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Monetary and Fiscal Policy in Times of Crisis

March 2011

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Prepared by the Economic Education Group of the Federal Reserve Bank of St. Louis

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Fiscal and Monetary Policy in Times of Crisis

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"We [policymakers] have been bold or deliberate as circumstances demanded, but our objective remains constant: to restore a more stable economic and financial environment in which opportunity can again flourish."
—Federal Reserve Chairman Ben S. Bernanke, August 25, 2009

The recent financial crisis and recession prompted unconventional and aggressive actions by monetary and fiscal policymakers. Monetary policymakers turned to quantitative easing. Fiscal policymakers increased government spending and reduced taxes. To better understand these widely debated actions, it is helpful to know the underlying intent of the decisions and the separate functions of monetary and fiscal policy.

Before the 1930s, "classical" economists generally believed economic downturns would correct themselves with little or no government intervention. However, the Great Depression caused many economists and policymakers to rethink classical economics and give more importance to policy intervention. Monetary and fiscal policies have since served as the main tools to promote optimal economic performance (maximum employment growth and low, stable inflation). Although both are ongoing processes, their implementation is widely scrutinized in times of economic distress.

Monetary policy, the responsibility of the Federal Reserve, is enacted through changes in the money supply and the federal funds rate (the rate at which banks lend money among themselves overnight). In theory, changes in the federal funds rate influence other market interest rates (e.g., mortgage, auto loan, and corporate bond rates). Changes in interest rates, in turn, affect saving and investment decisions.

During economic slowdowns, monetary policy is expansionary: The federal funds rate is lowered, which gives firms an incentive to expand and hire more workers and consumers an incentive to spend more. During 2008, the Fed incrementally lowered its target rate from 3.50 percent in January to below 0.25 percent in December, where it has remained. With the federal funds rate near zero and the unemployment rate still high, the Fed adopted quantitative easing—the purchase of financial assets such as Treasury and mortgage-backed securities—to lower long-term interest rates, thereby increasing the money supply.[1]

Fiscal policy, the responsibility of Congress and the White House, is enacted through changes in government spending and taxes. During economic slowdowns, fiscal policy is often expansionary: The government increases expenditures[2] and/or reduces taxes[3] to increase total spending and encourage firms to increase production and hire more workers.

To stimulate the economy, in early 2009, Congress passed the $787 billion American Recovery and Reinvestment Act, a temporary stimulus that included $288 billion in tax cuts and benefits and more than $150 billion for sectors such as education, energy, and transportation. Some economists believe such expenditures may contribute to future economic development. Others, however, argue that such expenditures lead to higher future taxes, which deters business investment today.

The fiscal stimulus package and the deep recession increased the government budget deficit. In January 2011, the Congressional Budget Office projected the deficit will average about 8.6 percent of GDP for fiscal years 2010 to 2012. Some economists argue, however, that the recession would have been worse without fiscal and monetary intervention. For instance, economists Alan Blinder and Mark Zandi calculate that, without fiscal stimulus, the unemployment rate in 2010 would have approached 11 percent instead of the actual 9.6 percent. Sustaining an expansionary fiscal policy remains a challenge because the government must borrow to finance some of it and a high budget deficit may eventually lead to smaller increases in the standard of living. Although the debate over optimal policy will continue, appropriate fiscal and monetary policies are vital to the recovery and future growth of the economy.

—By Constanza S. Liborio, Research Analyst

[1] When the Fed engages in quantitative easing, it increases the supply of bank reserves and thus the monetary base, which is sometimes called high-powered money. See the upcoming April 2011 *Liber8* for a primer on quantitative easing.

[2] Some economists warn that fiscal spending may "crowd out" (reduce) private spending.

[3] Supporters of tax cuts believe lower taxes will jump-start household spending by increasing after-tax income. Economic theory also suggests that a reduction in the corporate tax rate or an investment tax credit will prompt businesses to increase investment spending, which benefits the economy in the short and long run.

Articles and Resources on Fiscal and Monetary Policy

"What We Do and Don't Know about Discretionary Fiscal Policy," by Renee Courtois, Federal Reserve Bank of Richmond *Economic Brief*, April 2009, EB09-04.

Explains general short- and long-run effects of fiscal policy during a recession.

"The Fed's Exit Strategy for Monetary Policy," by Glenn Rudebusch, Federal Reserve Bank of San Francisco *Economic Letter*, Number 2010-18, June 2010.

Provides an overview of forthcoming monetary policies as the economy returns to pre-recession levels.

"Monetary Policy: Part Art, Part Science," by the Federal Reserve Bank of Atlanta.

A video that explains the federal funds rate and how it influences other market interest rates and prevents inflation.

