Fiscal Stimulus, Fiscal Inflation, or Fiscal Fallacies?

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Version 2.5 Feb 27 2009

"Fiscal stimulus" is the proposition that by borrowing money and spending it, the government can raise the overall state of the economy, raising output and lowering unemployment. Can it work? Do the arguments for it make any sense? If so, does the economy suffer from the ailments that fiscal stimulus can cure?

One form of "fiscal stimulus" clearly can increase aggregate demand. If the government prints up money and drops it from helicopters, this action counts as *fiscal* stimulus, since the money counts as a transfer payment. In practice, our Treasury would borrow the money, and use it for tax rebates, subsidies, bailouts, or any of the many ways that our government sends people checks. Then the Federal Reserve would buy up the debt with newly created money. The result is the same: A trillion dollars more money in private hands, just as if it had been printed and dropped by helicopters. People naturally don't want to sit on a trillion dollars of extra cash. They spend it, first creating demand for goods and services, and ultimately inflation.

This is perhaps the only prediction that is utterly uncontroversial among economists. It is a standard last-resort economic prescription to avoid a deflation.

Conventional monetary policy just exchanges treasury debt for money, without increasing the overall supply of money and debt. Whatever arguments there are that this action might affect overall demand for goods and services vanish when interest rates are near zero as they are now. Now, Treasury debt and money are nearly perfect substitutes. To inflate, the government needs to increase the overall quantity of government debt, not alter its composition.

To inflate, the government also has to make it clear that it will *not* pay back new debt. If we expect that debt or money will be retired with future taxes, then there is no great incentive to go out and spend to get rid of either. Only if it's clear the debt or money will soon be inflated away does it make sense for people to try to get rid of money or debt now, and go out and buy.

Is that the "fiscal stimulus" that the Obama economic team is arguing for? It's quite possible. The Obama economic team has not announced a clear schedule of future spending controls or tax increases that can pay off the new debt, and the Federal Reserve has already more than doubled the money supply and is widely announcing its intention to do much more. (We don't need to see higher tax *rates*, we need to see higher *revenues* or lower spending. A plan for higher rates can choke off growth implying lower revenues.) On the other hand, they have not announced the opposite, a determined intention to inflate rather than pay off the debt, which would give the maximum inflationary demand punch.

In any case, let us hope this is not the plan. Just because a little demand goose followed by inflation is possible doesn't mean it's a good idea. The inflation that will result from a trillion dollars of money permanently dropped on the economy, and the real economic dislocation of such a major inflation, is frightful to contemplate.

So let's ask the harder question. Let's think of a "fiscal stimulus" in which the government borrows money and spends it, but with the clear plan that the debt *will* eventually be repaid with future taxes, not just by printing money. Can *this* kind of stimulus work, and if so how?

Fallacies

Most fiscal stimulus arguments are based on fallacies, because they ignore three basic facts.

First, if money is not going to be printed, it has to come from somewhere. If the government borrows a dollar from you, that is a dollar that you do not spend, or that you do not lend to a company to spend on new investment. Every dollar of increased government spending must correspond to one less dollar of private spending. Jobs created by stimulus spending are offset by jobs lost from the decline in private spending. We can build roads instead of factories, but fiscal stimulus can't help us to build more of both[1] . This form of "crowding out" is just accounting, and doesn't rest on any perceptions or behavioral assumptions.

Second, investment is "spending" every bit as much as is consumption. Keynesian fiscal stimulus advocates want money spent on consumption, not saved. They evaluate past stimulus programs by whether people who got stimulus money spent it on consumption goods rather than save it. But the economy overall does not care if you buy a car, or if you lend money to a company that buys a forklift.

Third, people must ignore the fact that the government will raise future taxes to pay back the debt. If you know your taxes will go up in the future, the right thing to do with a stimulus check is to buy government bonds so you can pay those higher taxes. Now the net effect of fiscal stimulus is exactly zero, except to raise future tax distortions. The classic arguments for fiscal stimulus presume that the government can systematically fool people.

The central question is whether fiscal stimulus can do *anything* to raise the level of output. The question is not whether the "multiplier" exceeds one – whether deficit spending raises output by more than the value of that spending. The baseline question is whether the multiplier exceeds *zero*.[2]

A cure should have something to do with the diagnosis. The classic argument for fiscal stimulus presumes that the central cause of our current economic problems is this: We, the people and our government, are not doing nearly enough borrowing and spending on consumer goods. The government must step in force us all to borrow and spend more. This diagnosis is tragically comic once said aloud.

