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SHOULD FISCAL POLITICS CORNER MONETARY POLICY?

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Not too long ago, the prospect of a balanced federal budget seemed remote--even far-fetched. But now, both the Congress and the Administration appear to be serious about balancing the budget within the next seven to 10 years. This prospect has led many to presume that monetary policy must offset these changes in fiscal policy.

Conventional wisdom argues that tighter fiscal policy should lead to easier monetary policy. It is not clear to me, however, that this is the right response. Monetary policy should not be overly reactive in response to fiscal policy changes or other developments which have transitory economic effects. It should, instead, focus on what a central bank can do, namely, maintain the value of the currency.

What I'd like to do for the next few minutes is first consider the appropriate response of monetary policy to balancing the budget. Second, taking a broader perspective, I want to remind you that fiscal politics always poses a serious threat for monetary policy. And finally, I will mention some institutional safeguards that help to protect against this danger.

Proposed Changes

Let me first put the proposed changes in fiscal policy in context. The plan currently working its way through Congress would balance the federal budget within seven years. According to the Congressional Budget Office, such a plan requires $1.25 trillion be cut from the projected path of deficits. To put this figure into perspective, the deficit for fiscal year 1995 was 2.3 percent of GDP. Without changes in federal policies, the CBO projects the deficit will grow to 2.6 percent of GDP by 2002. So balancing the budget under this seven-year plan requires shrinking the deficit by less than 0.4 percent of GDP per year. By contrast, GDP is expected to grow in dollar terms 5 to 6 percent per year over the period, or 10 to 15 times the average amount of deficit reduction.

Eliminating the budget deficit would also slow the growth of the federal government's debt, which is currently 52 percent of GDP. Under present policies, this would grow to 56 percent by 2002. Under the Congressional plan, it would fall to less than 45 percent. While these figures seem high, they are much lower than the debt-to-GDP ratio of 114 percent reached immediately after

World War II, and below the current average for the world's seven largest industrial economies.

The Response of Monetary Policy

How should the Federal Reserve respond if either the Congressional or Administration proposal becomes law? I believe that any response to deficit reduction *per se* would be inappropriate.

As I mentioned, conventional wisdom implies that deficit reduction means tighter fiscal policy which should be met with an easing of monetary policy. The logic of this argument has two parts. First, that deficit reduction pushes the economy in the direction of recession. Second, that offsetting such disturbances or shocks to the economy is an appropriate role for monetary policy. Some have even argued that the Fed should act pre-emptively based simply on the prospect of deficit reduction.

My years in the Fed make me skeptical of this kind of argument for a number of reasons. First of all, conventional wisdom to the contrary, I'm not so sure that reducing government spending *and* taxes would be contractionary. After all, lower taxes

would allow households and businesses the freedom to choose how to spend a larger fraction of their hard-earned income. Their spending would naturally tend to fill the gap resulting from a decline in federal spending and, in fact, resources may be used more efficiently in the private sector. Such a result is presumably the fundamental objective of both the Administration and Congressional budget plans since each not only balances the budget, but also cuts taxes.

But let's say, for the sake of argument, that deficit reduction is contractionary in the short run. As a practical matter, the deficit reduction plans on the table are heavily back-loaded. Over two-thirds of the cumulative deficit reductions occur during the last three years of the plan. From a macroeconomic standpoint, little happens in the next couple of years. It will be the Congress elected in 1998 and the president elected in 1996 who will decide on fiscal 2000 appropriations. Monetary policy should certainly not respond now to the mere possibility that the budget will be balanced in the next century.

I have more fundamental misgivings about the presumption that the Federal Reserve should be in the business of trying to offset every shock to the economy. My view, and that of most economists, is that a market economy has strong self-correction mechanisms. Changes in fiscal policy force microeconomic adjustments. Jobs, for example, are destroyed by cutting agricultural subsidies. Jobs are also destroyed by cutting defense spending. But the resources freed through these actions can be used productively in a vital market economy to create new jobs. The money funneled to a defense contractor through federal borrowing might instead be channeled by financial markets to a new software company. Tax revenue that now funds agricultural subsidies might not leave workers' paychecks in the first place. Instead, workers might save the added take-home pay to meet the costs of their kids' college education.

