

THE FISCAL-MONETARY POLICY MIX

Alan Reynolds

In the early postwar years, during the heyday of fiscal fine-tuning, monetary policy was not widely considered a particularly interesting or important topic. The predominant view was that the main function of monetary policy was to “stimulate” debt-financed purchases by keeping interest rates low. Inflation was first considered a useful lubricant to be traded for lower unemployment, and inflation could be reduced only by tolerating high unemployment. In the late sixties and early seventies, when the shrinking dollar proved less popular than expected, inflation was routinely described by a thermal metaphor (“overheating”), and regarded as an endemic problem to be endlessly “fought” by using fiscal policy (a surtax) and incomes policy (wage-price controls), but never monetary policy.

In reality, the steadily accelerating inflation from 1965 to 1970 was *not* due to massive “guns and butter” budget deficits, as an historical hoax maintains, but to careless monetary policy. The deficit in 1967 was no higher than it was in 1998, as a share of GDP, and inflation did not reach 4 percent until *after* the surtax of mid-1968 when money growth briefly accelerated. As Karl Brunner and Alan Meltzer (1997: 69) later observed, “The reason for increasing money growth, in Keynesian analysis, was to get a proper mix of monetary and fiscal policy.”

The Tobin-Mundell Debate

When the “proper mix” of higher tax rates and faster money growth produced only stagflation, mainstream macroeconomics grudgingly took some interest in money by patching together a Keynesian-neoclassical synthesis. James Tobin called this the “funnel” theory: That is, the government could pour *either* fiscal or monetary stimulus

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Alan Reynolds is a Senior Fellow at the Cato Institute. An earlier version of this paper was published by the Joint Economic Committee of the U.S. Congress (Reynolds 2000).

into one end of the funnel, and faster growth of nominal GDP would come out the other end. If the economy were below full employment, faster growth of nominal GDP would automatically produce faster growth of *real* GDP. Demand was thought to create its own supply, turning Say's Law on its head. If the economy were above full employment, by contrast, workers would demand higher wages and employers would hike prices to cover that cost, creating an escalating spiral that supposedly required wage-price controls.

But President Nixon's experiment with wage-price controls exploded, creating horrific "stagflation" in 1973–75. By then, the hubris of expert demand management had suffered a permanent loss of credibility. Although the combination of recession and inflation seemed an anomaly when viewed through the funnel theory, it has nonetheless been the norm rather than the exception in post-Bretton Woods experience (i.e., 1970–71, 1973–75, 1980–82 and 1990–91). The "Keynesian" cure for recession was to stimulate demand, and the cure for inflation was to curb demand, but it was obviously impossible to do both at the same time. This led Robert Mundell to propose, in 1971, that the job of ending inflation be assigned entirely to monetary policy (similar to what is now called "inflation targeting"), while the toolkit of fiscal policy should be expanded to include a microeconomic focus on the supply side—i.e., through tax incentives, privatization, and deregulation to enhance potential supply.

The Current Debate

The old Tobin-Mundell debate over the proper policy mix remains central to the current debate about U.S. economic policy. When it comes to the alleged benefits of endless budget surpluses, the Clinton administration embraced the rhetoric of Herbert Hoover. The economic logic is still rooted in Tobin's quaint funnel theory—that is, it pivots on defining fiscal and monetary policy as two perfectly interchangeable tools for managing growth of nominal GDP. If that was really true, then we could prudently trade more fiscal restraint for more monetary stimulus, with no net impact on real growth, and therefore (because inflation is *defined* as overheated growth) no impact on inflation. But what do words like stimulus and restraint really mean? Until very recently (when budget surpluses began to be described as stimulative) a fiscal stimulus meant government borrowing—selling more Treasury bills and bonds to the public. Adding to the debts of taxpayers was supposed to make them feel richer, and therefore more inclined to spend (although that would not be so easy for those who had used their money to buy Treasury IOUs). Budget

surpluses, by contrast, were a “fiscal drag”—something that depressed progress.

