Fighting Recessions:
Monetary Policy versus Fiscal Policy
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From the mid 1980s until about 2015, the primary objective of many central banks was low and stable inflation, or in central bank lingo "price stability." This focus on price stability was a reaction to the high inflation rates of the 1970s. It also reflected a near consensus among macro economists that there is no long run tradeoff between inflation and unemployment. In 1989, New Zealand institutionalized this emphasis on price stability by adopting an inflation targeting framework, which called for a publicly announced inflation target and held the central bank accountable for achieving this target. Other central banks followed, formally in many cases, intellectually in others.

The Federal Reserve did not adopt inflation targeting. Its mandate from Congress, established in 1977, gives equal weight to achieving maximum employment and price stability. But in terms of how monetary policy was actually made – in its use of sophisticated models and forecasts, its stress on inflation expectations, its increasing transparency – the Federal Reserve operated in a similar fashion to many inflation-targeting central banks. This was particularly true after most inflation targeters became more flexible in their pursuit of low inflation, taking into account the state of output and unemployment and allowing themselves reasonable time to achieve their inflation objective.

Thus, even with widespread adoption of price stability as the key objective, central banks still used monetary policy to respond to economic downturns, lowering interest rates if output fell and unemployment rose. Indeed, since a decline in output would put downward pressure on prices, actions taken to stabilize real activity should also stabilize the inflation rate – provided the source of the shock to the economy was a shift in demand.

In the 1980s, 1990s, and the early years of the 21st century, monetary policy was the preferred mechanism for responding to economic downturns. Automatic stabilizers, such as unemployment insurance and progressive income taxes, also played an important role. But discretionary fiscal policy was not seen as effective. It was still used. Notably, in the 2000 presidential campaign, President George W. Bush promised to cut taxes for all Americans. When the economy slid into recession in 2001, some members of Congress who would otherwise have opposed Bush's tax cuts supported them because of the short-term economic boost they would provide.

Advantages and disadvantages of monetary and fiscal policy

What then are the advantages and disadvantages of monetary policy and discretionary fiscal policy in stabilizing economic activity?

Monetary policy, of course, works through changes in interest rates and the money supply. Lower interest rates increase investment, consumption and, perhaps, exports (the last through a decline in the exchange rate.) Financial markets determine how resources are allocated. Policy decisions are made by appointed experts or "technocrats."

Discretionary fiscal policy operates through government spending and taxes or transfers. Sectors receiving funds expand; sectors facing higher taxes or reductions in spending grow more slowly. These initial impacts may have multiplier effects on other sectors. Increased government deficits may raise interest rates, with potentially adverse effects on investment and exports. However, investment could also be encouraged by prospect of stronger growth overall.

In reducing inflation or slowing economic growth that threatens to become inflationary, monetary policy is clearly the go-to response. The unpleasant decision - to raise interest rates, in the case of monetary policy, or to cut spending or raise taxes, in the case of fiscal policy – can more easily be made by appointed technocrats, who care primarily about the regard of their professional peers, than by elected officials concerned about their popularity in the next election. Indeed, the need to make these difficult decisions is undoubtedly one of the reasons why many countries adopted an independent central bank model. It insulates elected officials from blame.

But what about providing stimulus in an economic downturn? What are the strengths and weakness of monetary and fiscal policy in those circumstances?

Monetary Stimulus

Monetary policy decisions may be more timely. Central banks are focused on a relatively narrow set of issues compared to their countries' legislative bodies, and central bank policy committees meet regularly to discuss the performance of the economy. They are staffed by economic experts who analyze reams of data and use sophisticated models to forecast output and inflation. Ideally, central banks should see recessions coming earlier than others, and certainly earlier than legislators. In fact, recessions are notoriously difficult to forecast and central banks' track records are not impressive. However, confronted by evidence of a downturn, monetary policy committees usually reach consensus on a course of action quite quickly. Deciding on a response is facilitated by the limited options available and the analysis of alternative scenarios by their staff economists.