Credit markets

A much more plausible diagnosis of our current troubles is staring us in the face: credit markets. The institutions that channel your and my savings into consumer and business borrowing are not working. Banks are in trouble, and more importantly the much larger markets for securitized debt seem really broken. New issues of securitized debt have dropped to next to nothing, unless they are guaranteed by the Federal Government. Savings is going to low-interest Treasuries and guaranteed agency debt, yet consumers and businesses who need credit face a small supply at very high prices.[3]

Imagine by analogy that several major refineries had blown up. There would be tankers full of oil sitting in the harbor, and oil prices would be low, yet little gasoline would be available and gas prices would be high. Stimulating people to drive around would not revive gas sales. Borrowing gasoline and using it on infrastructure projects would be worse. The right policy action would obviously be to run whatever government or military refineries could be cobbled together on short notice at full speed, and focus on rebuilding the private ones.

The former step is exactly what the Federal Reserve's many charmingly acronymed facilities (TALF, etc.) are doing, to the tune of over a trillion and a half dollars. Together, the Treasury and Fed are issuing huge amounts of Government debt, and they are turning around and lending the proceeds to consumers and businesses. This basic idea makes sense, though there is plenty to worry about in the details.

An unconventional potential defense of fiscal stimulus lurks in this story. If the Treasury borrows and the Government uses the proceeds for *investment*, then the government is in some sense acting as the missing intermediary. The focus on investment spending in the Obama plan reflects some of this thinking, though investment is anathema to the traditional Keynesian insistence that stimulus be channeled to consumption spending. However, this is a poor argument, since stimulus "investment" spending is on much different projects than the private sector would have funded. Fiscal stimulus investments make fuel oil, not gasoline. Moreover, the extra issues of Treasury debt will largely come from the few dollars that are flowing from savings to private investment, just what the "credit crunch" does not need. To "intermediate," additional government borrowing would have to come out of

consumption. People would have to be attracted to postponing a trillion dollars of consumption by slightly higher treasury yields.

A monetary argument for fiscal stimulus, logically consistent but unpersuasive

My first fallacy was "where does the money come from?" Well, suppose the Government could borrow money from people or banks who are pathologically sitting on cash, but are willing to take Treasury debt instead. Suppose the government could direct that money to people who are willing to keep spending it on consumption or lend it to companies who will spend it on investment goods. Then overall demand for goods and services could increase, as overall demand for money decreases. This is the argument for fiscal stimulus because "the banks are sitting on reserves and won't lend them out" or "liquidity trap."

In this analysis, fiscal stimulus is a roundabout way of avoiding monetary policy. If money demand increases dramatically but money supply does not, we get a recession and deflation. If we want to hold two months of purchases as money rather than one months's worth, and if the government does not increase the money supply, then the price of goods and services must fall until the money we do have covers two months of expenditure. People try to get more money by spending less on goods and services, so until prices fall, we get a recession. This is a common and sensible analysis of the early stages of the great depression. Demand for money skyrocketed, but the Fed was unwilling or, under the Gold standard, unable, to increase supply.

This is not a convincing analysis of the present situation however. We may have the high money demand, but we do not face any constraints on supply. Yes, money holdings have jumped spectacularly. Bank excess reserves in particular (essentially checking accounts that banks hold at the Federal Reserve) have increased from $2 billion in August to $847 billion in January. However, our Federal Reserve can create as much more money as anyone might desire and more. There is about $10 trillion of Treasury debt still outstanding. The Fed can buy it. There are trillions more of high quality agency, private debt, and foreign debt outstanding. The Fed can buy that too. We do not need to send a blank check to, say, Illinois' beloved Governor Blagojevich to spend on "shovel-ready" projects, in an attempt to reduce overall money demand. If money demand-induced deflation is the problem, money supply is the answer.

Some people say "you can't run monetary policy with interest rates near zero." This is false. The fact of low interest rates does not stop the Fed from simply buying trillions of debt and thereby introducing trillions of cash dollars into the economy. Our Federal Reserve understands this fact with crystal clarity. It calls this step "quantitative easing." If Fed ignorance of this possibility was the problem in 1932, that problem does not face us now.

A demand for all Treasury debt—a convincing diagnosis, but is fiscal stimulus the answer?