Monetary stimulus is easier to explain but slightly harder to describe. Monetary ease could be defined by the extent of Federal Reserve purchases of Treasury bills and bonds, which expands the supply of bank reserves and currency and thereby enables a greater expansion of liquid assets (“money”) used to purchase goods and services and pay creditors. Alternatively, we could define monetary stimulus or “ease” in terms of Fed efforts to keep interest rates low, since such efforts take the form of monetizing debt—i.e., purchasing T-bills with new reserves and currency. In either case, the Fed’s act of buying T-bills is surely quite different from the Treasury selling them. And the Fed does not need budget deficits to be a big buyer, because there are plenty of T-bills that can be purchased from the domestic or foreign public.

The notion that fiscal and monetary stimulus are interchangeable implies there is no difference between printing money and printing bonds. If that made any sense, then budget deficits might just as well be financed by issuing new currency rather than by selling bonds to the public (which has to surrender cash to obtain the bonds). Yet the alleged symmetry between marketing and monetizing T-bills, which lies behind the illusion of trading budget surpluses for monetary ease, is fundamentally flawed.

Federal Reserve open market purchases of T-bills with new cash are not at all comparable to the so-called “fiscal stimulus” of marketing Treasury securities to the public. If monetary policy is too easy, the result will be higher inflation—regardless whether the budget is in deficit, balance, or surplus. If monetary policy is too restrictive, the result will be deflation—even if the budget deficit is huge, as in Japan. Inflation and deflation are monetary phenomena, not fiscal or real.

Fiscalist Propositions

A useful theory should help us forecast the future. But fiscalist forecasts have been notoriously wide of the mark. In 1988, Tom Sargent wrote that “monetary policy is much less powerful than is often depicted, because . . . monetary policy authorities do not control the size of the portfolio of government debts that they must manage.” Sargent (1988: 321) boldly predicted that “under a deficit spending policy it is *impossible* to run a noninflationary monetary policy. These propositions are especially relevant for U.S. monetary policy in the late 1980s and the 1990s.” In fact, those fiscalist propo-

sitions turned out to be especially *irrelevant*, as did other unpleasant speculations of Sargent and Neil Wallace that were based on untenable assumptions that the U.S. government might soon be unable to peddle more securities to anyone but the Fed, or that real interest rates might persistently exceed the real rate of economic growth.

Twin Deficits Theory

In the early 1990s, the fashionable fiscal theory of “twin deficits” was a major rationale behind increases in individual income tax rates that took effect in 1991 and 1993. This theory predicts that countries with large budget surpluses, such as the United States and Australia at the present time, must therefore have large trade or current account surpluses. Countries with large budget deficits, like Japan, must likewise have large trade deficits. The twin deficits theory has fared no better than the Sargent–Wallace theories about fiscal inflation. As the federal budget moved from a deficit of 5.9 percent of GDP in 1992 to a surplus of 2.3 percent of GDP in 2000, the current account deficit simultaneously *increased* from 0.8 to 4.4 percent of GDP.

In truth, economists are not at all sure how to measure budget surpluses and deficits, much less what their effects are. No measure of government borrowing—not even the inflation-adjusted structural budget less capital outlays—is reliably linked to interest rates, inflation, real economic growth, or anything else. Whether we look at time series evidence within countries or cross-section evidence between countries, the importance long given to relatively minor annual changes in government debt cannot be reconciled with the facts. Several generations of students of macroeconomics have been hoodwinked.

Monetary policy has its own ambiguities, of course, but its short-term potency is not seriously in doubt. Fiscal policy, in the primitive sense of annual deficits or surpluses, is a poorly defined instrument for achieving no predictable result at all.

Fiscal theorists feel no obligation to accept any evidence as refutation of their theories, because fiscal theories can always be created or revised to explain anything that might happen. If the economy slumps, that is because budget deficits crowd out investment. If the economy booms, that is because budget deficits stimulate demand. If the dollar goes up, that is because budget deficits attract foreign investment. If the dollar goes down, that is because budget deficits create fears of inflation. If inflation goes up, that is because budget deficits are inflationary. If inflation goes down, that is because budget

deficits are not large enough. The fiscalist answer is always the same; only the questions change.

