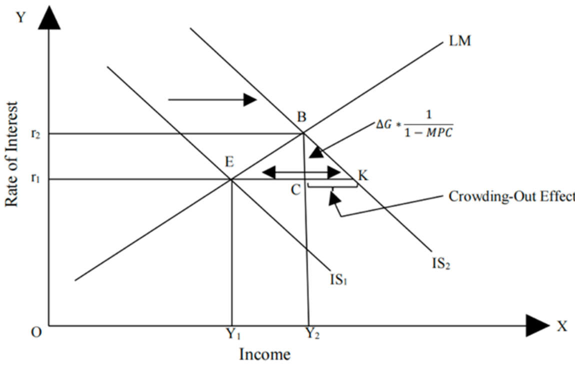

Figure 1: Illustration of Increase in Interest rates.

From figure 1 above, a loss of income equal to CK has occurred because of the rise in interest rates, which has caused a decline in private investment. The CK illustrates the displacement caused by a rise in public expenditure. This implies that more public spending will discourage certain forms of private investment. The economic effects may not become apparent for months or even years. While money may momentarily boost the economy, other economists argue that it does nothing more than raise prices and discourage investment.

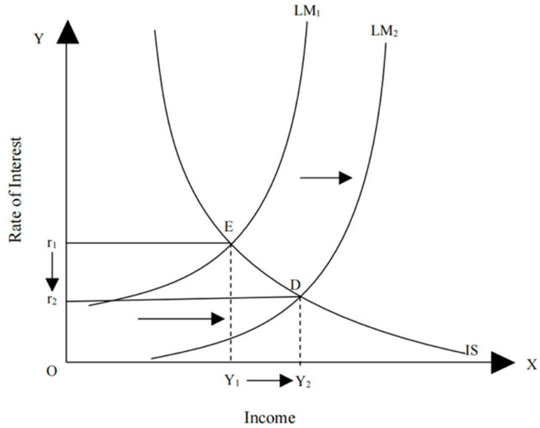

Figure 2*:* Decrease in rate of interest.

Changes in the interest rate (from r1 to r2), national income (from Y1 to Y2), and equilibrium point (from E to D) will cause a change in the economy. The IS-LM model shows that increasing the money supply reduces interest rates and boosts income. Interest rates can only be lowered to zero on a nominal basis, thus any further reduction below r2 might be risky; since rates are already at record lows, the bank has little room to maneuver with this policy tool[2] (Blanchard, 2019). Moreover, low interest rates over a long period may cause a liquidity trap when the savings rate is high relative to the interest rate, thereby nullifying the effects of monetary policy.

3. The Response to COVID-19 by the US Government

The start of 2020 was followed by severe health crises as COVID-19 spread worldwide. In the USA, the situation worsened, and the federal government had to set a fiscal and monetary framework to address the situation. The Fed's initiatives to stimulate the economy came into three primary categories: reductions in interest rates, increased lending and asset acquisitions, and changes to regulatory policies.

The US monetary policy response during COVID-19 was the target set of the federal funds rate first to 1%, which later was set at 0% by the Fed Stimulus measure and offering forward guidance to investors. In addition, the fiscal measure adopted by the federal government included mortgage reliefs, deferred payroll charges, deferment of utility bills, wage subsidies, unemployment benefits, and Value Added Tax (VAT) reductions[9] (Feyen et al., 2020). The loans and asset acquisitions occur in the form of general purchases conducted as part of quantitative easing (QE), when the Fed buys assets directly and repurchases operations.

Meanwhile, the Fed established several distinct lines of credit and programs through which it funded loans[8] (de Soyres et al., 2022). The goal of the monetary policy was to increase the money supply and maintain a price-stability economy. At the same time, the fiscal policy aimed to provide economic stability and constantly improve growth with capital formation.

