

April 24, 1981

Policy Debate

A major debate within the economics profession has now been reflected in the financial press and in policy circles. The debate concerns the appropriate role for monetary policy and, to a lesser extent, fiscal policy in the Reagan economic game plan. A March 23 *Wall Street Journal* editorial, entitled "Money Doesn't Matter," sets forth one point of view with the following propositions: 1) the Federal Reserve, through its monetary-policy tools, can control the money supply and thus the inflation rate; 2) the Federal government, through its fiscal-policy tools (tax rates and government spending) can affect productivity and employment; 3) monetary policy has little effect on employment and growth; 4) fiscal policy has little effect on inflation.

If these four propositions correctly describe the world, then the implementation of monetary and fiscal policy would be rather easy and straightforward. Monetary policy should be directed towards lowering inflation, because of its lack of consequences for real output. Fiscal policy should be directed towards lowering taxes and government spending to encourage productivity, because of its lack of consequences for inflation.

Rebirth of classical view

Some critics have labeled the *Journal's* argument as new, radical, and untested. That is misleading. Indeed, the *Journal's* editorial simply garbs in modern clothes the classical view of economics, which dominated the economics profession from the time of Adam Smith (*The Wealth of Nations*, 1776) to the time of Lord Keynes (*General Theory*, 1936).

This classical economic theory focused policy attention on the long run, where money was a veil, so that changes in the money supply only affected prices. Short-run business-cycle problems, in this view, simply reflected random economic events, which policymakers could not anticipate and thus

could not offset. But because private markets were efficient and flexible, the economy quickly returned to a new equilibrium value following any external shock. Policymakers' attempts to stabilize the economy in the short-run thus would be both unnecessary and undesirable. Rather, government policy should be directed toward long-run considerations—monetary policy to stabilize prices and fiscal policy to encourage economic growth.

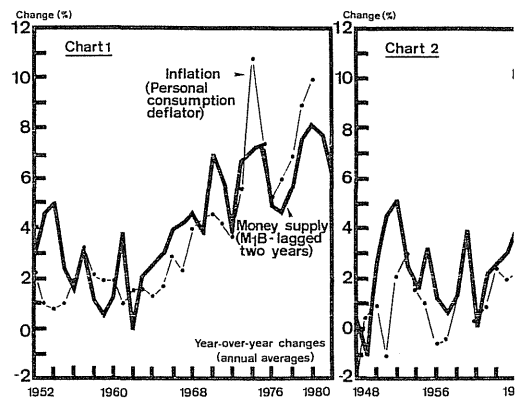
The Great Depression of the 1930's—a worldwide traumatic event—seemed to undermine one of the major assumptions of the classical theory, however. With the unemployment rate over 10 percent for a decade, economists could no longer reasonably assume that the business cycle was due to random shocks which would be self-correcting by the efficient and flexible response of private markets.

The "Keynesian Revolution" in economic thinking arose as a direct response to the Great Depression. It shifted the focus of policy analysis to the short run from the long run—"when we are all dead," in Keynes' words. It provided a theoretical rationale for the failure of private markets to adjust effectively to an outside shock (such as a decline in aggregate demand) and for the need for government "stabilization" policy to offset these influences. But although the Keynesian approach provided a theory for dealing with the short-run business cycle, it did not incorporate a long-run theory of either inflation or economic growth. (Keynes himself had strong, even classical, views on these topics, but they were not incorporated into his *General Theory*.) This turned macroeconomic policy on its head. While the classical theory focused on the long run and assumed away the short run, the Keynesian theory did just the reverse.

In recent years, the classical model has revived in response to the accelerating inflation

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For 1981, dots represent of debt and target gr

of the 1970s, which forced policymakers to focus more on reducing inflation and less on stabilizing income. Because of the Keynesian model's failure to provide a theory of inflation, economists began to return to a classical model—in its purest form, a “rational expectations” approach—which did provide such a theory.