Clintonomics

The newest twist is to turn Keynes on his head and assert that balancing the U.S. budget was the cause of brisk economic growth in 1996–2000, rather than brisk growth being the cause of the fiscal windfall. This notion of stimulative surpluses involves yet another odd variation on the old policy mix debate. Recent White House explanations of the role of fiscal and monetary policy, for example, can best be described in the following series of questions and answers:

Question: Why is the U.S. economy growing at a rapid pace?

Answer: Because of a budget surplus which is (loosely) attributed to higher tax rates in 1993.

Question: With such a large surplus, why can't we now roll back the highest tax rates?

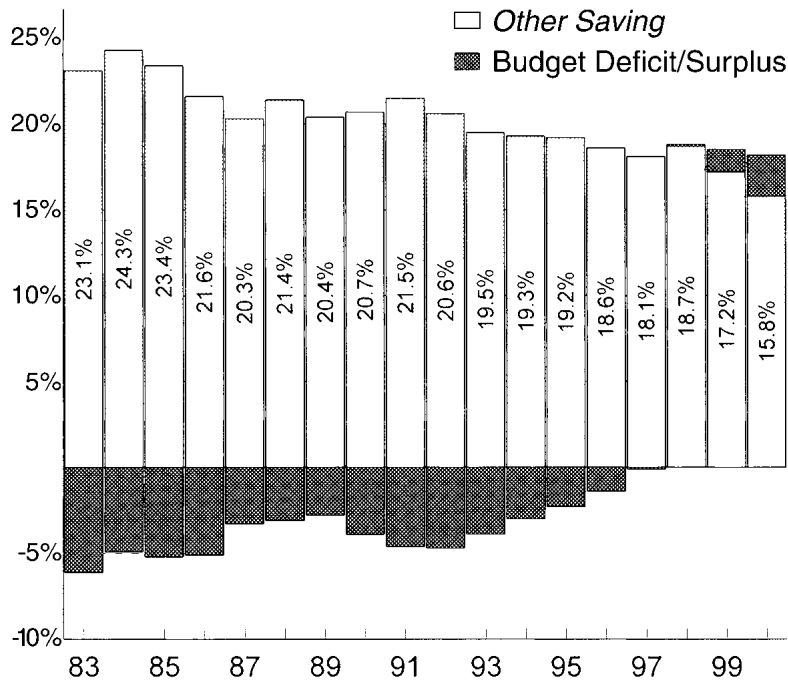
Answer: Because that would "drain the surplus," and any reduction of the surplus risks making the economy grow too fast. The rapid growth resulting from smaller surpluses, in turn, would force the Fed to raise interest rates, which would make the economy grow too slowly (presumably forcing the Fed to ease).

Conclusion: Real economic activity is stimulated by both budget surpluses and deficits, and the Fed's job is to offset surpluses with low interest rates and deficits with high interest rates.

There is a theory of sorts behind all this conceptual confusion. Like previous fiscal theories about twin deficits and inflationary deficits, however, the "stimulative surplus" of Clintonomics has been explained only by "stylized" (imaginary) facts. The theory is that budget surpluses increased national savings, as a share of GDP, and thereby pushed real interest rates down. Martin N. Baily, chairman of the Council of Economic Advisers under President Clinton, wrote in February 2000 that real interest rates during the 1983–89 expansion "were 50 percent to 90 percent higher on average than in the current expansion." Baily (2000) attributed Internet software investments and the post-1995 productivity surge to this seemingly huge reduction in real interest rates, citing his Republican predecessor Martin Feldstein about the way the budget deficits must "absorb a large fraction of domestic saving."

