Perspectives On Fiscal Stimulus

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The Role of Fiscal Stimulus

- **"There is now widespread agreement that countercyclical discretionary fiscal policy is neither desirable nor politically feasible."**

  - M. Eichenbaum, AER, 1997

- **"There is now widespread agreement in the economics profession that deliberate countercyclical discretionary [fiscal] policy has not contributed to economic stability and may have actually been destabilizing in the past"**

  - M. Feldstein, NBER, 2002

- **"…it seems best to let fiscal policy have its main countercyclical impact through the automatic stabilizers [and] discretionary fiscal policy to be saved explicitly for longer term issues"**

  - J. Taylor, JEP, 2000

- "Effectively timed and temporary fiscal policy measures could help reduce the risk of a broader economic downturn… fiscal action could boost near term economic growth….research indicates that monetary policy affects the economy over time rather than immediately, with the greatest impact in the year following the rate cuts not in the year the rate cuts are made…"

  - CEA, 2008

- "A key potential advantage of fiscal stimulus relative to monetary stimulus is that it can boost economic activity more quickly. … Thus fiscal stimulus implemented promptly can provide a larger near term impetus to economic activity than monetary policy can"

  - D. Elmendorf and J. Furman, Brookings, 2008

- "… it would be desirable to make sure that the actions take effect when stimulus is most likely needed and are designed to increase economic activity as much as possible for a given budgetary cost. Such well-designed stimulus can help bolster an economy suffering from weak aggregate demand and thereby help reduce the risk and severity of a recession."

  - CBO, 2008

What, If Anything, Changed?

- New evidence?
- New theory?
- Evidence that the 2001-2003 tax cuts worked and that relatively proper timing could be repeated?
- Evidence that monetary policy is less powerful than previously thought?
  - Due to housing channel problems and/or financial stress
- Evidence that a severe recession likely, altering risks of insufficient monetary stimulus
- None of the above?

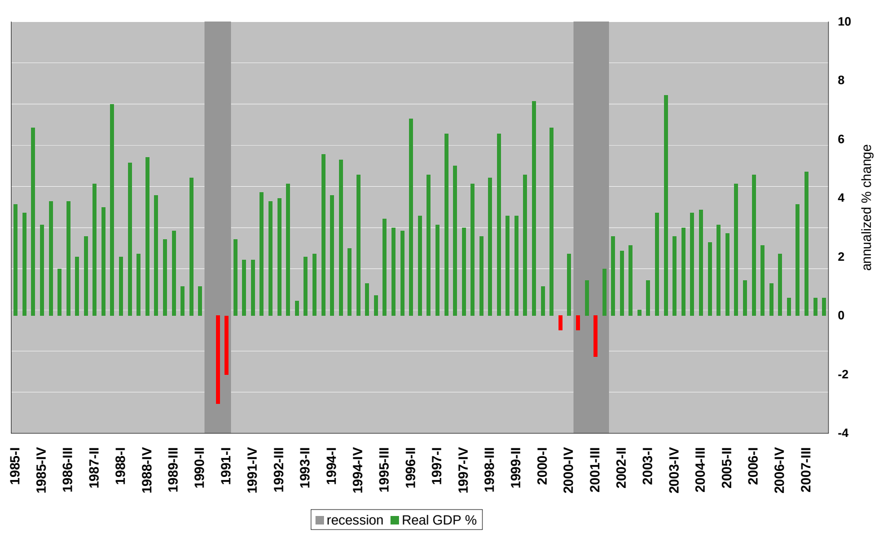
  Should we be relying on monetary policy and the automatic stabilizers?

  Are temporary rebates likely to be ineffective?

