Can Fiscal Stimulus Overcome the Zero Interest-Rate Bound?:

A Quantitative Assessment

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Abstract

This paper provides a quantitative assessment of the use of fiscal stimulus to achieve full recovery from a severe recession when the potency of monetary policy weakens after hitting its zero interest-rate bound. By contrast, most of the numerous recent zero interest-rate bound papers have ignored the use of fiscal stimulus, preferring to examine whether monetary policy alone can revive the economy despite the zero bound. We obtain our estimates by adapting and simulating a macro-econometric model that has been recently econometrically estimated, updated, and statistically tested using U.S. times series data. By contrast, most of the recent zero bound papers do not use an econometrically-estimated model. If the U.S. economy were hit with a large negative demand shock that drives the unemployment rate up to 7.9%, we estimate that even aggressive monetary policy that drives long-term interest rates to near zero would reduce the unemployment rate only to 6.7%. Full recovery would be achieved, however, if the aggressive monetary policy were complemented by sufficient fiscal stimulus in the form of cash transfers or income tax cuts to households. We estimate that a quarterly transfer to households that peaks at 2.7% of quarterly GDP and phases out gradually as it is repeated over seven quarters (so that the cumulative transfer is roughly 12% of quarterly GDP) would reduce the unemployment rate in such a recession by nearly an additional percentage point from 6.7% to 5.9%.

JEL code: E62
1. Introduction

This paper provides a quantitative assessment of the use of fiscal stimulus to achieve full recovery from a severe recession when the potency of monetary policy weakens after hitting its zero interest-rate bound. By contrast, most of the zero interest-rate bound papers have ignored fiscal stimulus (exceptions are Posen 1998, Bernanke 2000, Kuttner and Posen 2001, Seidman 2001, and Feldstein 2002), preferring to examine whether monetary policy alone can revive the economy despite the zero bound (Auerbach and Obstfeld 2005; Bernanke, Reinhart, and Sack 2004; Bernanke and Reinhart 2004; Eggertsson and Woodford 2004, 2003; Coenen and Wieland 2004; Clouse, Henderson, Orphanides, Small, and Tinsley 2003; Svensson 2003, 2002; Fuhrer and Sniderman 2000; Reifschneider and Williams 2000; McCallum 2000; and Krugman 1998).

We obtain our quantitative estimates by adapting and simulating a macro-econometric model that has been recently econometrically estimated, updated, and statistically tested using U.S. times series data. By contrast, most of the recent zero bound papers do not use an econometrically estimated model (an exception is Reifschneider and Williams 2000, but their paper ignores fiscal stimulus).

2. The Macroeconometric Model

We use the US quarterly macro-econometric model developed by Ray Fair of Yale University, which we modify to address the specific zero bound problem. The Fair model has been recently econometrically estimated, updated, and tested using U.S. times series data (Fair
Two recent articles have reported studies that use the Fair model to provide estimates of the effectiveness of monetary policy (Fair 2005a) and the impact of monetary and fiscal policy on the 2001 recession (Fair 2005b). Fair (1994, 2004) empirically tests for rational expectations with negative results and therefore omits it from his model; he comments that if expectations are not rational, then the Lucas critique is not likely to be important. Fair makes his model accessible to other researchers. We respecify parts of the Fair model, and then estimate and simulate the modified Fair model using the Fair-Parke program (Fair 1996) downloaded from Fair’s website (http://fairmodel.econ.yale.edu). Detailed information on the Fair model is given by Fair (1994, 2003, 2004). The impact on the economy of transfers to households depends on the marginal propensity to consume (MPC); we note that the Fair model embodies the following estimates for the MPC out of disposable income: one-quarter MPC = .20, two-quarter MPC = .36, three-quarter MPC = .47, and four-quarter MPC = .55.

3. The Recession

The baseline Fair forecast for the unemployment rate for eight quarters (2003.3 through 2005.2) is shown in the UB column of Table 1. We introduce a negative demand shock beginning in 2003.3 that generates a recession. If monetary policy were adjusted to keep the Treasury three-month bill rate\(^1\) on its baseline path (projected by Fair’s forecast), then the path the unemployment rate would follow is shown in the UR column. For example, in the eighth quarter

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\(^1\) The Treasury bill rate RS is the monthly auction average for the quarter.
of recession the

Table 1: Simulation Results for the Unemployment Rate (U) for the First Eight Quarters

Entries are Percentages

<table>
<thead>
<tr>
<th>Quarter</th>
<th>$U_B$</th>
<th>$U_R$</th>
<th>$U_M$</th>
<th>$U_{M&amp;F}$</th>
<th>$\Delta U_F$</th>
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<tr>
<td>1</td>
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<td>-0.1</td>
</tr>
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<td>3</td>
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<td>7.6</td>
<td>7.3</td>
<td>7.0</td>
<td>-0.3</td>
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<td>7.3</td>
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<tr>
<td>6</td>
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<td>6.1</td>
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<td>7.9</td>
<td>6.7</td>
<td>5.9</td>
<td>-0.8</td>
</tr>
</tbody>
</table>
unemployment rate would be 7.9% (versus 5.5% on the Fair baseline path).\(^2\) We will refer to the \(U_R\) column as \textit{the recession} path of the unemployment rate.