The only problem with the elegant Baily–Feldstein theory is that no part of it is true. Figure 1 shows the national savings rate was somewhat *higher* in 1983–89 (17.7 percent) than in 1993–99 (17.3

FIGURE 1
 FALLING PRIVATE SAVINGS OFFSET FALLING BUDGET DEFICIT
 (PERCENT OF GDP)



NOTE: Savings for Q4 2001 estimated. "Other" = personal + corporate + state and local government.

percent), despite the dramatic swing from budget deficits to surpluses during the latter period. In fact, the reduction in federal deficits was fully offset by a reduction in private savings. Moreover, real interest rates rose rather than fell when the savings rate was highest (1984 and 1998), and fell rather than increased when the savings rate was lowest (1991–93).

Not surprisingly, periods of strong investment have also been periods of strong corporate profits, which boosts national savings. Real interest rates have also been highest when the economy was growing most rapidly, and lowest when the economy was stagnant or worse. Bragging about low real interest rates is equivalent to bragging about poor investment opportunities and anemic economic growth.

The Fed's Interest Rate Moves

Back in 1988, when Sargent was suggesting that it did not matter much whether government deficits were financed by borrowing or printing money (i.e., that monetary policy was impotent because it merely affected this “composition” of debt), he also asserted that “monetary policy cannot be used to influence real rates of interest.” But note that this implies the Fed cannot even “influence” *nominal* rates of interest. Nobody could argue that cutting the fed funds rate from, say, 7 percent to 2 percent would automatically reduce expected inflation by five percentage points, nor that doubling the funds rate would *raise* inflation by a like amount.

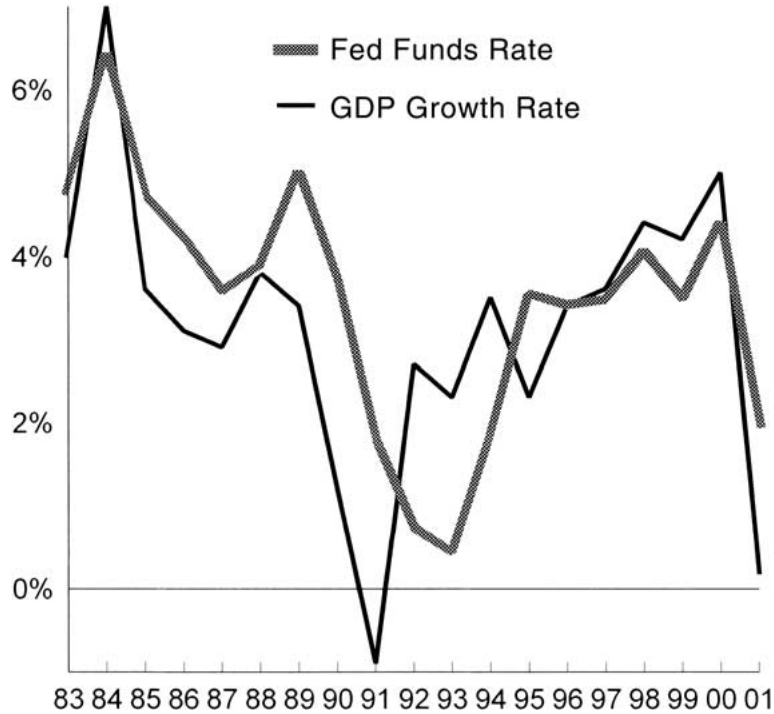
The Fed obviously can and does move short-term nominal interest rates up and down, and this certainly does “influence” the real rate of interest on cash (T-bills, bank deposits, and money market funds) for long enough to make a big difference.

Some missionaries for excess taxation (chronic surpluses) do *not* rest their case on the demonstrably false claim that surpluses *directly* reduce real interest rates by raising the national savings rate. Their fallback position is the old 1968 Keynesian policy mix—using surpluses as an excuse for easy money.