Data Sources on Fiscal and Monetary Policy

Resource: Historical Changes of the Target Federal Funds and Discount Rates (1971 to present)
Description: Tables of the rate changes as determined by the Federal Open Market Committee.
Published by: Federal Reserve Bank of New York
Location: http://www.ny.frb.org/markets/statistics/dlyrates/fedrate.html

Resource: Budget and Economic Outlook (1975 to present)
Description: Annual reports and Congressional testimony detailing economic conditions of the day, including forecasts of gross domestic product growth, price indices, the unemployment rate, and the government budget.
Published by: Congressional Budget Office
Location: http://www.cbo.gov/publications/bysubject.cfm?cat=0

Resource: "Track the Money"
Description: Data (available by zip code) on federal contracts, grants, and loans as reported by recipients of aid under the American Recovery and Reinvestment Act.
Published by: U.S. Government
Location: http://www.recovery.gov/Pages/default.aspx

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Name___________________________________ **Period**_______

Federal Reserve Bank of St. Louis *Liber8*:

“Monetary and Fiscal Policy in Times of Crisis”

After reading the article “Monetary and Fiscal Policy in Times of Crisis,” answer the following questions.

1. Before the 1930s, what did “classical” economists believe about economic downturns?

2. How did the Great Depression change economic thought?

3. Who is responsible for monetary policy?

4. Describe how monetary policy is often enacted during economic slowdowns and the intended results.

5. What is quantitative easing?

6. Who is responsible for fiscal policy?

7. Describe how fiscal policy is often enacted during economic slowdowns and the intended results.

8. Why do some question the effectiveness of expansionary fiscal policy?

Teacher's Guide

Federal Reserve Bank of St. Louis *Liber8*: **"Monetary and Fiscal Policy in Times of Crisis"**

After reading the article "Monetary and Fiscal Policy in Times of Crisis," answer the following questions.

1. **Before the 1930s, what did "classical" economists believe about economic downturns?**

   Before the 1930s, "classical" economists generally believed economic downturns would correct themselves with little or no government intervention.

2. **How did the Great Depression change economic thought?**

   Because of the Great Depression, economists realized the need for policy intervention.

3. **Who is responsible for monetary policy?**

   The Federal Reserve

4. **Describe how monetary policy is often enacted during economic slowdowns and the intended results.**

   Monetary policy during economic slowdowns is enacted through changes in the federal funds rate and the money supply. Because the federal funds rate influences other market interest rates, it changes the saving and spending decisions of consumers and firms. It is hoped that lower interest rates will spur investment.

5. **What is quantitative easing?**

   Quantitative easing is the purchase of financial assets such as Treasury and mortgage-backed securities to lower long-term interest rates, thereby increasing the money supply.

   Teacher note: Quantitative easing is an extension of the open market operations of the Federal Open Market Committee, but is different because it is used when short-term rates are near zero and its purpose is to affect long-term interest rates. Also, with open market operations, policymakers target a specific interest rate; with quantitative easing, policymakers instead target a specific size for the balance sheet. For example, they may decide to increase the balance sheet by $600 billion.

6. **Who is responsible for fiscal policy?**

   Congress and the White House

7. **Describe how fiscal policy is often enacted during economic slowdowns and the intended results.**

   During economic slowdowns, governments may increase expenditures and/or reduce taxes to increase total spending and encourage firms to increase production and hire more workers.

8. **Why do some question the effectiveness of expansionary fiscal policy?**

   Some question increased government expenditures because they fear they will lead to higher future taxes and thus deter business investment today.

   Teacher note: The prospect of higher future taxes to pay for increasing government debt may change a firm's expectations of future profits and thus change their investment plans today. Also, government borrowing may reduce loanable funds available to firms, resulting in higher-than-normal interest rates that discourage would-be borrowers from investing in capital goods. Another possibility is that government spending may reduce private spending. For example, if the government announces it will spend $25 billion more on education, people may spend less on education—that is, government spending may "crowd out" private spending.

For Further Discussion

Ask students to explain why both expansionary monetary policy and expansionary fiscal policy may be beneficial in the short run but must be reversed eventually. Some items you may want to discuss:

- Expansionary monetary policy effectively keeps interest rates low and increases the money supply—factors that increase the willingness of consumers to spend. However, neither factor increases the productive capacity of the economy. So, in the short run, increased spending will help take up some of the "slack" during an economic recession. However, once the economy starts to pick up and unemployed resources are put back into use, these same policies will likely spark inflation. Economists call this scenario *too much money chasing too few goods*.

- Expansionary fiscal policy involves increased government spending and tax reductions that likely lead to a growing deficit and a larger future debt burden. If such policy is used in the short-run only, and spending and taxes reset to previous levels as the economy recovers, then the growing economy will generate revenues to pay down the deficit. But, if spending increases and taxes are not reset, the growing deficit and debt may exceed the government's ability to repay lenders (bondholders), leading to a credit crisis.