This monetary story also does not ring true. Yes, banks are racking up huge reserves. But do they really care at all whether they hold reserves, which now earn interest, or whether they hold short-term and highly liquid treasury bills, earning almost exactly the same interest rate? More deeply, is the central source of our current economic slump that we – people, banks, etc.—want to hold a lot more money *and* a lot less Treasury debt, that we are unhappy with the *split* in our holdings of government securities between short-term Treasury debt and money?

No. People and institutions clearly want to hold lots more US government debt *overall*, and money and treasury bills are nearly perfect substitutes at near-zero interest rates. People are trying to shift their portfolios out of stocks and especially out of anything with a whiff of credit risk, and into cash or treasuries. We see this desire in the dramatically high interest rates, and correspondingly low prices, for any debt – jumbo mortgages, corporate bonds, municipal bonds, securitized debt -- that has even a small chance of default and no government guarantee, and the low interest rates and very high prices for government bonds and government-guaranteed debt. Government bonds have a "money-like" status now in that only they are accepted as collateral for loans, where many private securities used to be accepted. This fact alone is driving a large spike in demand for government bonds. People are also trying (finally) to save more, but they want to do so in the form of safe, government debt or government guaranteed debt.

To an economist, it seems that the private sector has become much more averse to holding risks. When risk aversion rises there is a "flight to quality" in portfolios and an "increase in precautionary savings" in spending decisions. A

good part of this increased risk aversion is simply in the way people feel – after large losses, people naturally retrench. Part of this change also comes from the failures of many of the institutions that help the economy to spread risk optimally, the "broken refinery" in the credit markets I alluded to earlier. People might be willing psychologically to hold more risks, but you can't ask people to suddenly hold complex securities directly, when they are used to holding those securities through intermediaries. Those securities will languish just as if people were simply risk averse.[4]

If you read carefully, this is the consensus diagnosis of the second main cause of the current recession. Keynesians say that "consumption demand" has fallen, and "investment demand" has fallen, therefore "aggregate demand" has fallen and must be made up by "government demand." Superficially, this analysis sounds incoherent, because you can't demand less consumption unless you demand more investment, and vice versa – you have to spend income on something. The statement seems to violate arithmetic (a "budget constraint" to economists). But in fact you can, with given income, consume less and invest less, if you hold more government debt including money. "Aggregate demand" is nothing more than the flip side of "demand for government debt and money." And while a "decline in consumption or investment demand" seems to come out of the blue as "animal spirits," I think we can sense a good reason why we are all trying to hold more government debt and money.

This second ingredient is important to understanding our recession. If we just had a credit crunch, we would expect to see stagflation – lower quantities sold, but upward pressure on prices. A credit crunch, like a broken refinery is a "supply shock." Since we are seeing lower quantities sold and easing inflation, we must also be seeing a "demand shock," and we need to understand its source.

The bottom line, then, is that people want to hold more of both money and government debt – and don't particularly care which. Trying to get it, we are trying to buy less of both consumption and investment goods. Again, this is a deflationary pressure. If the government does nothing, deflationary pressure will remain until goods are so cheap that we have the desired real value of nominal government debt. Until deflation happens, output falls.

What do to? In this analysis, monetary policy *is* impotent, but not for the usual reason that interest rates are nearly zero. The Fed can arbitrarily exchange Treasury debt for money, and increase the money supply as much as we like. But *nobody cares* if it does so, since the "flight to liquidity" is equally towards all forms of Government debt. If we want more fruit and less cheese, putting more apples and less oranges in the fruit basket won't help.

Looking at it this way gives us a logical reason that fiscal stimulus might work. It leaves the private sector with a trillion more dollars of government debt in their pockets. But the Fed's many facilities also issue government debt and money, which helps to satisfy the demand for government debt. Which is the better path?

The end game

It matters tremendously which path we choose. At some point the crisis will pass, and demand for Treasury debt and money will revert to normal levels. Sooner or later, investors and banks will decide they're sick of holding $850 billion of reserves and 2% treasuries when high-rated corporate bonds are going for 9% and tax-free municipal debt is going for 6%. Sooner or later banks will figure out that borrowing deposits at 4% and holding reserves that pay 0.75% is not a good long-term business model. If the resources are not there to unwind our current operations, to quickly retire at least two trillion dollars of newly created debt, a large inflation will result as people dump government debt. If history is any guide, this outcome will unleash economic dislocations on a scale to make our current troubles look like a pleasant memory.