I don't need to tell a St. Louis audience that this transition can be rocky, particularly for the companies and individuals directly affected. But, can the Fed speed up the transition and reduce the intervening pain? Unfortunately, monetary policy is not

an economic wonder drug. Unlike fiscal policy, monetary policy is fundamentally macroeconomic in nature. What does the Fed actually do? We adjust our holdings of government securities, which in turn determines the monetary base--currency held by the public and bank reserves. Though the monetary base is a key instrument influencing money and credit quantities, it is very broad. It simply is not a good instrument for helping laid-off defense workers find jobs in other industries.

It is true that growth in the monetary base may have some temporary impact on the overall level of economic activity. In principle, this increased activity might help the unemployed defense worker or bankrupt farmer. But to do this effectively, the Fed must be able to forecast the macroeconomic effects of thousands of changes in federal spending and other influences on the economy. Then it must correctly calibrate its response. We simply do not have the tools or knowledge to do this with the required degree of precision. Accordingly, the best-intentioned efforts to fine-tune the economy through monetary policy actions could well end up being destabilizing.

Moreover, growth in the monetary base on a sustained basis will be reflected in the overall supply of money, with inflation as the eventual result. The association of excess monetary growth with inflation and not real growth has been observed over and over again in U.S. history, and the history of every other country too. In fact, in the long run, the only lasting economic impact of monetary policy is on the general price level and inflation. The Fed cannot cause the economy to grow any faster on a sustained basis than real resources--the labor force, capital stock and natural resources--and gains in productivity will support.

Accordingly, in my view, the best monetary policy in response to a decline in federal expenditures and deficits would be one that held the general level of prices stable without inflation *or* deflation. It would thereby allow the private sector to pick up the slack, if any, resulting from a fiscal deficit reduction without major distortions in relative price signals. In a market economy, inflation or deflation creates uncertainty that distorts price signals and interferes with efficiency. These distortions inhibit the economy from realizing the potential of its real resources. Accordingly,

monetary policy can contribute to maximizing employment and output by providing a stable price level backdrop.

So, in the context of deficit reduction, the proper role of monetary policy is to assure that the reallocation of resources from public to private uses occurs as efficiently as possible. This smooth transition is most likely to result in circumstances where price signals are clear and not distorted by current inflation or uncertainty about future inflation.

An Institutional Pitfall

Although more responsible fiscal policy should not, in and of itself, change the immediate course of monetary policy, history warns us repeatedly that fiscal policy poses a clear and always present danger to the proper conduct of monetary policy.

Where is this danger? Economists have various fancy terms for it. "Monetization of the debt" is one of the more common. In simple English, I'm talking about the use of the printing press to pay for government spending.

The source of this problem is the unavoidable link between fiscal and monetary authorities. The federal government spends

and borrows, while the Federal Reserve issues money and serves as the federal government's banker. This relationship creates a tension between the two bodies in this or any other country.

Whether money creation occurs via the printing press or purchases of Treasury securities that increase the monetary base, it generates revenue for the federal government--nearly $25 billion in fiscal 1995. Governments would always like a bit more revenue. But maximizing government revenue from money creation is diametrically opposed to what *ought* to be the primary responsibility of a central bank, namely, to maintain the value of the currency.

When a government's need for revenue outstrips its ability to tax and borrow, it often turns to the printing press. The ensuing inflation can be of catastrophic proportions. While the United States is not presently close to this precipice, unchecked deficit growth would take us in that direction.

Why would any government let a disastrous inflation happen? The simple answer is that governments get themselves backed into tight fiscal corners. Corners in which political reality does not

allow cuts in spending, and economic reality cannot produce increases in tax revenue. Corners in which financial markets make it increasingly difficult for the country to borrow. Corners in which the only choice is the printing press.

Let me mention a handful of stories. The common thread is that extremely high inflation is always and everywhere a fiscal phenomenon. The most dramatic and well-known example is Germany's experience following World War I. Germany owed staggering reparations to the allied countries, which insisted on collecting them rapidly. The initial reparations' demands were far greater than Germany was ever able to pay, and the German tax system was completely incapable of supporting this massive drain.

The government's only real choice was to borrow from its central bank--in effect, to print money at an accelerating rate. By October 1923, 99 percent of German currency had been issued during the previous month! The result was inflation at rates that are hard to imagine, much less live with: first double digits, then triple digits, and so on until, at the end, it took one trillion old marks to buy one new mark. Overall, a *13*-digit inflation!