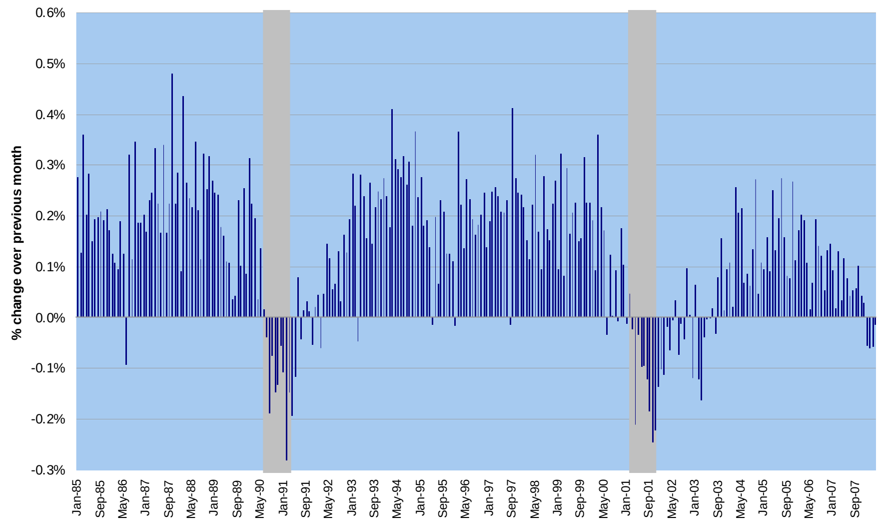
Anatomy of Three Downturns

	1990- 91	2001	Current
Issues:	▪ Oil shock ▪ Real estate bubble bursting (res & commercial) ▪ Credit crunch ▪ Basle I ▪ Defense drawdown ▪ Rising inflation (from 4%) ▪ Rising unemployment ▪ 1987 & 1989 stock market crashes ▪ Current account balance	▪ Stock bubble (esp. tech) crashes ▪ Rising inflation ▪ Very low unemployment (bellow NAIRU) ▪ Fiscal surplus ▪ Current account deficit ▪ 9/11 terrorist attacks ▪ Corporate scandals	▪ Oil shock ▪ Housing bubble crash ▪ Credit crunch ▪ Basle II ▪ Rising non-core inflation ▪ Modest unemployment ▪ Modest SR fiscal deficit ▪ LR fiscal issues much closer – baby boomers retiring ▪ Large current account deficit
Policy response:	▪ Tight money; slow easing ▪ Small fiscal stimulus (plus change in withholding later) ▪ RTC and explicit ex ante put via deposit insurance	▪ Very aggressive monetary easing plus announced FED funds rate would stay low ▪ Fiscal stimulus – phased in rate cuts followed rebates, sped up plus dividend and capital gains cuts added in 2003 ▪ SARBOX	▪ Aggressive monetary easing ▪ Sizable temporary fiscal stimulus via cash rebates ▪ FED expands lender of last resort role aggressively
Result:	▪ Brief, mild recession ▪ Slow early recovery ▪ Falling inflation ▪ Strong, durable expansion	▪ Brief, mild recession ▪ Slow early recovery ▪ Strong expansion	?