I would be happiest if the Fed and Treasury[5] satisfied the large demand for government debt and money by transparently buying or lending against high quality corporate and securitized debt, at market prices. I am happiest of all when they buy newly-issued commercial paper and securitized debt, acting as the missing intermediaries to help address the "credit crunch," as well as supplying government debt. These actions are easiest to unwind. When investors get sick of holding so much money or government debt, the Government can, in effect, take back in government debt in exchange for this private debt, and probably make a good profit.

Alas, the Fed and Treasury's current actions are not so clear. The Fed and Treasury are essentially running the world's largest hedge fund: short treasuries and long a lot of obscure[6] credit risk, in Wall Street parlance. Some of the Fed's assets are inherited from various bailouts. When it's time to unwind, will these assets be worth anything? It will be worse if the Government overpays. I still hear troublesome talk from the Fed of buying "troubled" assets. Buying $700 billion or so of worthless mortgage securities at inflated prices will not stir a magic liquidity pot to make $10 trillion of them more valuable, but will leave a several-hundred-billion dollar hole in the accounts. "Troubled asset" purchases from banks at above-market values can make those banks look better, but these are simple subsidies to banks shareholders and debt holders at the expense of future taxpayers or inflation. The government is also guaranteeing trillions of dollars of credit. This is no different than writing the "credit default swaps" which made some hedge funds and AIG look good for a while and ultimately collapse. If the government has to make good on any of these guarantees, there will be even less available to unwind all our new credit.

Another potential defense of fiscal stimulus lies in this analysis. If, rather than send out checks, the government invests the money in truly valuable infrastructure, if that infrastructure truly does expand output, and if that expanded output generates additional tax revenues for the government, then Investors will be happy to hold a larger quantity of government debt permanently, because that debt is a claim to a worthwhile stream of future taxes. There is a lot of "if" here.

In sum, the US needs to keep its fiscal powder dry. The Government's borrowing and taxing ability is limited. When the crisis fades, we will need *fiscal* resources to unwind a massive increase in government debt. If the debt corresponds to good quality assets, that's easy. If the debt corresponds to government investments yielding a stream of tax revenue, that's ok. If the new debt was spent or given away, we're in more trouble. If the debt will be paid off by higher future tax rates, the economy can be set up for a decade or more of high-tax and low-growth stagnation. If the Fed's kitty and the Treasury's taxing power or spending-reduction ability are gone, then we are set up for inflation; essentially a default on the debt. Needless to say, no amount of monetary or interest rate policy – fooling with the split of government debt between money and treasury bills – would stop that inflation. Trading money for debt will do no good when people want to dump both equally.

Some say, "we're in a crisis, we can't worry about the long run or inflation." However, the inflation can happen much sooner than you might expect, and it can happen long before the economy recovers. We are in a credit crisis, as well as experiencing a fall in aggregate demand. Even with perfectly managed aggregate demand, output will be lower while we rebuild credit markets, and there will be unemployment as people move from building houses to other jobs. We can easily have stagflation of monstrous proportions, and it can happen very soon after stimulus spending gets going.

A bit more carefully, the liquidity demand for government debt

Since I'm writing about "fallacies," I need to spell out this argument more carefully, especially to my fellow economists and "fiscal theorists" in particular.

We seem to see declining "aggregate demand," meaning that demand for and value of government debt are rising. Why? The value of government debt, including money, is equal to the present value of the primary[7] surpluses that the government will run in order to pay off the debt. Nominal debt is stock in the government, a claim to its taxing power. Now, investors have surely not just decided that the US government is going to run huge surpluses any time soon – that the "earnings" of this "stock" are more valuable. Rather, the "flight to quality" surely means that investors are happy with much lower returns, that a "liquidity premium" has lowered the discount rate applied to government debt, and made the same hoped-for surpluses more valuable in current terms.

This refinement is important for my analysis of the Fed and Treasury's operations. In normal times, if the Government buys a private bond for $100 and issues a Treasury bond worth $100, we should expect no effect on total demand. There is one more treasury bond, but the government has exactly the resources to redeem it with no claim on future taxes. Government debt is no more nor less attractive, so there is no change in "aggregate demand" as people try to hold more or less of it. The same holds for my slight defense of fiscal stimulus: In normal times, borrowing money to invest in a project which will just pay for itself in future tax revenues has no aggregate demand effect since the revenues just pay off the bonds. In normal times, the only way to increase aggregate demand really

is to print debt or money the government really does not intend to pay back. For debt purchases to have some effect on aggregate demand, Treasury debt must be in some sense artificially scarce. It must satisfy a need that the corporate bond does not satisfy. I think we're in that situation: the Government has a unique ability to avoid explicit default, and investors especially value debt with this unique feature. This means that a swap of government for private debt will help to alleviate the decline in "aggregate demand," even though people understand the debt will not be inflated away.