4. Aggressive Monetary Policy

We assume the Fed conducts an aggressive monetary policy: it expands its open-market purchases enough to reduce immediately the three-month Treasury bill rate to zero and also collapse the term structure, eventually reducing the corporate bond rate and the mortgage rate to near zero. This is more aggressive than the estimated Taylor rule in the Fair model, so to implement the simulation, we suspend the estimated Taylor rule in the Fair model and replace it with the aggressive monetary policy (details of how we respecified the model are given in the Appendix). Under the collapse of the term structure, both the bond rate and the mortgage rate are reduced to about 2.2\% in the fourth quarter and 0.9\% in the eighth quarter.\(^3\) The \(U_M\) column of

\(^2\) This simulation uses the \textit{Aaddfact} and the \textit{Aexogenous variable=RS} commands in Fair-Parke. We adjust (generally downward) the individual constant terms for eight quarters (2003.3-2005.2) in each of five equations: the equations for consumer expenditure for services, nondurables, and durables, as well as the equations for residential housing investment and business capital stock (which thereby reduces non-residential fixed investment).

\(^3\) The bond rate \(RB\) is the Aaa corporate bond rate, and mortgage rate \(RM\) is the FHA secondary market mortgage rate. Both are quarterly averages of monthly data.
Table 1 shows the path of the unemployment rate under this monetary policy. For example, the eighth quarter unemployment rate would be 6.7% (versus 7.9% without aggressive monetary policy).

5. Counter-Cyclical Fiscal Policy: Cash Transfers to Households

In this paper the fiscal stimulus is cash transfers to households, but the results would be similar if the fiscal stimulus were income tax cuts to households. While transfers can be implemented by discretionary action by Congress, we will assume in this paper that Congress pre-enacts a transfer rule (automatic transfer rules are discussed in Seidman 2001, Seidman and Lewis 2002, and Seidman 2003) that prescribes an automatic triggering of a new cash transfer to households in response to a high unemployment rate-- in particular, the rule prescribes a transfer/GDP ratio that is proportional to the unemployment gap. Congress would specify the aggregate transfer and also how the aggregate transfer is distributed to individual households (for example, an equal dollar amount per household). Specifically, the aggregate new anti-recession quarterly real transfer R would be given by

\[ \frac{R}{Y} = s \left[ U - (U^N + T) \right], \quad R > 0, \]

where \( \frac{R}{Y} \) is the transfer ratio and \( [U - (U^N + T)] \) is the unemployment gap; \( U \) is last quarter unemployment rate, \( U^N \) is the NAIRU (the non-accelerating inflation rate of unemployment), \( T \) is a threshold above the NAIRU, \( s \) is the strength parameter, \( R \) is the aggregate
quarterly real transfer, and $Y_{-1}$ is the quarterly real GDP of the last quarter. Hence, the transfer rule prescribes a transfer/GDP ratio that is proportional to the unemployment gap. The Congressional Budget Office would provide an estimate of the NAIRU. Based on the advice of technical staff, Congress would pre-enact the values of $T$ and $s$. In this paper for illustration, we will use $T=0.5\%$, $s=2$, and NAIRU=5.2\% (based on CBO=s recent estimate). Hence, in our simulations, a transfer is triggered whenever the unemployment rate exceeds 5.7\%. For example, in the first quarter of the recession in Table 1 the unemployment rate is 6.7\%, so applying the formula above, $R/Y_{-1} = 2[6.7\% - (5.2\% + 0.5\%)] = 2\%$. Thus, the aggregate transfer that would be triggered this quarter would equal 2\% of last quarter=s GDP--we will say that the prescribed transfer/GDP ratio is 2\%. The unemployment gap in this example is 1.0\%. With $s=2$, the transfer ratio would be twice the unemployment gap.

