

Death of a Theory

Executive Summary

In this article, Federal Reserve Bank of St. Louis President James Bullard discusses business cycle stabilization using fiscal rather than monetary policy. He concludes that the turn in recent years toward fiscal approaches to stabilization policy has run its course and that the conventional wisdom of the past several decades is reasserting itself. In short, the conventional wisdom says that stabilization is the realm of monetary policy and that fiscal policy should focus on medium- and longer-run goals.

Macroeconomic stabilization policy means reacting in a timely manner to aggregate shocks that hit the economy and in a way that smoothes out an otherwise rocky ride for the economy's businesses and households. Fiscal policy attempts to do this through changes in taxes and government spending, and monetary policy attempts to do this by targeting the nominal interest rate or, when the interest rate is near zero, by influencing inflation and inflation expectations primarily through quantitative easing.

Bullard notes that over the two decades leading up to the financial crisis, the conventional wisdom was that fiscal policy was not a good tool for macroeconomic stabilization. Conventional wisdom suggested that shorter-run stabilization issues should be handled by the monetary authority and that fiscal authorities should focus on a stable taxing and spending regime to achieve economic and political goals over the medium and longer run. This state of affairs lasted, broadly speaking, until the fall of 2008.

At that point, the short-term nominal interest rate targeted by the Federal Open Market Committee was pushed nearly to zero, where it remains to this day. This led many to conclude that the burden for short-term macroeconomic stabilization had, as a result, shifted to fiscal policy. Indeed, over the past three years, we have seen numerous attempts at stabilization policy by fiscal authorities in the U.S. and around the globe. Bullard argues that the net effect of these attempts has been to confirm much of the conventional wisdom regarding fiscal stabilization policy that existed prior to the financial crisis.

Much research has been published on when the fiscal approach to business cycle stabilization would be useful and effective. Bullard cites a paper by Michael Woodford¹ in which Woodford notes that "while a case for aggressive fiscal stimulus can be made under certain circumstances, such policy must be designed with care if it is to have the desired effect." This line of research assumes that monetary business cycle stabilization policy is ineffective and unable to influence real interest rates once the policy rate is near zero. In addition, the types of policy experiments considered in this research involve extra government spending and taxation *only* during the period when the policy rate is near zero and financial markets are in considerable turmoil, and not any longer than that.

Three key issues related to the assumptions in Woodford's paper lead Bullard to doubt the merits of possible fiscal stabilization programs for the present circumstances. These three issues are:

1. The types of fiscal policy interventions recommended in the research are fairly intricate and must be designed carefully if they are to have the desired effect. However, the conventional wisdom on fiscal stabilization policy emphasizes that political processes in the U.S. and elsewhere are not well-suited to make timely and subtle decisions like these.

¹ Michael Woodford, 2011. "Simple Analytics of the Government Expenditure Multiplier." *American Economic Journal: Macroeconomics* 3: 1-35.

2. Bullard emphasizes that monetary stabilization policy has been quite effective, even while the policy rate has been near zero. This is because the monetary policy authority can use many other tools to influence inflation and inflation expectations. Thus, a turn toward fiscal stabilization policy is not necessary.
3. Although the research says that taxes should be collected simultaneously with the increase in government spending, the actual fiscal stabilization policy for many countries has involved heavy reliance on government borrowing. This increased debt would be interpreted as promised future taxes. However, shifting the taxes into the future can undo most or all of the benefits that might otherwise come from the fiscal stabilization program.

In light of increased debt in the West, Bullard discusses issues related to debt sustainability. According to research on the topic, “too much debt” for a sovereign nation will be defined by the point where the temporary benefits of default exactly offset the value of continued access to international credit markets. The research says markets will understand the incentive to default and, thus, will not lend to a nation beyond this point. Bullard argues that debt yields alone are not the best way to evaluate whether a nation is borrowing too much; that is, low interest rates may not be a good indicator of the probability of a debt crisis. A look at the data for selected European countries, such as Greece and Portugal, from 2000 to the present confirms this.

Bullard concludes that the conventional wisdom on stabilization policy is being re-established in the U.S. Stabilization policy should be left to the monetary authority, which can operate effectively even with a near-zero policy rate. Fiscal authorities should set the tax and spending programs in a way that makes economic and political sense for the medium to longer term. In particular, a stable tax code that is aligned with a stable plan of government spending would allow businesses and households to plan for the future in the most effective way.