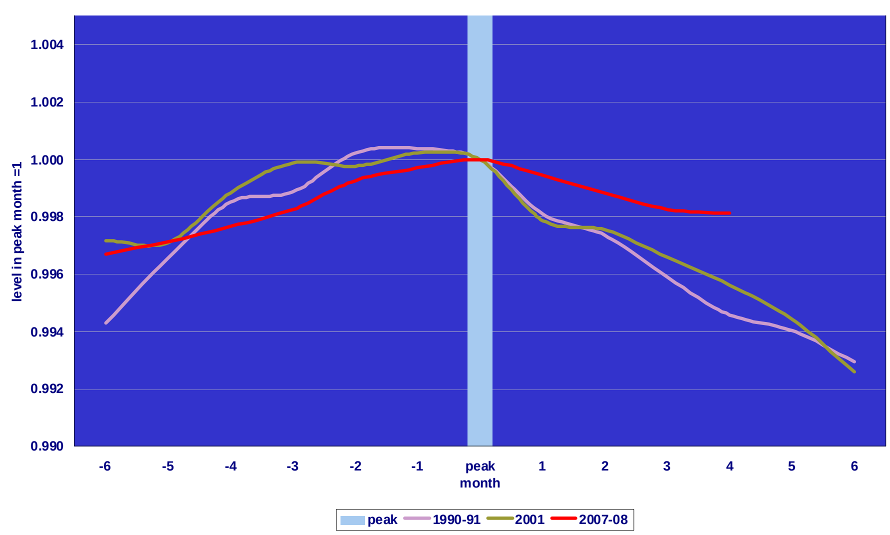
Quarterly % Change in Real GDP



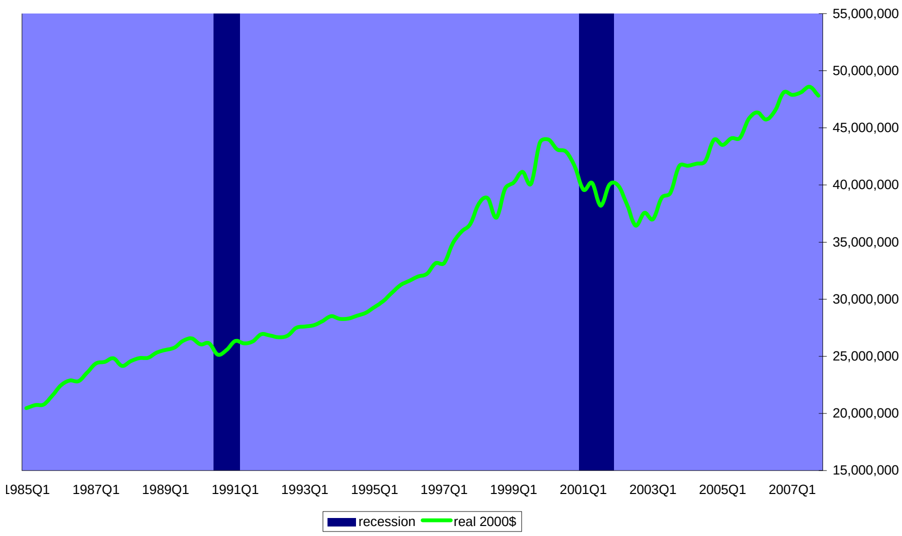
Changes In Non-Farm Employment



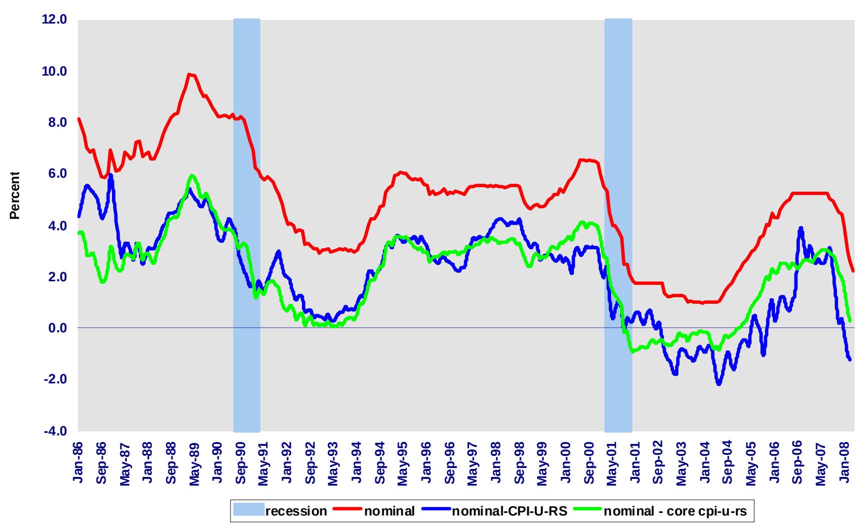
Non-Farm Employment

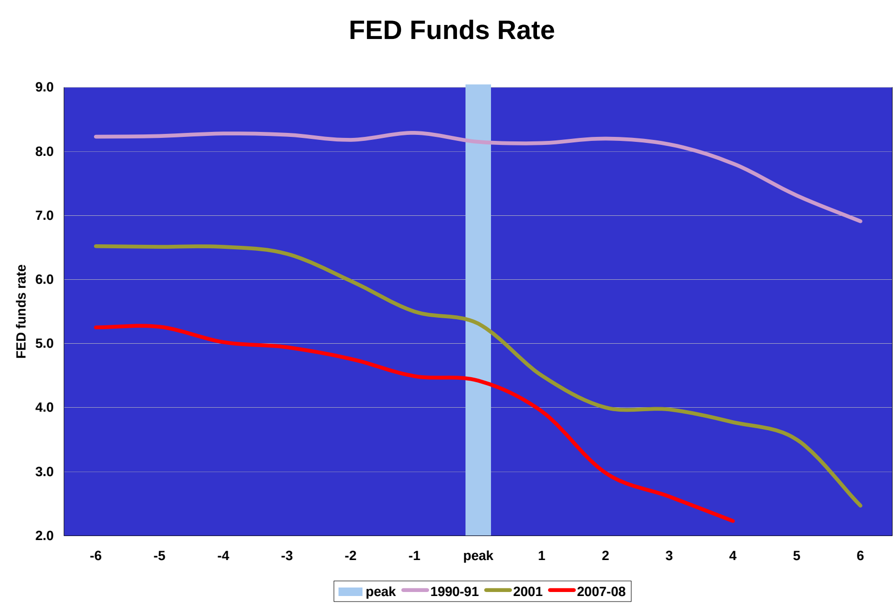


Household Net Worth in Chained 2000 $



Monthly Interest Rates for Federal Funds




FED Funds Rate
FED funds rate
9.0
8.0
7.0
6.0
5.0
4.0
3.0
2.0
-6
-5
-4
-3
-2
-1
peak
1
2
3
4
5
6
peak
1990-91
2001
2007-08