Taxes, tax rates, and incentives

How can one logically oppose stimulus spending and support stimulus tax breaks? If borrowing and spending doesn't work, borrowing and lowering taxes shouldn't work either.

There is one argument for tax reduction. Good economists distinguish tax*es* from tax *rates*. Borrowing to "put money in people's pockets," say by tax rebates, is exactly as pointless (or inflationary) as borrowing and spending. But lowering the distortions caused by high tax *rates* can do a lot of good. However, to really do any good, tax rates have to be low and predictable for a long time. Little short term special deals don't do any good in encouraging people to work, save, and invest. Alas, many of the Republican-inspired tax reductions in the Obama plan are rebates for past activities, which give cash with no change in incentives. Others are means-tested and phase out with higher incomes. From a macroeconomic perspective, these measures manage to achieve the worst of both worlds: They raise the marginal *rates* that lower incentives to work, save and invest while lowering tax *revenues*.

Even if we borrow to lower tax *rates*, we have to raise tax rates in the future to pay back the debt, so any borrowing-financed tax reduction can't be permanent and thus can't really have the desired incentive effects. The only real fiscal "stimulus" is to lower tax rates, broadening the base, while at the same time attacking the structural deficits that everyone knows otherwise mean higher tax rates in the future.

The economic "consensus"

This is not fancy economics. Most of my arguments come from simply asking where the money is going to come from, simple arithmetic. Why are so many economists said to support fiscal stimulus? Am I some sort of radical? No. In fact economics, as written in professional journals, taught to graduate students and summarized in their textbooks, abandoned fiscal stimulus long ago.

Keynesians gave up by the 1970s. They saw that fiscal programs took too long to implement. They especially disparaged temporary measures, which would not stimulate the consumption that classic Keynesians thought was important to stimulus. Every undergraduate text has repeated these conclusions for at least 40 years. I learned this view from Dornbusch and Fisher's undergraduate text, taught by Bob Solow, in the 1970s. Even the optimistic projections by the Obama economic team say that fiscal stimulus will not really kick in for two years, validating the durability of this view.

The equilibrium tradition which took over professional academic economics in the mid-1970s has even less room for fiscal stimulus. Some "equilibrium" analyses do say fiscal stimulus can increase output – but by making us feel poorer, work harder at lower wages, and consume less.[8] That's not what advocates have in mind! A large fiscal program can affect prices, wages, and interest rates with all sorts of interesting general-equilibrium implications, but these analyses haven't really converged on anything solid, much less the large "multipliers" necessary to make traditional fiscal stimulus attractive.

More deeply, macroeconomics was revolutionized starting in the 1950s, by the realization that what people think about the *future* is crucial to understanding how policies work *today*. As I have emphasized, the effects fiscal stimulus will have *now* depends crucially on whether people expect the new spending to be paid back by future taxes or whether they expect it to be quickly monetized. Classic Keynesian analysis analyzed policies by treating each point in time separately. We do not have to agree if expectations are formed "rationally," all we have to agree is that expectations of the future matter crucially for how people behave today, and the classic Keynesian analysis of fiscal stimulus falls apart.

In textbooks and graduate curriculums across the country, stimulus is presented at best as quaint history of thought with no coherent defense that one should believe it in the context of modern economics. (For example, David Romer's classic graduate text *Advanced Macroeconomics*.) At worst, it is presented as a classic fallacy. (My view of the treatment in Tom Sargent's *Dynamic Macroeconomic Theory* and Sargent and Ljungqvist's *Recursive Macroeconomic Theory*.)

"New-Keynesian" thought is devoted to defending the importance of *monetary* policy, and incorporating specific frictions in the equilibrium tradition, not to rescuing the ancient view that fiscal stimulus is important and abandoning that tradition. Mike Woodford's New-Keynesian opus *Interest and Prices* has no mention at all of fiscal stimulus. More deeply, new-Keynesian economics is completely devoted to the proposition that expectations of the future matter centrally for how the economy behaves today. Its central thesis is that central bankers must manage *expectations*, not manage "demand." It has no room at all for the sort of analysis in which one adds up "consumption," "investment," and "government" demands, without considering alternatives for those demands or expectations of the future, to determine output.