Keynesian theorists still assert, as in 1968, that budget surpluses permit the Fed to hold real rates much lower than otherwise. In fact, Fed officials have sometimes hinted (e.g., in 1932 and 1982) that they would be more “accommodative” if the budget were balanced. But what central bankers actually *do* is often different from what they say. Figure 2 shows *the Fed raises or lowers the real funds rate only in response to what has been happening to real GDP growth over the past year or so*. In fact, the Fed's interest rate moves often react to past GDP growth with a dangerously long lag (look at 1990–93). With eyes focused on the rearview mirror, the Fed thus held the real rate on cash well above the real GDP growth rate in 1990, and well below in 1993. Both extremes proved unsustainable (contributing to recession in 1990, then a sinking dollar in 1994) and were eventually reversed. What did budget deficits or surpluses have to do with these or any other moves in the real fed funds rate? Absolutely nothing. The notion of trading surpluses for easy money is a dangerous illusion, but an illusion nonetheless.

Since the real fed funds rate is closely linked to previous changes in real GDP in recent years, it follows arithmetically that the actual or nominal fed funds rate has likewise been closely tied to growth of nominal GDP. But it is the *real* component of GDP rather than inflation that generally motivates the Fed to raise or lower interest

FIGURE 2
REAL FED FUNDS RATE LAGS REAL GDP GROWTH



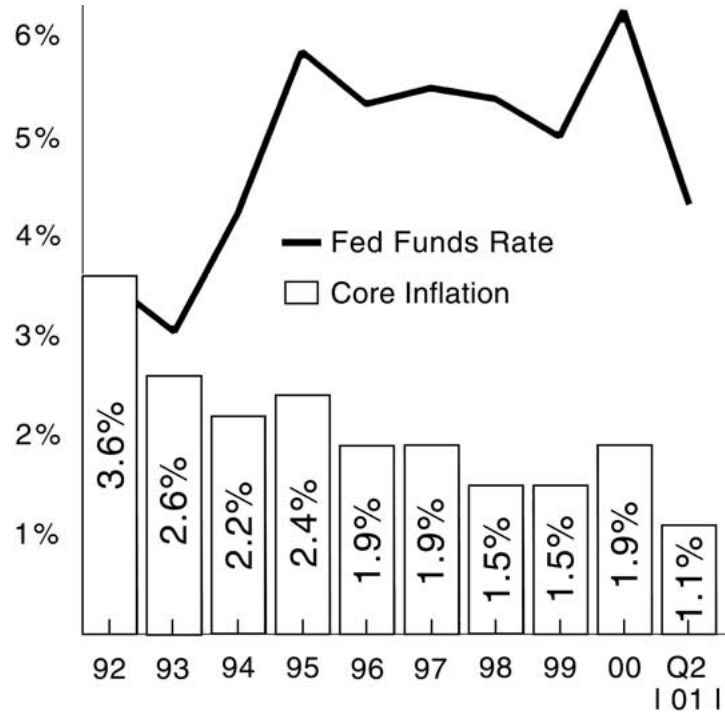
NOTE: “Real” funds rate subtracts rise in GDP chain price index. 2001 is second quarter.

rates. As Figure 3 indicates, *recent reductions and increases in the fed funds rate have been unrelated to changes in inflation*, at least by any measure of inflation that excludes world energy prices. If the Fed has been acting on the basis of any prices at all, it has been on the basis of energy prices *alone* (about 6 percent of the CPI).

The Fed’s Ambiguity

Congressional testimony of Fed officials often emphasizes *hypothetical* rather than actual inflation, and such extraneous matters as stock prices (but only when they are rising), low unemployment, productivity forecasts, big current account deficits, low personal savings, rectifying assorted “imbalances,” narrowing “gaps” between actual and potential growth, and, of course, preserving fiscal rectitude.