Monetary policy operates though financial markets. Although central banks commonly lower interest rates by buying government securities, the goal is to lower interest rates for borrowers generally. Who benefits from these lower rates depends upon the decisions of individual lenders and borrowers. This is both a strength and weakness of monetary policy. Credit is allocated by financial markets. This may be efficient, as funds go where returns are highest. But the impact is opaque. Winners and losers are not obvious. Accordingly, monetary policymakers generally do not consider the impact of their decisions on specific industries, regions, or population groups. Their focus is the aggregate economy. But some needy segments of the economy may not receive help. And some elements thought to be undeserving may benefit.

Milton Friedman famously said that monetary policy operates with long and variable lags. These lags are generally thought to be six months to two years. It takes time for lenders and borrowers to react to lower interest rates. Investment plans must be developed and approved by lenders. It takes time for exporters to take advantage of a decline in the value of the currency. However, in one area, refinancing home mortgages, lower interest rates sometimes have a very rapid effect. Even if housing construction is slow to respond, rate reductions may spur a wave of refinancing that reduces households' monthly mortgage payments and allows them to consume more. Refinancings were a potent factor in the U.S. recovery from the 2001 recession, although not so much after the Global Financial Crisis when home values fell and many homeowners could not refinance because their mortgages exceeded the value of their houses.

Fiscal Stimulus

Discretionary fiscal policy is the use of government spending and taxes to stabilize the economy. It usually requires legislative approval. As noted, in practice, it is more relevant for alleviating downturns than curbing inflationary pressures, although it certainly could be used for the latter.

Fiscal policy can take many forms. That is both its strength and its weakness. It can have an immediate impact – provided decisions are made quickly and funds are distributed rapidly. We saw this in the rapid responses to the covid-19 downturn in the spring of 2020. Governments in many countries provided unprecedented support for both businesses and workers adversely affected by the pandemic. Money was in people's hands within a few months. Businesses were preserved despite no customers. Households were able to maintain adequate living standards, even if unable to work. In the United States, some critics complained that aid did not reach everyone who needed help and that money went to some recipients who did not need or deserve it. There was fraud. But in my judgment, this was a very successful application of fiscal policy. The threat was clear; the response was decisive; and the distribution of funds was timely.

It is not always that way. Fiscal policy can be targeted quite precisely, at least in its initial impact, and it can be used to achieve goals beyond economic stabilization. These might appear as advantages. Being able to focus aid on those who are in the greatest need and who are most likely to spend any income received should increase the efficiency and effectiveness of fiscal policy. The problem is that people – including our elected representatives - may disagree about who is most needy or deserving. Fiscal policy necessarily entails picking winners. The initial response to covid was unusual in being very broad; and many of those who did not receive help recognized they would benefit from the support provided others. Frequently, however, views differ on who should be helped – the poor or the middle class? households or businesses? In contrast to monetary policy, winners and losers are clear. They know who they are. And they are likely to make their voices heard. As a consequence, developing an aid package can be contentious and take a long time, with the result that funds are not distributed in a timely manner.

Fiscal policy can serve multiple purposes, not just countering a decrease in economic activity. It can be used to achieve a host of longer run goals, such as redistributing income, strengthening the nation's defenses, improving roads and bridges, increasing international competitiveness. For proponents of these long-term goals, fiscal policy appears to be a win-win proposition. But for opponents, the negative long run effects may dominate the near-term benefits of stabilization. Again, debate over how funds are to be spent or what taxes to cut may be contentious and may delay development of a timely aid program.

Even when there is agreement on the longer run objective, actually spending the money may take time. In the case of infrastructure spending, plans must be developed, RFPs sent out and bids evaluated; and even after contractors are chosen, the project may take years to complete. So, the funds may be disbursed after the recession is over, when they are no longer needed for stabilization.

