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ROLE OF MONETARY-FISCAL POLICIES

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A free market economy was once believed to be capable of functioning without interference by government; however, it does not automatically establish optimum demand for goods and services. During the 1920's the quantity theory of money became widely accepted, and the Federal Reserve was believed to be capable of preventing future "booms" and "busts." The great depression shattered those hopes, resulting in increased emphasis on fiscal policy.

In 1946 Congress passed the Full Employment Act, which in effect made the government responsible for maintaining high levels of employment without inflation. The essential idea is that the government, through monetary-fiscal policies, should augment or offset private demand in such a way as to maintain high levels of employment and stable prices. Recently emphasis has been given to two additional objectives, promoting economic growth and protecting the balance of payments.

Presently economists generally agree that monetary-fiscal policies should and can be used to prevent extreme economic fluctuations. Almost all economists agree that monetary policy should be "tighter" in a period of full employment and inflation than during a period of under-utilization of economic resources. They also agree that government revenues relative to receipts should be higher during inflation periods and lower during recessions.

Unfortunately this still leaves much room for disagreement on which of these tools represents the more potent force, on how tight or how easy money should be in particular circumstances, and on the most desirable size of the budget deficit or surplus. Also, opinion differs considerably about length of lags, for both monetary and fiscal policy, between: (1) recognition of a need for action, (2) taking of action, and (3) eventual impact upon the economy.

These issues cannot be settled by logical analysis alone. Empirical evidence must be brought to bear upon these areas of conflict.

In this discussion I will present the basic theory underlying the fiscal policy approach and the monetary policy approach, cite what I consider to be the relevant evidence and then apply my conclusions to the current debate concerning the desirability of a tax cut as well

as the dispute concerning use of monetary policy for reducing a balance-of-payments deficit.

THE CONFLICT OF THEORIES

Those emphasizing fiscal policy as a tool for affecting total demand usually use the Keynesian framework in analyzing the effects. Keynes' theory placed primary emphasis upon private and public investment. Keynes argues that: (1) people's aggregate income will be increased by some multiple of increased investment and (2) this multiple, or multiplier, is determined by the amount saved and invested from each \$100 of increased income. For example, a 1 billion dollar increase in investment spending might result in a 2.5 billion dollar increase in income if the multiplier is 2.5. The multiplier would be 2.5 if people saved and invested \$40 of each \$100 of increased income, spending the other \$60 for consumption (\$100 is two and a half times \$40). Also, a sharp reduction in taxes amounting to 10 billion dollars would raise total incomes 25 billion dollars. In other words, an increase in disposable income would result from a tax cut, and this in turn would lead to a rise in consumer spending by some multiple of the decrease in taxes, depending on the size of the multiplier.

The probable reason for emphasis on fiscal policy by Keynesian economists is Keynes' argument that under certain circumstances monetary policy would be completely ineffective. Keynesians tend to hold that whether a deficit is brought about by a reduction in tax receipts or by an increase in government spending is of little significance.

The Keynesian contends that the influence of money, if any, would be via its influence on interest rates and, hence, its effect upon investment expenditures. Changes in the quantity of money are not assumed to influence consumer expenditures directly.

Those placing primary emphasis upon monetary policy usually base their arguments on the quantity theory of money. Quantity theorists argue that changes in total spending, including both consumption and investment, are highly correlated with monetary change. They hold that an increase in the money supply leads to an increase in liquid assets and that holders of liquid assets will attempt to reduce excess liquidity by increasing spending; hence, spending flows will rise. Quantity theorists typically argue that the method of financing a deficit is of critical importance. Unless the money supply rises, the quantity theorist would contend that a deficit, regardless of how it is brought about, would not exert a strong stimulus upon total spending.

Both of these approaches to analyzing the factors influencing final demand is internally consistent.

WHAT THE EVIDENCE SHOWS

The essential question is which theory is most nearly consistent with the facts and can, therefore, yield the better prediction. These two approaches have been tested far too little, but I would like to relay the results of some recent studies which bear upon this issue.

Evidence on Monetary Policy

A recent study by Milton Friedman of the University of Chicago, and David Meiselman, formerly of the University of Chicago, attempts to test the Keynesian theory and quantity theory over the period 1897 to 1958 [1]. The evidence was remarkably consistent and clear cut, and although several competent economists have tried to question the results, they have not done so successfully, to my knowledge.