FIGURE 3
THE FED FUNDS RATE AND CORE INFLATION

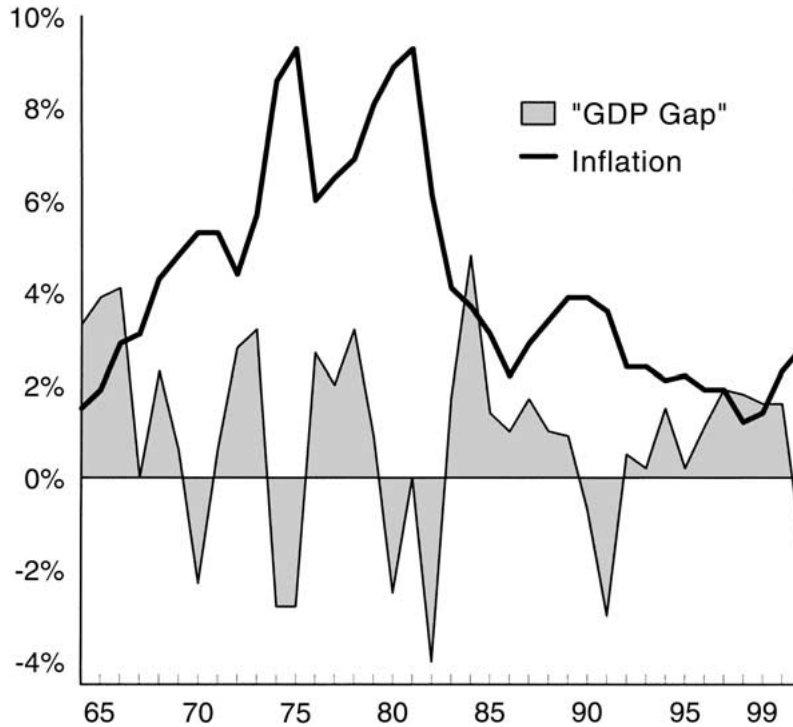


NOTE: Core inflation is measured by changes in the personal consumption expenditure (PCE) deflator less food and energy.

The Fed appears to have given itself many targets and goals, but has not bothered to demonstrate (aside from verbal conjecture) how even one of these self-selected anxieties is remotely related to the task of preserving the long-term purchasing power of its product—Federal Reserve notes.

Rather than focusing on any measure of inflation per se, Fed officials often define their job as preventing real growth from somehow exceeding a typically dismal estimate of potential growth. This explanation for Fed decisions is at least consistent with the previous observations—namely, that the real funds rate follows changes in *real* GDP (see Figure 2), and that the nominal funds rate has been halved or doubled for reasons having nothing to do with any visible changes in core inflation (see Figure 3).

FIGURE 4
 GAP BETWEEN ACTUAL AND "POTENTIAL" 2.5 PERCENT
 GROWTH OF REAL GDP IS WIDEST WHEN INFLATION
 IS LOWEST



NOTE: 2001 is first two quarters.

The trouble with attempting to fine-tune the gap between actual and real GDP, however, is that this gap is *inversely* related to inflation. As seen in Figure 4, inflation has always been lowest when actual growth was above alleged potential growth (here arbitrarily estimated at 2.5 percent), and inflation has always been highest when growth was furthest below such potential. The thermal metaphor—that inflation is caused by “overheating”—is the opposite of what we observe.

Many of Greenspan’s recently expressed concerns revert to the stubborn hunch that prosperity must be inflationary, in theory, although we have experienced serious inflation only during periods of “overcooling” such as 1974–75 and 1980–82. The chairman’s congress-

sional testimony in February 2000, for example, predicted that low unemployment must either push prices up or profits down:

At some point in the continuous reduction in the number of workers willing to take available jobs, short of repeal of the law of supply and demand, wage increases must rise above even impressive gains in productivity. This would intensify inflationary pressure or squeeze profit margins [Greenspan 2000].