We assume it is administratively feasible to trigger a transfer this quarter based on the unemployment rate ($U_{-1}$) and GDP ($Y_{-1}$) for the preceding quarter. The Bureau of Labor Statistics announces its estimate of last month=s unemployment rate on the first Friday of this month. The Department of Commerce issues a preliminary estimate for the preceding quarter=s GDP one month after the end of the quarter. To mail the checks out in the second and third month, the Treasury can have the addresses ready to go in advance and can enter the dollar amount per check as soon as the Commerce Department=s GDP estimate is available. The actual experience with the 2001 $600 tax rebate enacted in June, and mailed out in July, August, and September--shows

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4 Just as it did for the 1975 and 2001 rebates, Congress would indicate how the aggregate amount converts into specific dollar amounts on individual checks. In 2001, each two-adult households received $600, whereas in 1975 the dollar amount varied between $0 and $200 based on income.
that implementing the transfer policy with a one-quarter lag is feasible. Similar speed of implementation was achieved in the summer of 2003 with an advanced payment of the child tax credit.

We introduce into the Fair model a new endogenous transfer from the federal government to households through the transfer rule.\(^5\) The new endogenous transfer is included in the Fair model as follows. The real transfer is \(R_t\) (and real GDP in the preceding quarter is \(Y_{t-1}\)). The total nominal transfer from federal government to households is \(TRGH_t = TRGH_{bt} + (PH_t)R_t\), where \(TRGH_{bt}\) is Fair’s nominal exogenous transfer and \((PH_t)R_t\) is the nominal anti-recession transfer \((PH_t\) is a consumer price deflator). Implementing the transfer rule involves solving the Fair model successively with the Fair-Parke program.\(^6\)

The \(U_{M\&F}\) column of Table 1 shows the path of the unemployment rate under the transfer rule combined with a monetary policy that achieves the same interest rate path as would have been achieved with the aggressive monetary policy described above. The transfer rule substantially improves the performance of the economy. It reduces the unemployment rate of the economy by nearly a full percentage point: the unemployment rate in the eighth quarter is 5.9% versus 6.7% with monetary policy only; the improvement in the unemployment rate is shown in the \(\Delta U_F\) column (for example, -0.8% in the eighth quarter).

\(^5\) Another endogenous transfer which is already included in the Fair model is nominal state and local unemployment insurance benefits.

\(^6\) Initially, the variable \(TRGH\) is treated endogenously (utilizing the GENR command); the \(TRGH\) path and the \(U\) gap path are solved simultaneously. In successive rounds the \(TRGH\) path is treated as exogenous from the previous round and the model is solved for the endogenous \(U\) gap path. The transfer rule is then used to solve for the implied \(TRGH\) path. Iteration continues until the \(TRGH\) path is roughly the same in consecutive rounds.
Table 2 shows the magnitude of the transfers and the resulting government deficit and debt over the eight quarters. The *transfer ratio* R/Y is the ratio of the new anti-recession quarterly real transfer to quarterly real GDP. The R/Y column shows the path of the transfer ratio under the transfer rule combined with the monetary policy that achieves the same interest rate path.

### Table 2: Simulation Results for the First Eight Quarters

Entries are Percentages

<table>
<thead>
<tr>
<th>Quarter</th>
<th>R/Y</th>
<th>[D/Y]_M</th>
<th>[D/Y]_M&amp;F</th>
<th>[ΔD/Y]_F</th>
<th>[B/Y]_M</th>
<th>[B/Y]_M&amp;F</th>
<th>[ΔB/Y]_F</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.0</td>
<td>3.8</td>
<td>3.8</td>
<td>0.0</td>
<td>33.6</td>
<td>33.6</td>
<td>0.0</td>
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<td>2</td>
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</tr>
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<td>4.4</td>
<td>4.6</td>
<td>0.2</td>
<td>35.7</td>
<td>37.8</td>
<td>2.1</td>
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</table>
(as would have been achieved with the aggressive monetary policy described above): the quarterly transfer as a percent of that quarter’s GDP begins at 1.9% in the second quarter, peaks at 2.7% in the third quarter, declines to 1.5% in the sixth quarter, and to 0.4% in the eighth quarter; the sum of the percentages in the R/Y column—*the cumulative transfer percentage* is roughly 12% of a quarter’s GDP. This is the fiscal stimulus required to reduce the unemployment rate by nearly a full percentage point (from 6.7% to 5.9%).

The *deficit ratio* (D/Y) in Table 2 is the ratio of the government deficit to GDP. The [D/Y] column shows the path of the deficit ratio under the aggressive monetary policy, and the [D/Y] column shows the path under the transfer rule combined with the monetary policy that achieves the same interest rate path (as would have been achieved with the aggressive monetary policy). The [ΔD/Y] column shows the difference between the two paths: [ΔD/Y] rises to a peak of 2.7% in the third quarter, declines to 1.1% in the sixth quarter, and to 0.2% in the eighth quarter. Note that after the third quarter, [ΔD/Y] is less than R/Y because the fiscal stimulus has strengthened the economy and generated endogenous tax revenue that reduces the deficit.