Throughout the period 1897-1958, the quantity of money was much more closely associated with final demand than were investment expenditures. In fact, the correlation between money and consumption expenditures was .985, and the correlation between changes in money and changes in consumption was .695. For the same period the correlation between investment expenditures and consumption was substantially lower, .756, and the correlation between changes in investment expenditures and consumption was .095.

Furthermore, when money effects were held constant, the correlation between investment and consumption disappeared and was frequently negative, whereas when the effects of investment expenditures were held constant, the correlation between money and consumption remained about the same as previously.

If these findings can be accepted, control of the stock of money is far more useful than control over investment expenditures as a tool for affecting total spending and, hence, the level of income and employment. This is indeed fortunate because control of monetary change through the Federal Reserve Board is far easier than either control of government spending and revenue or private investment through the action of Congress and the Chief Executive.

In another recently published study, Friedman and Anna Schwartz (of the National Bureau of Economic Research) concluded that changes in the stock of money are closely correlated with sub-

sequent economic expansions and contractions [2]. Recessions in the last century have been preceded by monetary contractions, and recoveries have been preceded by monetary expansion. They also presented strong evidence that the causal influence runs from money to economic activity, not from economic activity to money. Their principal conclusion was, "Appreciable changes in the rate of growth of the stock of money are necessary and sufficient condition for appreciable changes in the rate of growth of money income."

Monetary trends in seven other leading free market countries of the world are also closely related to the changes in total gross national product, i.e., total spending on finally produced goods and services [3]. Countries which had the higher growth in money also had the higher growth in GNP since 1956. Since real resources were generally available in the countries studied, increased spending was achieved without sharp inflation except in France and Italy.

Rapid monetary growth is frequently assumed to lead to low interest rates. Yet, if monetary growth does stimulate spending and total economic activity, the consequent higher rate of spending will conceivably generate a strong demand for money and, therefore, result in higher interest rates. In fact, the countries studied which have had the highest monetary growth rate in recent years also had higher, not lower, interest rates. Thus, interest rates appear to be primarily a result of economic activity rather than a cause.

Evidence on Fiscal Policy

Evidence to support the argument that government deficits are stimulating and surpluses are restraining, irrespective of the method of financing, is hard to find. Yet, the argument tends to be accepted as gospel.

Adverse budget swings during economic expansions are frequently assumed to have thwarted full economic recovery, that is, fiscal policy is assumed to have acted as a depresser or restrainer of total spending. Yet, although our tax system has been essentially unchanged during the past three recoveries, the first recovery was excellent and the second which ended in May 1960 was inadequate. The present recovery has not yet achieved full employment even though it is now in the thirty-first month of expansion. Furthermore, the budget swing as a percent of GNP growth was largest during the most satisfactory recovery and smallest during the present expansion.

Correlation between the budget position and the accompanying GNP changes for the postwar period amounts to +0.39 according to

a recent study by George Terborgh of the Machinery and Allied Products Institute [4]. These data are contrary to the general argument that deficits encourage expansion and surpluses exert restraint since deficits are associated with weak GNP performance and surpluses with strong trends in GNP. When the budget position is correlated with income trends six months later, the correlation shows no statistical significance.

On the international front Michael Levy of the National Industrial Conference Board investigated budget-economic growth data for six European countries, Canada, and the United States for the years 1950-1960. He concluded that the correlation

. . . does not indicate any statistical relationship between budget deficits and growth. Rapid economic growth well in excess of that of the U. S. was associated with significant surpluses in the case of Austria, the Netherlands, and Portugal and with substantial accumulated deficits in the case of France. Similarly, much lower rates of economic growth coincide with cumulative budget deficits for the United Kingdom and the United States. . . . Limited and admittedly crude empirical evidence presented does not support current pronouncements and prescriptions that larger deficits, as such, will almost automatically result in accelerated economic growth over the years [5].

Conclusions on Monetary vs. Fiscal Policy

The data that I have presented support the conclusion that monetary changes, and not budget changes, are the prime determining factor influencing subsequent spending changes. This view should not be interpreted to mean that the only factor limiting economic growth is insufficient money. Increases in the stock of money can increase total spending and, hence, GNP, but whether the GNP will represent inflation or increases in real production will depend upon supply factors. Potential for economic growth is determined by changes in real supply factors such as the size and quality of the labor force, average hours of work, the stock of capital, the state of technology, and the efficiency with which resources are combined. On the other hand, the degree of utilization of these resources is determined principally by the volume of total demand which can be influenced by monetary change. Since 1957, persistent economic slack suggests that demand has not been adequate to utilize all our resources.