3.1 The Limitation of Mainstream Economics in Post-Covid Era

As time goes by, empirical evidence refutes some of the theoretical pillars of mainstream economics. According to Göpel[10] (Göpel, 2016), mainstream economics does not use terms such as needs but instead adopts the concept of utility. The paradigm seeks to understand people's needs and what motivates them to do certain things. From the research, the utility obtained from a certain service or product expresses a cost-benefit or plain-pleasure trade-off when making certain choices. The research shows that mainstream economics views people's needs and satisfaction as always willing to improve their balance sheet to achieve greater utility. The models of mainstream economics are built on the laws of demand and supply and the law suggesting that a market always tends towards equilibrium.

3.2 The Limitation of Utility-Based Theory

According to Cambridge Core, one of the main assumptions of mainstream economics is that because economists always seek utility, it is clear that everyone seeks to satisfy their personal needs[3] (Cambridge Core, 2019). This being the case, the impact of mainstream economics on vaccine rollout depends on whether consumers achieve utility. For example, during the Covid-19 pandemic, different countries' governments ensured vaccines were effectively rolled out to reduce the spread[16] (Salmon, et al. 2021). Because mainstream economics assumes that people always seek their benefits, people are likely to go and get the vaccines. However, the vaccination rate only got to a certain point and became difficult to improve further because only some trusted it. The shortcoming of mainstream economics in dealing with real-life issues today is that people only sometimes make decisions based on utility.

3.3 The Misused Stimulus Checks

Because Covid-19 paralyzed many businesses and jobs, the US government rolled out direct payments for people unable to meet their daily needs. According to Coscieme, et al, some of the myths that mainstream economists outlined is that increasing income leads to higher levels of well-being[6] (Coscieme, et al., 2019). From the research, this assumption is not applicable today because when human beings get additional income, they sometimes cease to become rational thinkers in terms of spending. Therefore, when the US government offered direct payments to the citizens, they assumed that these people could make rational decisions and use the money appropriately. However, there are people who, instead of using direct payments to cater to their basic needs, use the money for leisure activities which is different from the government's wish.

3.4 The Side-Effect of Unemployment Benefit

For people who were unemployed or lost their jobs during the Covid-19 pandemic, the government offered them benefits such as food and housing aid. Mainstream economists assume that increased efficiency leads to decreased use of resources[6] (Coscieme, et al. 2019). These economists, therefore, assumed that when people are offered such benefits, there will be increased efficiency in the economy. Unfortunately, in today's world, a number of people tend to misuse such privileges given to them by the government. When the US government realized that people were suffering because of the effects of the pandemic, they decided to print more money to cushion those unable to take care of their needs[13] (Kirwin & Ettinger 2022). However, printing such money at this time would mean increased inflation, possibly affecting the economy negatively. Therefore, the assumption that offering such benefits to people ensures efficiency in the economy only holds in the short run because of adverse effects such as inflation.

3.5 The Increasing Wealth Gap

As per Coscieme, et al, wealth does not flow from the rich to the poor in globalized economies[6] (Coscieme, et al., 2019). Mainstream economists assume that when the rich have money, the money will flow to the poor. In the world today, it is observed that most of the time, the rich continue to become richer while the poor remain in their state. While the US government's decision to protect small businesses was a viable idea, today's world only sometimes works according to the stipulations of mainstream economics. In order to ensure there is consistent growth in the economy, governments should ensure they protect consumers as well as offer subsidies for businesses in order to achieve success and grow the economy at large.

4. Lessons Learned and Possible Future Opportunities

Mainstream economics plays a significant part in many aspects of people's lives. However, in many cases, mainstream economics needs to improve in dealing with the real-life effects at the household level. These issues affect people directly through the consumer price index (CPI), unemployment, financial markets, and sentiment. In addition, these factors are directly influenced by events such as US dollar interest rates, changes in the financial market, the global commodity crisis, and the effects of the COVID-19 pandemic.