These ideas changed because Keynesian economics was a failure in practice, and not just in theory. Keynes left Britain 30 years of miserable growth. Richard Nixon said, "We are all Keynesians now," just as Keynesian policy led to the inflation and economic dislocation of the 1970s--unexpected by Keynesians but dramatically foretold by Milton Friedman's 1968 AEA address. Keynes disdained investment, where we now all realize that saving and investment are vital to long-run growth. Keynes did not think at all about the incentives effects of taxes. He favored planning, and wrote before Hayek reminded us how modern economies cannot function without price signals. Fiscal stimulus advocates are hanging on to a last little timber from a sunken boat of ideas, ideas that everyone including they abandoned, and from hard experience. If we forget all that, we could repeat the economics of postwar Britain, of spend-and-inflate Latin America, and of bureaucratic, planned India.

There has been no grand empirical reevaluation of fiscal stimulus either. Empirical work is hard, since governments try fiscal stimulus in bad times. If you bleed with leaches when you have a cold, empirical work might say that the leaches cured you. Empirical work has to find fiscal stimulus events that were applied randomly, without regard to the state of the economy. Harder still, it has to find stimulus spending that people expected to be paid off rather than inflated away. Most current empirical work does not make this distinction, and therefore is in danger of measuring the slope of the Phillips curve rather than the fiscal multiplier. Finally, empirical work without a plausible mechanism is hard to believe. Even so, doing the best to surmount these problems, nothing in recent empirical work on US data has revised a gloomy opinion of fiscal stimulus.[9] Looking across the world, large government deficits and spending programs are clearly not the keys to economic health, and evidence of stimulus effects over time in the US needs to be reconciled with this supreme lack of evidence across countries.

The Administration's estimates for the effect of a stimulus plan cite no new evidence and no theory at all for their large multipliers. The multipliers come ".. from a leading private forecasting firm and the Federal Reserve's FRB/US model." (Appendix 1) Multipliers are hard-wired in these models by assumption, rather than summarizing any evidence on the effectiveness of fiscal policy, and the models reflect the three theoretical fallacies above. The multipliers in this report are not conditioned on "slack output" or something else -- they state that every dollar of government spending generates 1.57 dollars of output always! If you've got magic, why not 2 trillion dollars? Why not 10 trillion dollars? Why not 100 trillion, and we can all have private jets? If you don't believe that, why do you think it works for a trillion dollars? Their estimates of industry effects come from a blog post (p. 8)! Ok, they did their best in the day and a half or so they had in the rush to put the report together. But really, before spending a trillion dollars of our money, wouldn't it make sense to spend, say one tenth of one percent on figuring out if it will work at all? (That would be 100 million dollars, more than has ever been spent on economic research in the entire history of the world.)

Some economists tell me, "Yes, all our models, data, and analysis and experience for the last 40 years say fiscal stimulus doesn't work, but don't you really believe it anyway?" This is an astonishing attitude. How can a scientist "believe" something different than what he or she spends a career writing and teaching? At a minimum policy-makers shouldn't put much weight on such "beliefs," since they explicitly don't represent expert scientific inquiry.

Others say that we should have a fiscal stimulus to "give people confidence," even if we have neither theory nor evidence that it will work. This impressively paternalistic argument was tried once with the TARP. Nobody could

say *how* it would work in any way that made sense, but it was supposed to be important do to something grand to give people “confidence.” You see how that worked out. Public prayer would work better and cost a lot less. Seriously, as social scientists, economists don’t have any special expertise to prescribe what intrinsically meaningless gestures will and will not give “confidence,” so there is no reason for anyone to listen to our opinions on that score.

"Well," I'm often asked, "we have to do something. Do you have a better idea?" This is an amazingly illogical question. If the patient has a heart attack, and the doctor wants to amputate his leg, it's perfectly fine to say "I know amputating his leg is not going to do any good," even if you don't have a five-step plan to cure heart attacks. As a matter of fact, as above, there are perfectly good answers to this question, but even if there were not, it simply makes no sense to "do something" that you know won't work. One of the most important things that scholars can do is to explain ignorance. I often say “I don’t know, but I do know with great precision why nobody else knows either.” Ninety percent of good economic policy is, “first, do no harm.”

The bottom line

In sum, there is a plausible diagnosis and a logically consistent argument under which fiscal stimulus could help: We are experiencing a strong portfolio, precautionary, and technical demand for government debt, along with a credit crunch. People want to hold less private debt and they want to save, and they want to hold Treasuries, money, or government-guaranteed debt. However, this demand can be satisfied in far greater quantity, much more quickly, much more reversibly, and without the danger of a fiscal collapse and inflation down the road, if the Fed and Treasury were simply to expand their operations of issuing treasury debt and money in exchange for high-quality private debt and especially new securitized debt.

