In hard times, properly targeted and timely government spending can act as a short-term crutch, serving as temporary support until the private market is again able to stand on its own. The crutch has been sorely needed the past two years as we have dealt with a severe financial crisis and deep recession.

Help in averting an even worse economic malady has come at substantial cost. We at the Dallas Fed calculate that this year's spending by federal, state and local authorities—net intragovernmental transfers, in economists' lingo—will sum to more than a third of our gross domestic product. Federal deficits alone are projected to total between $7 trillion and $9 trillion for the next 10 years. These are truly startling figures.

The Federal Reserve does not, and should not, involve itself in the planning or execution of the federal budget. Taxing and spending is the business of those serving in the legislative and executive branches.

Yet, deficit spending does have the potential to impact the conduct of monetary policy.

Historically, fiscal deficits that loom too large for too long come with a significant long-term price tag: the potential for higher interest rates and higher tax rates. As these deadweights bog down economic growth, fiscal authorities may look to the central bank to monetize the debt and inflate away government largess.

I know of no member of today’s Federal Open Market Committee who has any intention of acquiescing to such pressures, should they materialize.

Maintaining a balance between necessary fiscal stimulus and long-term fiscal health is a task for the folks we elect to represent us. But we at the Fed will keep a watchful eye on fiscal policy's effects as we monitor the growth and price dynamics of the economy.

We will also continue to monitor the fiscal health of states. When national economic conditions deteriorate, state governments typically face budget squeezes, forcing them to choose between painful program cuts and tax hikes. This downturn has proven particularly difficult for state budgets, as senior research economist Jason Saving tells us in Southwest Economy’s “On the Record” interview (see page 8). Fortunately, he finds Texas to be more fiscally fit than other states.

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