Germany was only able to end its hyperinflation with the help of the Dawes plan, which cut reparations payments, with massive cuts in public spending, and with the creation of a new, legally independent central bank.

The disturbing reality that fiscal politics can corner monetary policy is not just a foreign problem. The phrase "not worth a Continental" came from our Revolutionary War currency. During the Civil War, the use of the printing press caused prices in the Union to more than double in less than four years, while in the Confederacy there was a hyperinflation as virulent as that in Germany after World War I. And during the four years after our entry into World War I, the U.S. inflation rate averaged more than 15 percent.

Nor is the link between fiscal policy and inflation just ancient history. The 1980s and 90s saw severely damaging inflations in Bolivia, Argentina, Brazil, Russia, Israel and much of Eastern Europe.

In fact, *every* example of very high inflation is clearly associated with fiscal policies that force a government to tap the

monetary piggy bank. The pattern started over a thousand years ago in the Chinese empire, which had the distinction of inventing paper money. It continues to the present. Big inflations don't all come from wars. In South America and Russia, they are the delayed consequences of years of expensive social and economic policies that could not be financed by tax revenues. Instead, these countries turned to their central banks.

Could it happen here? It *has* happened in the past. It could happen again. One of the central responsibilities of economic policymakers is to make sure that it does not.

Institutional Safeguards

We can take steps to minimize the risk that fiscal policy could back monetary policy into an inflationary corner. The most obvious are first, to give monetary policymakers a clear, achievable objective for which they can be held accountable, and second, to assure that the Fed continues to be independent within government.

Currently, the Federal Reserve is charged with pursuing several goals--maximum employment, maximum sustainable economic growth and stability of the price level. As I said earlier,

the Fed can only promote sustained output and employment growth by providing a backdrop of price stability. So in the long-run, these several goals can be reconciled.

But in the short run, the existence of multiple, sometimes conflicting, goals can create a political tug-of-war for monetary policy. Accordingly, the Fed should be made responsible for something we can actually accomplish, namely a stable price level. Congress must recognize explicitly that there really isn't any other choice. We can't keep the unemployment rate at 4 percent. We can't ensure real growth of 6 percent a year. The only thing a central bank can hope to influence in the long run is the path of prices. The consequence of trying to stimulate long-term growth using monetary policy is inflation. Economics is quite definite on this point, though our marching orders from Congress are not.

Fortunately, there are signs that legislators are heading in the direction of making price stability the primary goal of monetary policy. The explicit, achievable objective of price stability would enhance the Fed's accountability and make monetary policy less subject to the winds of politics.

The second step I mentioned to reduce the risk that fiscal politics might corner monetary policy is maintaining Fed independence. In the United States, we currently have a central bank with the independence necessary to control inflation. Fed policymakers are able to look beyond the next six months or the next election. This independence derives from the Fed's structure, which was carefully crafted by Congress to minimize the influence of short-term political agendas, while preserving the accountability that any policymaking institution must have. Over the years, the Fed has been modified in many ways. Yet the balance between political independence and public accountability has wisely been maintained.

Congress continues to advance proposals, including as recently as last year, that would significantly alter the Fed's structure. Similar proposals are likely simmering on the back burner right now. In general, these proposals would subject monetary policy decisions to greater political pressure, upsetting the delicate balance between accountability and independence. Put bluntly, those who spend the public's money would have greater

control over those who determine the nation's money supply, increasing the potential for high inflation. Although the structure of the central bank is indeed an appropriate topic for debate, the public must be ever wary of the possible consequences of reduced Fed independence.

In conclusion, we should be generally encouraged in this country when we think about the prospects of fiscal politics cornering monetary policy. We enjoy a central bank structure where there is an appropriate balance between independence and public accountability. And, there are promising signs with respect to giving the Fed a clear, achievable objective for which it can, in fact, be held accountable. But we must acknowledge that the Fed is, ultimately, a political creation, and that the winds of crisis can topple even the most independent, properly focused central bank. Fiscal irresponsibility can easily destroy the work of the most conservative central banker.

Thus, the American people must insist, as they have recently, that their elected representatives exercise fiscal responsibility. This will assure that Congress and the Administration do not look to the

Fed for help in doing their job through monetizing deficits, and in turn, that *we* will always be able to do ours.