Even this policy is not easy. We do not want the Federal Government to run credit markets forever. The main focus for policy must be on rebuilding the private credit markets. How? The first step is to stop chaotic interventions. Who would buy bank stock, lend long-term, or buy securitized debt, knowing that the government might rewrite the rules at any point? Second, the government must focus on the policy issue, which is making sure *new* savings can flow to *new* borrowing, not who takes the hit for old bad loans. Alas, many of our chaotic bailout proposals break both rules. Needless to say, the phones are ringing off the hook in Washington from people who don’t want to take a bath on poor past investments.

Then we can get to the hard work of building a much more transparent, simple and trustworthy credit system. This too is not a simple task, but one that takes a separate analysis.

Fiscal stimulus can be great politics, at least in the short run. The beneficiaries of government largesse know who wrote them a check. The businesses and consumers who end up getting less credit, and the businesses that can’t sell them products, can only blame “the crisis,” and call up their congressmen to get their own stimulus. Roosevelt understood this, and his biggest stimulus came as political support was flagging.[10] But President Obama has such widespread support, he doesn’t have to buy votes any time soon.

My analysis is macroeconomic, and does not imply anything about the specific virtues or faults of the Obama team’s spending programs. If it’s a good idea to build roads, then build roads. (But keep in mind the many roads to nowhere, and ask why fixing Chicago's potholes must come from Arizona's taxes funneled through Washington DC.) If it’s a good idea for the government to subsidize green technology investment, then do it. (But keep in mind that the internet did not spring from industrial policy to improve the Post Office, the word processor did not come from a public-private consortium to rescue the typewriter industry, and that a huge carbon tax is much more likely to spur useful green ideas, and the only way to spur conservation.) The government *should* borrow to finance worthy projects, whose rate of return is greater than projects the private sector would undertake with the same money, spreading the taxes that pay for them over many years, after making sure its existing spending meets the same cost-benefit tradeoff. Just don’t call it “stimulus,” don’t claim it will solve our current credit problems, “create jobs” on net, or do anything to help the economy in the short run, and don't insist that we have to pass this monstrous bill in a day without thinking about it.

Footnotes

1. Gene Fama's analysis of fiscal stimulus focuses on this point.
http://www.dimensional.com/famafrench/2009/01/bailouts-and-stimulus-plans.html
2. Robert Barro also thinks zero is the right baseline: http://online.wsj.com/article/SB123258618204604599.html.
3. The difference between true and intermediary-induced risk aversion is most important to pure free-marketeers. If people are just more risk averse, it's hard to argue that the government should force them to take risks through their taxes that they are not willing to take directly. If something's broken, it's easier to argue for policy response. Most economists however are willing to be paternalistic about high risk aversion and call it a "problem" needing government response.

4. Even this much is not completely obvious; Bank lending has not in fact declined – anecdotes do not add up to data, as Chari et al (2008) point out, and the declining supply and increase in interest rates for risky debt may simply reflect greater risk aversion of investors, discussed below, (a leftward shift in supply), rather than dysfunction in the intermediary markets (a wedge between supply and demand). For example, Wirtz (2009) doesn't find as much "credit rationing" as you might expect. But this diagnosis is at least a bit more worth pursuing than the last one, and most people buy it, so it's worth tracing through "what should policy do if there is a credit crunch," meaning a wedge between supply and demand of risky debt.
Chari, V.V., Lawrence J. Christiano, and Patrick Kehoe, 2008, "Facts and Myths about the Financial Crisis of 2008," Federal Reserve Bank of Minneapolis working paper 666
http://www.minneapolisfed.org/research/wp/wp666.pdf. (Did you guys pay someone for that number?)
Wirtz, Roland A., "Raising the Credit Bar or Getting Clubbed by it?" *Fedgazette* Federal Reserve Bank of Minneapolis, January 2009 21 (10) 1-7, http://www.minneapolisfed.org/pubs/fedgaz/09-01/cover.pdf
5. Federal Reserve H3 report, January 15 2009, http://www.federalreserve.gov/releases/h3/Current/
6. This analysis is explained in greater depth in the "fiscal theory of the price level," see for example the articles in http://faculty.chicagogsb.edu/john.cochrane/research/Papers/#Fiscal.

