St. Louis Fed's Bullard Discusses Fiscal Approaches to Stabilization Policy

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CHICAGO – Federal Reserve Bank of St. Louis President James Bullard previewed a new research paper he will release next week, titled “Death of a Theory,” at an event sponsored by the Korea-America Economic Association on Saturday. The event was held during the annual meeting of the American Economic Association/Allied Social Science Associations.

In his remarks, Bullard discussed business cycle stabilization using fiscal rather than monetary policy. The former attempts to react to aggregate shocks to the economy through changes in taxes and spending, while the latter reacts to aggregate shocks by targeting the nominal interest rate or by influencing inflation and inflation expectations through quantitative easing when the interest rate is at the zero lower bound.

Bullard noted that over the two decades leading up to the financial crisis, the conventional wisdom concerning macroeconomic stabilization was that fiscal policy was in fact not a good tool. Shorter-run stabilization issues should be handled by the monetary authority while fiscal authorities should focus on a stable taxing and spending regime to achieve economic and political goals over the medium and long run.

In late 2008, the Federal Open Market Committee set the policy rate at 0 to 25 basis points, effectively at the zero lower bound on nominal interest rates. This led many to conclude, erroneously in Bullard’s view, that the burden for short-term macroeconomic stabilization had shifted to fiscal policy. Thus, the last three years have detoured from the conventional wisdom.

There has been a very active literature on when the fiscal approach to business cycle stabilization would be useful and effective. Bullard cited a paper by Michael Woodford[1] 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.” The literature assumes that monetary business cycle stabilization policy is ineffective once the zero lower bound is encountered. In addition, the types of policy experiments considered in this literature involve extra government spending and taxation *only* during the period when the zero bound is a binding constraint and financial markets are in considerable turmoil.

Given current conditions, Bullard pointed out three caveats related to the assumptions in Woodford’s paper:

3. The political process is ill-suited to make the types of timely and subtle decisions that are called for based on the literature.
4. Bullard emphasized that, in fact, “monetary policy has been quite effective, even while the policy rate has been at the zero lower bound.” Thus, he said, “it is not necessary or desirable to turn to fiscal stabilization policy.”
5. While the literature says that taxes should be collected simultaneously with the increase in government spending, the actual policy for many countries involved heavy reliance on government borrowing. Increased debt would be interpreted in the literature as delayed taxes.

Bullard also discussed issues related to debt sustainability and argued that low interest rates may not be a good indicator of the probability of a debt crisis.

Bullard concluded that “the turn toward fiscal approaches to stabilization policy has run its course, and that the conventional wisdom that existed in the decades prior to 2007 is being re-established in the U.S.” Therefore, “stabilization policy should be left to the monetary authority, which can operate effectively even at the zero lower bound,” Bullard said. And, 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 aligned with a stable plan of government spending would allow businesses and households to plan for the future in the most effective way,” Bullard noted.

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[1] Woodford, M. 2011 “Simple Analytics of the Government Expenditure Multiplier.” *American Economic Journal: Macroeconomics* 3: 1-35.