This approach in effect asserts that monetary policy should be directed in the long run towards lowering the inflation rate. It asserts also that in the short run, the business cycle is largely due to random fluctuations, which policy authorities can neither anticipate nor do anything systematic to offset. If policy is systematic, it can also be anticipated by the public, who will act to offset its influence. For example, if the Fed announces a 5-percent faster growth in the money supply in response to a rise in unemployment, the public will revise its inflation expectations by 5 percent, so that there would be no favorable impact on real growth or unemployment.

Markets are rational in the sense that they use all information available in a systematic way, and they are efficient in the sense that they respond to external shocks in the least-cost way. Thus, there is no role for stabilization policy in this rational-expectations world—the world of the *Wall Street Journal* editorial. Because of the current importance of that approach, the major propositions stated in the *Journal* editorial deserve further analysis.

Monetary policy and inflation

Does monetary policy affect the inflation rate? Apparently yes. Monetary policy, measured by the annual rate of change in the money supply, is a good predictor of the inflation rate, with approximately a two-year lag (see Chart 1). For example, money-supply growth in 1978 was a major factor explaining the inflation rate in 1980.

The trends of money and prices over long periods of time are closely related. Low money growth was associated with a low inflation rate in the pre-1965 period, while

high money growth was associated with a high inflation rate in the post-1965 period. Specifically, the inflation rate averaged about one percentage point below the money-growth rate before 1965, and about one percentage point higher in later years.

Non-monetary factors—such as the upsurge in OPEC oil prices—can also affect the inflation rate in the short run. The oil crisis pushed the inflation rate above that related to underlying monetary factors in 1974 and again in 1979-80. Weather-caused food shortages have caused similar price shocks on several other occasions.

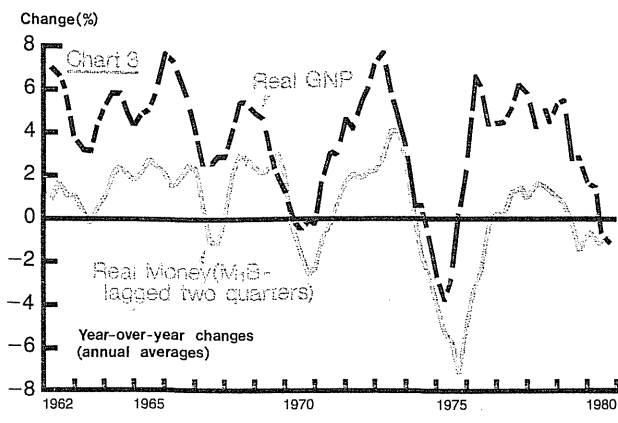
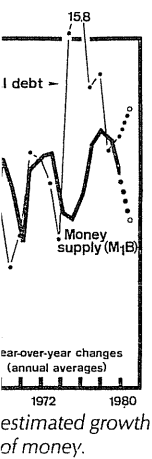
Fiscal policy and inflation

Does fiscal policy affect inflation? Apparently not, at least in any significantly direct way. For example, an increase in the government deficit increases the demand for credit and therefore tends to push up interest rates. However, it does not necessarily increase the demand for goods, and thus does not push up the inflation rate. This is because the deficit's pressure to raise interest rates tends to “crowd out” a roughly equal amount of private interest-sensitive spending, so that the total demand for goods fails to rise significantly. This suggests that the deficit, even in the short run, will not systematically affect the inflation rate.

However, fiscal policy and the government deficit can affect the inflation rate indirectly, through money-supply effects. The rate of change in the government deficit is closely related in most years to the rate of change in the money supply (see Chart 2). This close statistical association is not based on any basic behavioral relationship; in fact, the relationship is not nearly as close in other countries as it is in the United States.

The close historic relationship between deficits and money in this country reflects a number of potential factors:

- Even-keel considerations. Until the mid-1970's, the Federal Reserve tended to hold interest rates steady during periods of large



estimated growth of money.

Treasury financing. The reserves and money created during such "even-keel" periods may not all have been offset in subsequent periods.

