Economics 104b
Paper #2

Stimulus?

Since the Great Depression in the 1930s, the Federal Government has played an active role in maintaining stability in the country's economy. The government has two different tools with overlapping goals at its disposal to achieve stability. Fiscal policy is "the use of the federal budget to achieve macroeconomic objectives such as full employment, sustained economic growth, and price level stability," and can include such measures as tax cuts and varying government expenditure to regulate cyclic fluctuations of the business cycle.[1] Monetary policy, on the other hand, deals with the control of the amount of money in circulation at any given time, and this is handled directly by the Federal Reserve System, or Fed. The Fed uses monetary policy ideally to "keep inflation in check, maintain full employment, moderate the business cycle, and contribute toward achieving long-term growth."[2] When the economy went into recession in 2001, a variety of fiscal and monetary policy initiatives were taken in order to regenerate growth. These policies have had a significant impact on the economy over the last several months, but it is still uncertain if the stimulus will be sufficient to usher in the return of an expansion.

The sluggish economy brought about many significant changes in fiscal policy, but probably the most well known of these was the tax cut introduced by President Bush. President Bush's budget for 2004 calls for, in addition to other stimuli, a "$1083 average tax cut for 92 million Americans."[3] Some simple calculation reveals this to be a total tax cut of about $99.64 billion, and using the most recent price deflator from the Fed (111.25), this translates to about 89.56 billion 1996 dollars[4]. According to the St. Louis Fed, actual GDP at the end of 2002 was 9,439.9 1996 dollars, and the potential GDP for 2002 was estimated at 9,633.7.[5] Thus, the difference between real and potential GDP is 193.8 billion, and given this recessionary gap, the Lump Sum Tax Multiplier would have to be about 2.16 if the proposed tax cut is to return the economy to its potential level. Whether or not this is the case is largely dependent on the marginal propensity to consume, and thus is difficult to determine. Additionally, it should be noted that Bush's proposed future tax cuts will hopefully work to increase current GDP because this will lead to an increase in expected future income, and “aggregate demand increases, and the aggregate demand curve shifts rightward…when expected future income…increases.”[6]

Bush’s plan to stimulate the economy through fiscal policy also includes the increase in government expenditure over the next few years. In 2002, the government had combined expenditures of about 2,010 billion dollars. For 2003 and 2004, the government has proposed an increase in expenditure to 2,140 billion dollars and 2,229 billion dollars respectively.[7] Because government purchases are a part of aggregate expenditure, increasing government expenditure will lead to an increase in real GDP. In this case, “when government expenditures change, aggregate expenditure and real GDP change,” and this “induces a change in consumption expenditure, which brings about further change in aggregate expenditure.”[8] The amount that a given increase in government expenditure will increase real GDP is thus subject to the Government Purchases Multiplier. Like the Lump Sum Tax Multiplier, the Government Purchases Multiplier is tied to the marginal propensity to consume, and thus can be difficult to predict. Nevertheless, increasing government purchases should definitely provide some stimulus to the economy.

The government’s monetary policy makers have also been hard at work to help stimulate the economy. In February of 2001, the Federal Funds Rate and the Discount Rate were at 5.49% and 5.00% respectively. Because of the 2001 recession, the Fed chose to begin decreasing the discount rate, which encourages banks to create more money through loans, since required reserves can easily be obtained at a low interest rate. The Fed also began buying securities in order to put more money into circulation. Because of these measures, both the Federal Funds Rate and the Discount Rate fell throughout 2001 and 2002, and at the end of 2002 the Federal Funds Rate was at 1.24% and the Discount Rate was .75%.[9] With interest rates (which are tied to the Federal Funds Rate) at this low level, the opportunity cost of holding money fell significantly, so people were encouraged to demand more money and put less in savings accounts and other less liquid stores. Because of this, more money was spent overall. Low interest rates also encourage firms to borrow money from banks, and this also leads to an increase in GDP as firms use borrowed funds to finance new endeavors.

All of these governmental actions have been intended to stimulate the economy and bring real GDP back up to potential GDP. But it is important to consider the effectiveness of such policies in meeting their stated goals. According to the Office of Management and Budget, “The tax relief laws enacted in 2001 and 2002 were vital to avoiding a longer, deeper recession, and to getting a recovery started.”[10] Similarly, the Fed projects that “most probable outcome for this year to be a pickup in the pace of economic expansion.”[11] However, there are many critics of the current solutions to the present monetary and fiscal policies who suggest that current measures will actually have adverse effects on the economy. In particular, many have criticized the choice to run a large deficit by simultaneously cutting taxes and raising expenditures. Congressmen Conrad of North Dakota claims that “Instead of offering the nation a plan for long-term economic prosperity, the Bush budget burdens us, and our children, with trillions of dollars of new debt.”[12] Such an assertion hinges on the notion that short term economic stimuli like the tax cut will not have significant long term effects, and will thus be overridden by the negative effects of a large government debt. Indeed, government debt does have some adverse effects, leading “Mr. Greenspan and others [to] worry that budget deficits will crowd out private investment and force up interest rates.”[13] Whether or not the proposed deficits will have a profound effect on the future economy, it is certain that running a large deficit does create at least some problems that will temper the benefits of the current stimulus package. There is also some concern about the current monetary policy and what effect it will have in the long run. The April 2003 issue of *Monetary Trends* suggests that “With the inflation rate as low as it is now, the risk of sustained deflation cannot be discounted, especially because disinflation now would yield little offsetting benefit.”[14] Finally, there are factors currently working on the economy that cannot be controlled by governmental policy. Instances of this include the fact that recently, “geopolitical tensions, especially the situation in Iraq, elevated uncertainties about the future economic climate.”[15] Such uncertainties lead potential consumers and investors to be more frugal with their money, and thus can limit expansion further. At any rate, the current stimuli are by no means a panacea, and while it is certain that they will provide aid to the current weak economy, whether they will be enough to induce sustained expansion remains to be seen.

[1] Parkin, Michael. Macroeconomics, 6th ed., 258.
[2] Parkin, 308.
[3] http://www.whitehouse.gov/omb/budget/fy2004/highlights.html
[4] http://research.stlouisfed.org/fred/data/gdp/gdpdef
[5] http://research.stlouisfed.org/fred/data/gdp/gdppot
[6] Parkin, 138.
[7] The Budget for the Fiscal Year 2004, Historical Tables, available at http://www.whitehouse.gov/omb/budget/fy2004/pdf/hist.pdf, 117.
[8] Parkin, 264.
[9] http://research.stlouisfed.org/publications/mt/mt.pdf
[10] Charting a Course for the Federal Budget, http://www.whitehouse.gov/omb/budget/fy2004/charting.html
[11] Monetary Policy and the Economic Outlook, http://www.federalreserve.gov/boarddocs/hh/2003/February/ReportSection1.htm
[12] Bush budget shows record deficit, billions in tax cuts, CNN.com, Inside Politics, http://www.cnn.com/2003/ALLPOLITICS/02/03/bush.budget/index.html
[13] Taxing Times, http://www.economist.com/agenda/displayStory.cfm?story_id=1666114
[14] Symmetric Inflation Risk, http://research.stlouisfed.org/publications/mt/mt.pdf
[15] Monetary Policy and the Economic Outlook, http://www.federalreserve.gov/boarddocs/hh/2003/February/ReportSection1.htm