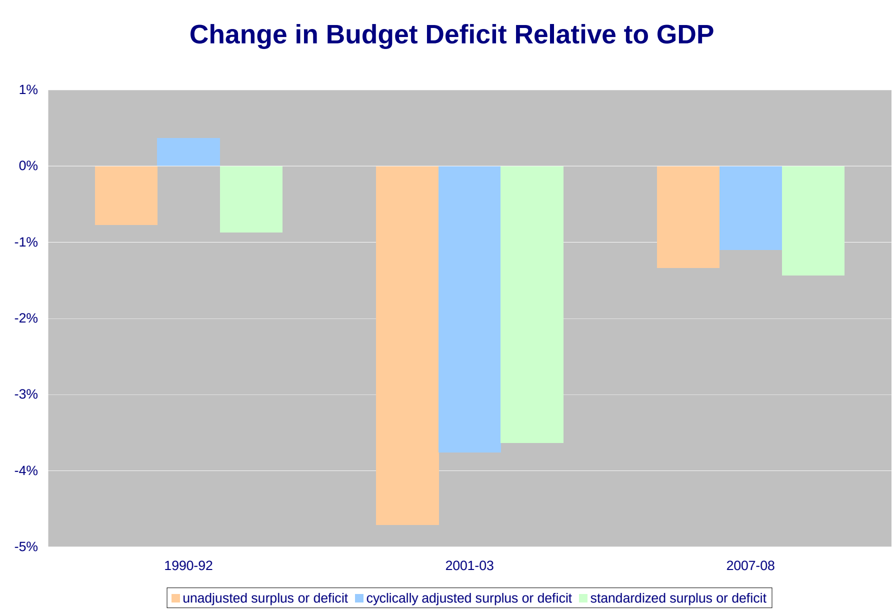

Change in Budget Deficit Relative to GDP
1%
0%
-1%
-2%
-3%
-4%
-5%
1990-92
2001-03
2007-08
unadjusted surplus or deficit
cyclically adjusted surplus or deficit
standardized surplus or deficit

Table 1
GDP Percentage Increase Due to 1.5 Percent Point Reduction
In Federal Funds Rate

	Percentage Increase in GDP			
Model	**Q1 2008**	**Q2 2008**	**Q3 2008**	**Q4 2008**
Federal Reserve Model	**0.02**	**0.20**	**0.35**	**0.39**
Taylor's Model	**0.24**	**0.30**	**0.30**	**0.26**
Small FED Model	**0.17**	**0.33**	**0.38**	**0.33**
Small ECB Model	**0.24**	**0.30**	**0.29**	**0.24**

Source: Wieland (2008)

Table 2
GDP Percentage Increase Due to Fiscal Stimulus
as Estimated by Elmendorf and Furman (2008)

	Percentage Increase in GDP		
Fiscal Stimulus (1% of GDP)	**Q2 2008**	**Q3 2008**	**Q1 2009**
Sustained Increase in Federal Purchases	**1.0**	**1.0**	**0.7**
One-Off Tax Rebate (20% spent)	**0.3**	**0.0**	**0.0**
One-Off Tax Rebate (50% spent)	**1.0**	**1.2**	**- 0.2**

Source: Elmendorf and Furman (2008), based on Federal Reserve model

Table 3
GDP Increase Achieved by Fiscal Stimulus in Other Models

	Percentage Increase in GDP		
Fiscal Stimulus (1% of GDP)	**Q2 2008**	**Q3 2008**	**Q1 2009**
Sustained Increase in Federal Purchases			
Taylor's Model	**1.1**	**0.9**	**0.6**
Small ECB Model	**0.8**	**0.7**	**0.5**
One-Off Increase in Federal Purchases			
Taylor's Model	**1.0**	**- 0.1**	**0.0**
Small ECB Model	**0.9**	**- 0.1**	**0.0**
One-Off Tax Rebate			
Taylor's Model	**0.15**	**0.08**	**0.03**
Small ECB Model	**0.0**	**0.0**	**0.0**

Source: Wieland (2008)

Conclusion

The effectiveness and desirability of discretionary fiscal stimulus depends upon:

- **Timing and state of the economy;**
- **What stimulus is used;**
- **Degree of forward-looking behavior (PIH) vs. liquidity constraints**
- **The FED reaction (via monetary policy rule or rule-like behavior)**
- **Costs**
  - **Direct budgetary and PV future taxes;**
  - **Future behaviors of various economic agents (consumers, investors, firms, workers, state and local governments, etc.)**
  - **Potential higher inflation**

All of which depend on many factors, e.g. the state of the economy, inflation and inflation expectations, budget position current and projected, etc.

My base case: modest additional insurance (rough estimate 0.3-0.5% (1.2-2.0% annualized) increase in GDP in Q3 2008, then dissipating) , likely timely, only if FED doesn't offset AD impacts but a very diffuse prior on the likely size of the impact is called for. FED decision whether or not to do so should be determined over time by economic conditions.

Such discretionary fiscal actions should be the exception, not the rule. Strongest case when very likely large, long-lived downturn and FED has lowered Federal funds rate close to zero, as in the last episode.