4.1 Inflation

The influence of mainstream economics on the Consumer Price Index has shifted dramatically over the last 15 years in response to changes in the global financial markets, changes in current interest rates, and financial crises like the 2008 financial recession and the global commodity crisis[4] (Chen et al., 2018). The response of households to different economic events was compounded when the COVID-19 crisis hit, leading to complicated economic dynamics. A report by the San Francisco Federal Reserve indicates that most OECD countries have generally displayed similar CPI inflation rates to each other[12] (Jorda et al., 2022). Generally, the US core CPI inflation remained about 1 percentage point higher than OECD countries[12] (Jorda et al., 2022). This difference was primarily created by the Global Financial Crisis and the euro-area sovereign debt crisis that followed soon after, meaning that most OECD countries faced difficulties in raising inflation to the target.

The inflation level has been at its worst in recent years for the entire world. People from different countries are all facing the issue of inflation, market declines as well as a potential recession of the economy. The main reason is that the interest rates have increased by almost 90 central banks, and half have been swift—at least 75 basis points[15] (Miller, 1). In my view, it slows down economic development, and business owners cannot raise prices swiftly, leading to our current recession.

As US dollars are the global currency, thus it is connected with the whole world. The unexpectedly lowered taxes by the new British government caused the pound and the market for UK government bonds to fall[14] (Mackintosh, 1).

4.2 Unemployment Rate

Unemployment rates in the country have steadily reduced as the recovery from the COVID-19 pandemic continues, with the US economy rebounding at an astonishing rate. After the recession, unemployment decreased consistently before the COVID-19 pandemic, which led to increased rates of led to increased rates that got to as high as 14.7% in April 2020 during the first COVID-imposed lockdowns[12] (Jorda et al., 2022). A marked increase in employment rates led to a 3.8% unemployment rate as of February 2022. Reports by the Congressional Budget Office reveal that the gap between the potential GDP rate and actual GDP has almost reduced to below 0.5%[12] (Jorda et al., 2022). Further room for these figures to improve exists as there has still not been a full recovery in the global supply chain, which is faced with persistent distortions due to the forecasting of possible financial recession and subsequent waves of COVID-19 infections that have continually disrupted service-oriented industries. This means that the unemployment rates could reduce even further if the recession is avoided.

4.3 Financial Market Stability

Financial markets have been affected by the global commodity crisis that saw financial markets decline steeply. The primary risk posed by the crisis of financial market developments is that these markets tend to affect the real economy through weaker confidence, tightening financial conditions with a repricing of risk, and declining asset prices. As a result, knock-on effects can be produced worldwide due to decreased consumption within the United States. Nevertheless, it is possible to mitigate the risks as long as financial conditions eventually return to normal[7] (De Rato, 2007), because household finances will be continually sustained through steady employment growth, and many corporations will remain highly profitable. Therefore, in such instances, the financial markets and the US economy will continue to grow moderately, and no adverse effects will be felt at the household level.

4.4 Future Expectation

Over the past decade, significant changes have been driven by sentiment and predictions regarding the economy. For instance, in the present financial climate, many people are apprehensive about the future as home prices soar and financial experts predict the possibility of a financial recession. This is familiar because people have generally followed market trends and predictions. As a result, people are apprehensive about the markets and are, therefore, unwilling to spend, leading to a reduction in the cash in circulation. Factors like these contribute to economic downturns and may contribute to any possible financial crisis. For instance, during the global commodity crisis, people sold their stocks. They opted to invest in real estate, which contributed to the oversaturation of the housing market, which has played a part in the current crisis.

5. Conclusion

Many aspects of people's lives are affected by mainstream economics. In many cases, mainstream economics has significant shortcomings in dealing with the real-life effects at the household level. This paper analyzes the effects of the Consumer price index (CPI), unemployment, financial markets, and sentiment. The Consumer Price Index has shifted dramatically over the last 15 years in response to changes in the global financial markets, current interest rates, and financial crises like the 2008 financial recession and the global commodity crisis. Unemployment decreased consistently before the COVID-19 pandemic leading to increased rates of as high as 14.7% in April 2020 during the first COVID-imposed lockdowns[12] (Jorda et al., 2022). It is possible to mitigate the risks as long as financial conditions eventually return to normal because household finances will be continually sustained through steady employment growth, and many corporations will remain highly profitable. People have generally followed market trends and predictions, and any changes are bound to affect the individual.

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