- Federal Reserve operating procedures. Until October 1979, the Fed controlled the money supply via an interest-rate targeting procedure. A large deficit could put upward pressures on interest rates, which would tend to induce monetary accommodation.
- Policy coincidence. Government deficits were usually associated with business-cycle recessions, when monetary policy was typically eased and the money supply increased.

The one major break in the link between large deficits and rapid money growth occurred in 1975-76, when money growth stabilized in the face of a record increase in the deficit. But Administration policymakers expect that experience to be repeated in the 1981-82 period. The Federal Reserve is targeting a 3½-to-6 percent growth rate in the (M-1B) money supply in 1981—considerably below the 1980 rate—and presumably it will target even less in subsequent years. On the other hand, the Government deficit may remain high this year and next, as tax revenue reductions are expected to outpace planned spending cuts.

We might encounter difficulty repeating the 1975-76 experience in the 1981-82 period. The 1975-76 deficit was associated with the 1974-75 recession—the most severe since the 1930's—which sharply reduced private demands for credit. Therefore, financial markets were able to finance an unusually large government deficit with relatively little strain, with little pressure on the Fed to monetize that deficit. But no one expects a recession of 1974-75 magnitude over the next year or so, which means that financial markets could feel considerable strain under the conflicting pressures of a high government deficit and a slowdown in money-supply targets.

Monetary policy and GNP

Does monetary policy affect real output (GNP)? Economists generally recognize that the growth in real output, in the long run, depends on the growth of capital, labor and technology, and that fiscal policy can affect those variables importantly through government taxing and spending decisions. However, in the short run, the growth in real GNP is largely a function of incentives to utilize the existing stock of capital and labor. These incentives depend upon the level of aggregate demand, which can be influenced by monetary policy.

As we have seen, monetary policy tends to affect inflation with a lag. In the meantime, a change in the nominal money stock affects the real (or inflation adjusted) money stock, which tends to change aggregate demand with about a two-quarter lag (Chart 3). Many other factors are involved, of course, but real money and real GNP have maintained a systematic cyclical relationship over time.

In summary, economists widely accept the long-run relationships between monetary policy and inflation, and between fiscal policy and real output. But it also seems true that monetary policy can affect real income in the short run. In addition, fiscal policy appears to influence the inflation rate, at least indirectly, through its impact on the growth of the money supply.

Policymakers cannot ignore the short-run costs involved in the necessary attack of monetary policy on inflation. These costs are of two kinds. First, there are the costs in terms of pressures on financial markets when tight money is associated with large government deficits. Second, there are the costs of tight money associated with a decline in real output and a rise in unemployment. Recognizing these costs should not paralyze action to fight inflation. But being forewarned about costs, one can be forearmed to deal with them.

Michael W. Keran

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 4/8/81	Change from 4/1/81	Change from year ago	
			Dollar	Percent
Loans (gross, adjusted) and investments*	146,216	- 456	6,681	4.8
Loans (gross, adjusted) — total#	123,851	- 504	6,114	5.2
Commercial and industrial	36,486	- 122	1,837	5.3
Real estate	51,552	44	5,708	12.5
Loans to individuals	22,695	- 57	- 1,641	- 6.7
Securities loans	1,497	- 66	774	107.1
U.S. Treasury securities*	6,617	36	92	1.4
Other securities*	15,748	12	475	3.1
Demand deposits — total#	42,931	- 487	- 2,216	- 4.9
Demand deposits — adjusted	30,677	329	- 2,553	- 7.7
Savings deposits — total	31,588	572	4,529	16.7
Time deposits — total#	75,411	- 488	12,460	19.8
Individuals, part. & corp.	66,677	- 422	12,245	22.5
(Large negotiable CD's)	28,995	- 83	6,533	29.1
Weekly Averages of Daily Figures	Week ended 4/8/81	Week ended 4/1/81	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves (+)/Deficiency (-)	n.a.	n.a.		35
Borrowings	2	118		200
Net free reserves (+)/Net borrowed(-)	n.a.	n.a.		- 165

* Excludes trading account securities.

Includes items not shown separately.

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