

When Should Fiscal Policy Be Used for Stabilization?

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When should we use fiscal policy for stabilization?

- Fiscal policy is helpful to stabilize the economy when monetary policy is imprecise
 - zero lower bound (ZLB) on nominal interest rates: interest rates cannot be reduced further (Great Depression, Great Recession)
 - monetary union: government does not control monetary policy / interest rates but it controls fiscal policy (Euro area, states in US)
- Why not use fiscal policy before monetary policy?
 - because of distortions in provision of public goods (distortions in basket of goods consumed), fiscal policy is not as appropriate for stabilization → it's not optimal to stabilize the economy perfectly w/ fiscal policy
 - efficient allocation cannot be achieved w/ fiscal policy alone.
 - political economy central banks are institutions designed for stabilization, unlike parliaments / legislative branch
 - central banks are independent
 - central banks collect information constantly & can act fast.