The bottom line is that fiscal policy is inherently highly political and thus subject to debate and delay. Implementation may also be prolonged simply because of the time required to take the necessary actions.

Targeting Monetary Policy?

Some of these differences between monetary policy and fiscal policy are eroding. Specifically, there seems to be growing interest in the distributional impacts of monetary policy and in having central banks take on new responsibilities with identifiable winners and losers. A potential outcome is that central banks and the conduct of monetary policy will become more contentious and political.

In response to the Global Financial Crisis (GFC), many central banks reduced short term interest rates to near zero. Zero or a little below is thought to be the floor for interest rates, as long as holding cash is an option. With this traditional tool of monetary policy fully deployed, the Federal Reserve and some other central banks then tried to drive down longer-term interest rates, with massive purchases of longer-term securities. These purchases greatly expanded central banks' balance sheets.

Most of the discussion about balance sheet policy has focused on the size of the expansion and its effect on interest rates. However, the door was also opened to using the composition of the balance sheet as a policy tool. Most of the longer-term securities purchased were government securities, but the Federal Reserve also bought mortgage-backed securities issued by the government-sponsored enterprises, Fannie Mae and Freddie Mac. For at least some proponents, the rationale was to direct help to the collapsing housing market. Other central banks bought limited amounts of corporate debt.

The recovery from the GFC was sluggish and inflation in many countries remained below targeted rates. Accordingly, central banks continued to keep interest rates low and, in some cases, continued to expand their balance sheets. Achieving high levels of employment became an increasingly important goal. Notably, New Zealand, which had pioneered inflation targeting, adopted a dual mandate in 2019, formalizing the importance of achieving high employment, as well as price stability.

In the United States there was also concern about whether monetary policy might be increasing inequality. The extended period of exceptionally low interest rates that followed the GFC was accompanied by a very robust stock market. Many analysts and central bankers saw cause and effect. Very low interest rates on longer term government securities increased investors' demand for alternative assets, including stocks. While a strong stock market should be stimulative, stock ownership is highly concentrated among the wealthy. Thus, monetary policy may have exacerbated wealth inequality.

At the same time, monetary policy may have helped some of those at the lower end of the income distribution. The expansion after the GFC was sluggish but long. The unemployment rate eventually fell to levels not seen since the 1960s – until the Covid-19 crisis drove it up again. Low unemployment rates are particularly beneficial to Black workers. In the United States, the Black unemployment rate has been roughly twice the white rate in good times and bad for at least 50 years. When the overall rate falls, the gap narrows in absolute terms. With increased attention to the plight of Blacks after the death of George Floyd, some have said that the Federal Reserve should do more to help Blacks and should run the economy hotter than otherwise to create more job opportunities for Black workers and other disadvantaged populations.

Focusing on the distributional effects of monetary policy is likely to entangle central banks in political debates. As Paul Tucker argues in his book, *Unelected Power* (Princeton University Press, 2018), redistribution should be the responsibility of elected officials. Because monetary policy has not been seen as resulting in substantial redistribution, governments in many countries have been willing to delegate responsibility to independent institutions run by unelected technocrats. If monetary policy is perceived as having large-scale redistributive effects, elected officials will want control. One possible outcome is that monetary policy decisions may become more contentious and less timely.

To come – Section 13 (3)

An exception to my assertion that monetary policy does not target specific sectors or groups is Section 13 (3) of the Federal Reserve Act. Section 13 (3) was enacted in the Depression and gave the Federal Reserve the ability to lend to any "individual, partnership or corporation" in "unusual and exigent circumstances." In its capacity as lender of last resort, the Federal Reserve used these powers in the GFC for the first time since the 1930s. These lending powers were seen by some as too sweeping and they were curtailed in the Dodd-Frank financial reform legislation passed after the GFC. However, in the Covid-19 recession, the Fed was prepared to use Section 13 (3) on an even larger scale, not only to preserve financial stability but also as a general support to the economy. I will address Section 13 (3) in a subsequent observation.