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**FISCAL POLICY: INFLUENCE  
ON MONEY, SAVING AND  
EXCHANGE RATES**

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# Fiscal Policy: Influence on Money, Saving and Exchange Rates

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Proper harnessing of monetary- and fiscal-policy objectives is the key problem facing policymakers in this bitter winter of 1982. Two articles in this issue of the *Economic Review* contribute to the policy discussion by examining the domestic and international aspects, respectively, of the controversy. A third article, on household-saving decisions, ties in with this broader theme because of the importance of household savings for financing Federal deficits in a non-inflationary manner.

William Dewald raises the question whether budget deficits and monetary growth have been in fact related in the United States. The economics literature yields no conclusive answer, but he re-examines the question by introducing the concept of fiat money as a way of disentangling monetary from fiscal-policy actions. Fiat money is that part of the total monetary base—currency plus depository-institution reserves—which is directly controlled by Federal Reserve actions.

Dewald's analysis of data over a number of business cycles supports the view that deficits have led to faster money growth in the United States since World War II. He notes two potential avenues whereby fiscal policy may affect monetary policy: "Deficits may apply upward pressure on interest rates which automatically induces increases in the uncontrolled part of the monetary base, leading to faster money growth. The other potential link may occur as the Federal Reserve increases the controlled part of the base (fiat money) leading to more rapid money growth." The former factor was most evident prior to 1970, while the second factor dominated the money-deficit relation after 1970.

Dewald argues that without monetary accommodation, via one or another of these approaches, fiscal policy would have had only a transitory effect on nominal GNP in the last several decades, "Thus, in order to prevent fiscal deficits from being inflationary, the Fed must use the controlled part of the money supply to offset the automatic accom-

modation of the deficits by the induced part of the money supply." He concludes that the likelihood of non-inflationary deficits has improved in recent years—now that the Fed is focusing on controlling monetary aggregates, rather than interest rates, in its policy decisions.

Turning to the international scene, Joseph Bisignano and Kevin Hoover test the proposition that the mixture of monetary and fiscal policies significantly affects exchange rates. Since exchange-rate floating began in March 1973, the countries cited in their study followed very different domestic economic policies—and exhibited very different exchange-rate patterns. Over the period covered by their estimations, the rate against the U.S. dollar appreciated sharply for Germany and Japan, and depreciated sharply for Canada and Italy. Their estimations thus suggest that asset-market models help explain these movements, which means that different mixtures of economic policies can explain such developments.

Bisignano and Hoover caution against accepting the model results too literally—especially since their portfolio models are short-run models, whose long-run implications have not been empirically described. "Nonetheless, the estimated portfolio models suggest that the dollar exchange rate against the German mark, Italian lira, and Japanese yen will appreciate in the short run should the U.S. run a sizable government-deficit which is financed in the private market. Our evidence suggests that in the short run, at least, a combination of large Federal deficits and slow monetary-base growth will result in a major appreciation of the U.S. dollar."

Substantial and prolonged deviations from purchasing-power parity apparently had occurred in recent years between the U.S. and other major industrial countries. In the preceding issue of the *Economic Review*, Charles Pigott attributed such deviations to shifts in relative prices. Bisignano and Hoover claim, however, that these deviations could

also be due to the behavior of real interest rates, caused by changes in the monetary-fiscal policy mix among major countries. "A large increase in U.S. government debt in 1982, combined with low monetary growth, would thus continue to keep the effective (trade-weighted) U.S. dollar exchange rate away from its purchasing-power value, as has occurred since late 1980."

Brian Motley turns to a key element in the Administration's program for higher productivity and growth—the encouragement of personal saving. Specifically, he investigates the effects of inflation, interest rates, and taxes on the consumption and saving behavior of households. However, Motley's study differs from most others in that its primary focus is on *saving* rather than on consumption. He treats the act of saving as a demand for various kinds of assets—both financial and tangible—which are expected to yield returns in the future, so that total saving depends on all the factors which influence the public's purchases of assets.

As Motley notes, economic theory suggests that decisions to consume or to save are likely to be influenced by changes in interest rates, inflation, and tax rates. But theory frequently cannot predict which way these effects will go. His results indicate, however, that increases in real after-tax interest rates on securities are likely to encourage current consumption, but to discourage purchases of both

household durables and financial assets. "Thus, if real interest rates can be brought down from current high levels, the flow of financial savings available to finance business investment and government deficits should expand." However, Motley also finds that the direct effect of a reduction in the inflation rate would be to increase current consumption and to reduce total saving, because households would not have to set aside funds to offset the ravages of inflation.

A major finding of Motley's study is a strong association between saving behavior and the personal tax rate. "During the sample period, tax-rate increases stimulated current consumption as well as purchases of homes and consumer durables, and led households to assume more debt to finance these outlays." This finding was predictable: interest payments on household debt are tax-deductible, so that higher tax rates reduce the net cost of borrowing to finance both tangible-goods purchases and current consumption. He thus concludes, "Lower tax rates, whether brought about by legislation or by a slower movement of families into higher tax brackets, conversely should reduce the demands which households make on the nation's resources, both real and financial, and thus should release funds for the financing of business investment and government deficits."