I say "Fed and Treasury" because they're in this together. The current facilities are structured as special-purpose-vehicles. The Treasury owns the equity tranche, using TARP money (the one good use of TARP money I can think of), and the Fed "lends" to the special purpose vehicle, consistent with its legal authority to lend rather than buy securities. While the Fed is proud that this limits its credit risk, from the point of view of policy and taxpayers, the Fed and Treasury together have simply bought securities by issuing Government debt. Other facilities consist of Fed lending money long term, using private debt as collateral. Some of this lending is done as "repurchase agreement" in which the Fed literally does buy the private debt, but the borrower agrees to buy it back. Functionally, these are all very closely related: the private sector gets more Treasury debt and money, the Government gets more private debt and credit risk. And you thought structured finance was dead.

7. Primary surpluses exclude debt payments. Governments dig out of a hole just like we do if and only if they are making payments that exceed the interest charges.

8. No, I'm not making this up. Two examples:
Baxter, Marianne and Robert G. King, 1993, "Fiscal Policy in General Equilibrium," *American Economic Review* 83, 315-34;
Edelberg, Wendy, Martin Eichenbaum, and Jonas D. Fischer, "Understanding the Effects of a Shock to Government Purchases," *Review of Economic Dynamics*, 2 166-206.
9. A good survey, from Greg Mankiw, who advocates Keynesian thinking as a good rough guide to how "real" models work, but is nonetheless unimpressed: http://gregmankiw.blogspot.com/2008/12/spending-and-tax-multipliers.html See also Barro's WSJ oped cited above.
10. See Amity Shlaes' wonderful *The Forgotten Man: A new History of the Great Depression*

Yet, the fiscal austerity policies adopted in many countries today wrongly see deficits as the biggest short-term problem, rather than financial regulatory failures, epic levels of inequality and anemic demand for goods and servicesâ€"the ultimate pillar of growing employment and revenue generation. The slashing of public expenditure in healthcare, education, social protection and job programs required by these policies is making ordinary people pay disproportionately for a budget crisis they had no hand in creating. The administrationâ€™s touted fiscal stimulus multipliers do not have any theoretical or evidentiary underpinnings and embody all 3 of the aforementioned fallacies. â€¢ Some economists insist that the efficacy of fiscal stimulus must be believed in despite 40 years of contradictory evidence. â€¢ Restoring the publicâ€™s confidence is another argument posited by fiscal stimulus proponents, which again goes against concrete evidence. â€¢ Economists must acknowledge that they do not have any specific or knowledge or expertise in divining what... Fiscal stimulus refers to increasing government consumption or transfers or lowering taxes. Effectively this means increasing the rate of growth of public debt except that particularly Keynesians often assume that the stimulus will cause sufficient economic growth to fill that gap partially or completely. 196 views Â·. View upvotes.Â Monetary policy, inflation expectations, fiscal policy, expectations for future economic performance, and geopolitical events all affect yields. The shape of the yield curve will depend on the level of fiscal stimulus relative to these factors. As a starting point, letâ€™s look at what would happen if there is no fiscal stimulus and monetary policy becomes more restrictive. 3 John H. Cochrane, "Fiscal Stimulus, Fiscal Inflation, or Fiscal Fallacies?" Feb 27, 2009. faculty.chicagobooth.edu/john.cochrane/research/Papers/fiscal2.htm. 2. The literature provides mixed theoretical and empirical evidence on the efficacy of stimulus packages in developed economies.Â China's stimulus contained both monetary and fiscal elements. In the 4th quarter of 2008, the government announced a monetary policy shift from "moderately tight" to "moderately loose". The annualized real money supply (M2) growth rate rose from 14.9% in 2008 Q4 to 26.2% in 2009 Q1 and then 30.4% in 2009 Q2, while the annualized real growth rate in total loan balances rose from 13.1% to 27.9% and then 33.9% in the same intervals (Figure 1). In comparison, the average. Supportive Environment for Fiscal Stimulus. The deleveraging cycle appears likely to last if consumer and business sentiment don't improve. We think governments can break this cycle, even though they're highly leveraged, too. Central bank asset purchase programs are in place, so governments could finance spending initiatives by expanding the money supply. And given low rates, the interest expense burden should be fairly small.Â Also, when monetary policy is constrained by zero interest rates, fiscal stimulus raises inflation expectations, causing real interest rates to decline. This decline raises overall demand substantially, which further heightens inflation expectations and depresses real interest rates. This process can help break the deflationary dynamics of zero interest rates.