APPLICATION TO THE CURRENT SITUATION

The two major areas of current economic policy debate are: (1) the appropriateness of the proposed tax cut and (2) the role of monetary policy in stemming the balance-of-payments deficit.

A tax cut cannot be counted on to stimulate total spending and, hence, strengthen final demand unless it is accompanied by adequate monetary expansion. Therefore, monetary and fiscal policies should be used to complement each other. Data cited suggest that adequate monetary expansion would result in strong final demand even without a tax cut. Nevertheless, a tax cut is desirable for several reasons regardless of its effects on final demand.

First, our tax system is in serious need of revision for the purpose of increasing incentives and thereby increasing the capacity of our economy to grow. Many tax laws were adopted during periods of war when little attention was given to the effect upon incentives. A substantial reduction in high marginal personal rates accompanied by a significant reduction in the corporate tax rate would substantially strengthen existing incentives to work, save, and invest.

Second, on philosophical grounds I prefer limited federal government to expanding federal activities. With a highly progressive tax system, the federal government's tax receipts rise more than proportionately when the economy expands. Political pressures almost guarantee that increased revenues will be spent rather than used for reduction of the federal debt. Only an occasional reduction in tax rates can provide a good chance of limiting growth in federal activity. Some argue this view is not realistic since it will merely result in a continuous federal deficit. The postwar experience does not support that assertion. You may be surprised to note that from mid-1946 to mid-1961 we had a cumulative cash surplus of 4.2 billion dollars in the federal budget. Through fiscal 1963 we had a cumulative cash deficit of 5.7 billion dollars, that is, a total cash deficit of 9.9 billion dollars in the last two fiscal years. Congress has not done such a bad job of balancing the budget on average during the postwar period. Deficits in recent years have been sizable, however, due largely to the fact that the economy has performed somewhat less than satisfactorily.

Finally, a tax cut would facilitate the current objective of maintaining high short-term interest rates for balance-of-payments purposes while continuing to promote adequate monetary growth.

Although monetary policy can exert sizable effects upon domestic spending trends, it is not well adapted to stemming the deficit in our balance of payments. Some have argued that under present circumstances a much tighter monetary policy should be adopted for the purpose of substantially increasing short-term interest rates. Although a sizable rise in short-term interest rates would undoubtedly have a favorable impact on short-term capital

flows, it could be achieved via monetary policy only through monetary contraction, which would inevitably reduce domestic spending and force the economy into a recession. Furthermore, short-term interest rates would drop sharply, adversely affecting the balance of payments.

The policy actually pursued in recent months has been much more moderate. The Federal Reserve and Treasury have attempted to twist the yield curve by raising short-term rates while preventing a rise in long-term rates. The moderate narrowing in yields resulting from these actions has so far been achieved without monetary contraction. The modest increases in short-term interest rates is of dubious benefit to the balance of payments particularly since many foreign short-term rates also adjusted upward.

A serious question is whether concern about the deficit in our balance of payments will inhibit monetary policy from exerting a strong stimulus during any future recession. Hopefully, we will not repeat the bitter experiment of 1931 when concern about gold outflows led to an aggressively tight monetary policy which, in my opinion, substantially deepened and prolonged the great depression. This is not the place to discuss the serious question of how we solve our balance-of-payments problem, but suffice is to say that monetary policy is not an appropriate tool.

SUMMARY

We may conclude that the primary role of monetary-fiscal policies is to influence final demand for goods and services. Unfortunately the free enterprise system has nothing in it which will properly regulate total spending automatically. Therefore, conscious governmental actions are required. Although monetary-fiscal policies can prevent severe swings in economic activity, little evidence is available to indicate that our knowledge is sufficient to permit perfection. Inadequate knowledge concerning the variability and length of lags will continue to encourage actions which in hindsight prove to have been wrong. The evidence would suggest that without a proper monetary policy, fiscal policies exert only limited effects upon final demand. Furthermore, little evidence is available to show that monetary policy is well adapted to alleviating balance-of-payments difficulties. Although our knowledge concerning the impact of monetary-fiscal policies continues to grow, further refinement based upon careful economic research is urgently needed.

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