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Stimulus without debt in a severe recession

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Abstract

This paper simulates the impact in a calibrated small macroeconomic model of a policy that attempts to apply sufficient effective stimulus in a severe recession without increasing the government deficit or debt, or inflation. This stimulus- without-debt policy has two components: (1) a large standard fiscal stimulus; (2) a *non-standard* monetary stimulus—a large transfer from the central bank to the treasury of the same magnitude as the fiscal stimulus, offset by an equal cut in the central bank's open market purchases so that the bank's transfer to the treasury is *money-neutral*. According to the simulations, the policy would achieve prompt full recovery from the severe recession without generating any adverse effect on government debt as a percent of GDP or on the inflation rate in either the short run or long run. The difference between the stimulus-without-debt policy and alternative stimulus policies is explained.
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The limits of conventional macroeconomic policies in the 2008 Recession have been pointed out by many economists—for example, by the following participants in a *Journal of Policy Modeling* symposium: Blanchard (2010), Feldstein (2010), Stiglitz (2010), and Salvatore (2010). This paper analyzes and simulates a new policy to combat a future severe recession: "stimulus-without-debt."

In a severe recession, suppose the central bank wrote a large transfer check to the treasury (or to the treasuries of member states in the case of the European Central Bank). Legal authority for this transfer would have to be provided to permit this transfer in a particular jurisdiction. The large transfer would be offset by an equal cut in the central bank's open market purchases so that the bank's transfer to the treasury is *money-neutral*. In turn, suppose the treasury deposited the

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central bank's transfer check and used it to write a small $X cash transfer ("tax rebate") check to each household in the economy. The central bank's check would be a transfer, not a loan, to the treasury, and each $X treasury tax rebate check would be a transfer, not a loan, to each household. The treasury would not owe the central bank any future repayment of the transfer, and each household would not owe the treasury any future repayment of the $X tax rebate. If this were done, what would happen to the economy? By the end of this paper, we will offer an answer to this question. We will begin our paper, however, by analyzing the impact of combined fiscal and monetary stimulus in a severe recession.

1. Fiscal and monetary stimulus without debt

In a mild recession, adequate stimulus can usually be provided by standard monetary policy: the central bank writes checks to sellers of treasury bonds in the open market who deposit the checks in their banks. The banks then reduce interest rates enough to induce sufficient borrowing and spending of the deposited funds to cure the mild recession. In the deep pessimism and anxiety of a severe recession, however, standard monetary policy may be inadequate to achieve a full recovery because not enough borrowing and spending will occur even if interest rates are reduced to zero. But if a large standard fiscal stimulus – a tax cut and/or increase in government spending – is used to complement standard monetary stimulus, there may be a large short-run increase in the government deficit and debt. It is possible that the debt increase will be less than feared (DeLong & Summers, 2012; Seidman & Lewis, 2009). But fear of such an increase in the deficit and debt may limit public and political support for fiscal stimulus.

This paper analyzes the impact of a macroeconomic policy that attempts to apply sufficient effective stimulus in a severe recession without increasing the government deficit or debt. This "stimulus-without-debt" policy consists of two components (Seidman, 2013): (1) a large standard fiscal stimulus – in this paper we will use one example of a standard fiscal stimulus – tax rebates from the treasury to households—but our analysis would apply to any standard fiscal stimulus (cut in taxes or increase in government spending); (2) a non-standard monetary stimulus—a large transfer from the central bank to the treasury of the same magnitude as the fiscal stimulus, offset by an equal cut in the central bank's open market purchases so that the bank's transfer to the treasury is *money-neutral*. The central bank would make the decision about the amount of the transfer to the treasury in the same way that it makes decisions about the amount of bonds to purchase or sell under standard open market operations.

This paper owes a substantial debt to three papers that focus on policies to combat a recession: Seidman and Lewis (2002), and Ball (1999, 2006). Seidman and Lewis (2002) analyzed and simulated fiscal stimulus that generates government debt. By contrast, this paper analyzes and simulates fiscal stimulus that does not generate government debt due to a novel complementary monetary policy. Ball (2006), which extends his model in Ball (1999), also attempts to avoid a rise in government debt when fiscal stimulus is used to combat a severe recession. But our paper has two major differences from Ball's.

First, Ball shows that a money-financed fiscal stimulus would avoid the rise in government debt that occurs under a bond-financed fiscal stimulus *if* treasury bonds held by the central bank are *not* officially counted as government debt. But currently treasury bonds held by the central bank *are* usually counted as government debt, and there may well be significant resistance to excluding them from government debt. Our paper presents a policy that would avoid a rise in debt under fiscal stimulus while still counting treasury bonds held by the central bank as government

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