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7 The transfer is 1.9% of *this* quarter’s GDP and 2% of *last* quarter’s GDP (as prescribed by the transfer rule formula with U₁ = 6.7%).

8 The deficit ratio is the ratio of the NIPA nominal federal deficit deflated by the GDP deflator, to real GDP.
The debt ratio (B/Y) in Table 2 is the ratio of government debt held by the public (excluding the central bank) to GDP. The [B/Y] column shows the path of the debt ratio under the aggressive monetary policy, and the [B/Y] column shows the path under the transfer rule combined with the monetary policy that achieves the same interest rate path (as would have been achieved with the aggressive monetary policy). The [ΔB/Y]F column shows the difference between the two paths: [ΔB/Y]F rises gradually to 2.1% in the eighth quarter. Note that the aggressive monetary policy mitigates the increase in B/YC the ratio of government debt held by the public (excluding the central bank)-- because the Fed absorbs some of the government securities sold by the Treasury to finance the deficits.

7. Conclusions

This paper provides a quantitative assessment of the use of fiscal stimulus to achieve full recovery from a severe recession when the potency of monetary policy weakens after hitting its zero interest rate bound. By contrast, most of the recent zero interest-rate bound papers have ignored the use of fiscal stimulus, preferring to examine whether monetary policy alone can revive the economy despite the zero bound. We obtain our estimates by adapting and simulating a macro-econometric model that has been recently econometrically estimated, updated, and statistically tested using U.S. times series data. By contrast, most of the recent zero bound papers

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9 The debt ratio is the ratio of the value of government securities outstanding (outside the federal government including the Fed) deflated by the GDP deflator, to annual real GDP.
do not use an econometrically estimated model. If the U.S. economy were hit with a large negative demand shock that drives the unemployment rate up to 7.9%, we estimate that even aggressive monetary policy that drives long-term interest rates to near zero would reduce the unemployment rate only to 6.7%. Full recovery would be achieved, however, if the aggressive monetary policy were complemented by sufficient fiscal stimulus in the form of cash transfers or income tax cuts to households. We estimate that a quarterly transfer to households that peaks at 2.7% of quarterly GDP and phases out gradually as it is repeated over seven quarters (so that the cumulative transfer is roughly 12% of quarterly GDP) would reduce the unemployment rate in such a recession by nearly an additional percentage point from 6.7% to 5.9%.
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Appendix

1. The Fair model uses a historically-estimated interest rate rule for RS (stochastic equation 30). We suppress equation 30 and set exogenous RS equal to (essentially) zero.\(^{10}\)

2. We set the path for BR exogenously. BR rises and falls smoothly from $80 billion to $152 billion in the fifth quarter to $104 billion in the eighth quarter.

3. In the Fair model, BR is determined from MB by identity, equation 57. Since BR is now exogenous, we invert identity 57 to solve for MB.

4. In the Fair model, MB is determined from MH, MF, and CUR by identity, equation 71. Since MB is now determined by identity 57, we invert identity 71 to solve for MH (given values for MF and CUR, determined as explained below). The Fair model uses stochastic equation 9 for MH. Since MH is now determined by identity 71, it is necessary to suppress equation 9.

5. In the Fair model, MF is determined by stochastic equation 17. We suppress equation 17. We solve for MF as follows: \(MF = 0.84[-MB]\). The coefficient 0.84 is the approximate average value of \(MF/[-MB]\) under the interest rate rule.

6. In the Fair model, CUR is determined by stochastic equation 26. We suppress equation 26. We

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\(^{10}\) The discussion in Fair’s (2003) Table A.8: Solutions under Alternative Monetary Policy Assumptions, is a useful guide for the modifications to the Fair model that are made for this simulation (in particular, the column for UBR exogenous). Because the path of the exogenous bank reserves push the equilibrium Treasury bill rate below zero, however, it is necessary to modify the material in Table A.8.
solve for CUR as follows: \( \text{CUR} = 0.80[-\text{MB}] \). The coefficient 0.80 is the approximate average value of \( \text{CUR}/[-\text{MB}] \) under the interest rate rule.

7. In the Fair model, RB is determined by stochastic equation 23. We suppress equation 23. We solve for RB as follows: \( \text{RB} = 0.8\text{RB}[-1] \).

8. In the Fair model, RM is determined by stochastic equation 24. We suppress equation 24. We solve for RM as follows: \( \text{RM} = 0.8\text{RM}[-1] \).