Some Background

What is the role of monetary policy in alleviating economic downturns?

ECONOMIC STIMULUS

Q. What is the role of monetary policy in alleviating economic downturns?

A. Economists view monetary policy as the first line of defense against economic slowdowns—the Federal Reserve can act faster than the president or Congress, and it is better equipped to judge the appropriate timing and magnitude of economic stimulus.

Monetary policy—adjustments to interest rates and the money supply—can play an important role in combatting economic slowdowns. Such adjustments can be made quickly, and monetary authorities devote considerable resources to monitoring and analyzing the economy. Monetary policy can offset a downturn because lower interest rates reduce consumers' cost of borrowing to buy big-ticket items such as cars or houses. For firms, monetary policy can also reduce the cost of investment. For that reason, lower interest rates can increase spending by both households and firms, boosting the economy.

The Federal Reserve can adjust monetary policy more quickly than the president and Congress can adjust fiscal policy. Because most contractions in economic activity last for only a few quarters, a prompt policy response is crucial. Yet fiscal policy in practice responds slowly to changes in economic conditions: it takes time first to enact a stimulus bill and then to implement it, and time for the spending increases or tax reductions to reach consumers' pockets. As a result, the effect of fiscal stimulus on household and business spending may come too late.

Whether and how much stimulus is needed depends on present economic conditions, on projections of future conditions, and on possible risks to both economic activity and inflation. Forecasting economic conditions—or even determining the current state of the economy—is inherently difficult, given limitations in the data available and in economists' understanding of the world. But the Federal Reserve's large and sophisticated team of analysts is better positioned to accomplish this task than any other agency of the federal government. In addition, the Federal Reserve staff carries out this work independent of political considerations.

The potential of monetary policy to combat extreme events is limited, however, because its primary tool is the short-run interest rate, and that rate can't fall below zero. That means that in a particularly severe downturn such as the recent Great Recession, the Federal Reserve will reduce the short-run interest rate to zero, after which the Fed can employ only less effective and well-understood policies such as asset purchases. Under those conditions, fiscal policy may complement monetary policy in boosting the economy.

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Some Background

ECONOMIC STIMULUS

What are automatic stabilizers and how do they work?

Q. What are automatic stabilizers and how do they work?

A. Automatic stabilizers are features of the tax and transfer systems that temper the economy when it overheats and stimulate the economy when it slumps, without direct intervention by policymakers.

Automatic stabilizers offset fluctuations in economic activity without direct intervention by policymakers. When incomes are high, tax liabilities rise and eligibility for government benefits falls, without any change in the tax code or other legislation. Conversely, when incomes slip, tax liabilities drop and more families become eligible for government transfer programs, such as food stamps and unemployment insurance, that help buttress their income.

Automatic stabilizers are quantitatively important at the federal level. A 2000 study estimated that reduced income and payroll tax collection offset about 8 percent of any decline in gross domestic product (GDP). Additional stabilization from unemployment insurance, although smaller than that from the tax system, is estimated to be eight times as effective per dollar of lost revenue because more of the money is spent rather than saved. Altogether, a 2016 study estimated that if transfer payments were reduced in size by 0.6 percent of GDP, US output and hours worked would be about 6 and 9 percent more volatile, respectively.

The Congressional Budget Office estimates that through increased transfer payments and reduced taxes, automatic stabilizers provided significant economic stimulus during and in the aftermath of the Great Recession of 2007–09, and thereby helped strengthen economic activity. That stimulus amounted to more than $300 billion annually in 2009 through 2012, an amount equal to or exceeding 2.0 percent of potential GDP in each year. (Potential GDP measures the maximum sustainable output of the economy.)

Automatic stabilizers also arise in the tax and transfer systems of state and local governments. However, state constitutions generally require balanced budgets, which can force countervailing changes in outlays and tax rules. These requirements do not force complete balance annually: they generally focus on budget projections rather than realizations, so deficits can still occur when economic conditions are unexpectedly weak. In addition, many governments have "rainy day" funds they can draw down during periods of budget stringency. Even so, most state and local governments respond to an economic slowdown by legislating lower spending or higher taxes. These actions are contractionary, working at cross-purposes with automatic stabilizers.

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Q. What characteristics make fiscal stimulus most effective?

A. Fiscal stimulus can raise output and incomes in the short run. To have the greatest impact with the least long-run cost, the stimulus should be timely, temporary, and targeted.

Fiscal stimulus, such as tax cuts or spending increases, can raise output and incomes in the short run by increasing overall demand. To have the greatest impact with the least long-run cost, the stimulus should be timely, temporary, and targeted. *Timely*, so that its effects are felt while economic activity is still below potential; when the economy has recovered, stimulus becomes counterproductive. *Temporary*, to avoid raising inflation and to minimize the adverse long-term effects of a larger budget deficit. And well *targeted*, to provide resources to the people who most need them and will spend them: for fiscal stimulus to work, it is essential that the funds be spent, not saved.

TIMELY

Making fiscal stimulus timely is especially challenging because it involves not just enacting tax cuts or spending but also implementing them. For example, even once enacted, increased government appropriations may not translate into actual spending for quite some time. Poorly timed fiscal policy can destabilize the economy, intensifying rather than damping the business cycle: If fiscal stimulus is enacted too slowly, it might fail to prevent a drop in output and incomes or arrive after recovery has begun, leading to overexpansion and higher inflation.

TEMPORARY

Fiscal stimulus should be temporary because, in the long run, the Federal Reserve generally keeps the economy operating close to full employment and full capacity through monetary policy. This means that, in the long run, fiscal stimulus would not increase output, but instead simply crowd out other economic activity or induce the Federal Reserve to tighten monetary policy to keep inflation down.

Over the long run, permanent tax cuts or increases in government spending that are not matched by changes on the other side of the ledger reduce national saving. The result is less investment or more foreign borrowing. This, in turn, diminishes economic growth and future national income. Also, larger expected budget deficits tend to push up long-run interest rates, which restrain investment and weaken net exports by pushing up the value of the dollar—effects that will undo part or all of the direct stimulative effects of lower taxes or higher government spending. Therefore, a temporary stimulus is likely to be more effective than a permanent policy change, and at a much lower long-run cost.

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What characteristics make fiscal stimulus most effective?

TARGETED

Fiscal stimulus should be well targeted in two ways. First, it should go to households or businesses most likely to raise spending in response to the stimulus and thus increase gross domestic product in the short run. Second, it should provide the greatest benefit to the people most adversely affected by the slowdown. These two aspects of targeting are complementary. Higher-income households can generally smooth their consumption over the business cycle by drawing down their savings or borrowing. Therefore, directing resources to them will likely have little effect on consumer spending. In contrast, lower-income families are more likely to cut back their consumption in hard times. These families are likely to spend any additional money they receive from tax cuts or transfer payments, which helps protect them from the downturn while also boosting the economy.

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