This quaint Phillips curve theme suffers even more problems than usual. First, there has been no “continuous reduction in the number of workers willing to take available jobs.” If that had happened the unemployment rate would have fallen, rather than hovering near 4 percent or more since October 1999. Second, the “law of supply and demand” does *not* imply that employers will foolishly continue to add workers at higher wages if doing so squeezes their profit margins. On the contrary, elementary price theory teaches that employers add workers only up to the point where the added cost is matched by added revenue. Third, nonfarm productivity rose by 5.9 percent over the four quarters ending in the second quarter of 2000, pushing unit labor costs up only 1.7 percent as business prices rose by only 2 percent. When theory and facts diverge so dramatically, it is not the facts that are at fault. Fourth, even if unit labor costs were rising rather than falling, that would not make it any easier for firms to hike prices without losing sales to domestic or foreign rivals. Short of repeal of the law of supply and demand, fewer sales must mean fewer jobs, thus reversing the hypothetical decline in unemployment that was supposed to produce the hypothetical rise in unit labor costs.

The Fed’s old story about falling unemployment being inflationary is illogical and out of touch with reality. Trying to make some sense out of it, Greenspan even resorted to finding fault with rising productivity. “The problem,” he claims, “is that the pickup in productivity tends to create even greater increases in aggregate demand than in potential aggregate supply.” However, “should productivity fail to continue to accelerate,” he added, “that would engender inflationary pressures.” A pickup in productivity can be inflationary, in the chairman’s view, because it boosts profits and stock prices and therefore consumer demand. Yet a slowdown in productivity would also engender inflationary pressures by raising unit labor costs.

The rhetorical agility required to convert booming productivity into an inflation threat was needed to rationalize the Fed’s odd anxiety about productivity-driven growth. Since a slowdown in productivity “would engender inflationary pressures,” any Fed crusade to slow real

growth must be inflationary. No sensible employer in today's tight labor market would respond to a possibly temporary slowdown with a rash of layoffs. And that, in turn, means the coveted "soft landing" would slow or stop the productivity surge, pushing unit labor costs back up.

"A lower rate of economic growth that did not carry with it a significant deterioration in productivity growth obviously would be a desirable outcome," says Greenspan. But slower economic growth is obviously undesirable to anyone outside the Fed, and it would surely carry with it a significant setback in productivity growth. The Fed cannot slow the growth of real output without simultaneously slowing the growth of real output per hour worked (i.e., productivity).

Recent scarcity of qualified workers means rapid economic growth can *only* come from higher productivity, not from oversized employment gains. If it turns out that rapid productivity growth cannot be sustained, then growth will necessarily slow. Yet there is no reason for the Fed's central planners to put artificial speed limits on growth that arises from productivity gains. Attempts to fine-tune a slowdown by keeping the fed funds rate far above the rate of nonenergy inflation must prove counterproductive, if not dangerous.

Conclusion

The Mundellian or "supply side" revolution of 1971–86 mainly consisted of assigning price stability to monetary policy while putting much greater emphasis on the microeconomic details of fiscal incentives (marginal tax rates and regulations) rather than the macroeconomic morass of fiscal outcomes (budget deficits and surpluses). The subsequent fiscalist counterrevolution mainly consisted of a renewed fascination with federal borrowing and a revival of theories previously associated with conservative Keynesians of the Eisenhower–Nixon years. The key predictions of this theory were that budget surpluses would increase national savings, reduce real interest rates, and eliminate the current account deficit. All of those predictions proved false. A corollary theme was that a tighter fiscal policy (often meaning higher tax rates) would and should permit an easier monetary policy (lower interest rates). That prediction also proved false. The Fed raised the fed funds rate in late 1999 and 2000 as the budget surplus grew larger.

The fiscalist counterrevolution has now been rigorously tested against reality, and it failed quite spectacularly. The fact that politicians continue to obsess over minor variations in federal borrowing or debt repayment is a political fact without any coherent economic

explanation. Meanwhile, the power of monetary policy has again become quite evident, yet the goals and methods of U.S. monetary policy remain vague and mysterious. It is time to put the quaint fiscal fallacies of the 1990s aside and refocus our attention on (1) creating a tax and regulatory environment conducive to economic progress, and (2) creating a mandate for monetary authorities to eschew efforts to fine-tune real GDP, unemployment, or stock prices and to instead focus exclusively on stabilizing the value of their product—Federal Reserve notes.

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