

# ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

## Is Current Fiscal Policy an Obstacle to Sound Monetary Policy?

by W. Lee Hoskins

**R**ecently, there has been a new focus of debate among many economists and policymakers, centered around the relationship between monetary and fiscal policy. The debate concerns two questions: what does fiscal policy imply about the conduct of monetary policy, and what does monetary policy imply about the conduct of fiscal policy?

Many learned economics at a time when the answer to this question could be found in the textbook Keynesian demand-management paradigm. Central to this paradigm was a belief in the ability of policymakers to fine-tune economic activity through judicious choices from a complementary mix of fiscal and monetary policy instruments. The notion that higher levels of real economic activity could be bought with higher inflation was part and parcel of this view of the world. As long as this idea prevailed, it was reasonable to presume that inflation was an inevitable, and acceptable, price to pay for sustained economic growth.

The high unemployment and inflation of the 1970s effectively destroyed this idea of a stable trade-off between inflation and unemployment. The misfortunes of that decade also led to growing skepticism about the ability of discretionary changes in fiscal or monetary policy to smooth the short-run cyclical

fluctuations in business activity. An impressive number of economists and policymakers now accept the idea that the goal of both fiscal and monetary policies is to maximize *long-run* economic growth, and that price stability, in particular, is the only contribution that monetary policy can make to this objective.

Despite this progress, there is concern because, too often, policy discussions that accept the goal of price stability proceed to question its attainability, retarding public acceptance. A common fear is the threat of recession that is frequently associated with the pursuit of price stability. Recently, I have argued that threats of recession should not interfere with the long-run goal of price stability, because price stability actually reduces the risk of recession and is a pro-growth policy.

Yet another popular argument raised against the goal of price stability states that we should not seek price stability until we have our fiscal house in order. Those who hold this view claim that we cannot commit to a policy of price stability because large deficits cause high interest rates, thereby limiting monetary policy's ability to reduce inflation under conditions reasonably consistent with full employment.

**Must the pursuit of sound monetary policy await further progress toward more desirable fiscal policies? Arguments that monetary policy must offset the economic effects of fiscal policy choices may be based on false premises.**

My message is a simple one. Federal budget deficits should not be allowed to compromise either the Federal Reserve's goal of price stability or the adoption of a specific timetable to achieve it. Quite the contrary: poor monetary policy, which here will be equated with the failure to pursue a goal of price stability, interferes with the pursuit of a sensible long-term fiscal policy. This is not to suggest or imply that current fiscal policy is ideal, appropriate, or the result of bad monetary policy. I believe that savings are too low, at least partly because of budget deficits, and that measures to address our savings shortfall probably must include measures to reduce the deficit. However, while we strive for better fiscal policy, we should recognize that monetary policy cannot offset the harm caused by fiscal deficits; indeed, it can only add to those costs.

#### ■ The Elements of Sound Policy

Even policymakers who disagree on details recognize that sound policies must have clear objectives, verifiable outcomes, and rules that are consistently adhered to. Above all, predictable, verifiable policies ensure that individual economic decisions are made with a minimum of uncertainty about policy objectives and outcomes. If this requirement is satisfied, long-term planning and resource allocation decisions will not be foiled by policy decisions that deviate from the expectations of reasonably informed citizens. Sound policy thus requires a resolute focus on the long term and resistance to policies that, while expedient in the short run, introduce even more uncertainty into an already unpredictable world.

What this means for monetary policy is clear. We have learned through disappointing experience that monetary policy cannot be used to manipulate real variables for any reasonable period of time. We have also learned that, in the long run, inflation is the one economic variable for which monetary policy is

unambiguously responsible. Because inflation is a monetary phenomenon, inflation must always be the primary concern of those who set monetary policy.

My support for long-run zero inflation, or, equivalently, a price-level target, is a matter of record. Inflation can ultimately contribute to recession and has debilitating effects on economic performance. Equally important, a zero inflation policy satisfies the key requirements of sound policy: it is clear, it is verifiable, and it has consistent rules. Unlike other inflation rates, zero inflation is a policy goal that has the potential to be unambiguously understood by everyone.

In a similar fashion, a sound fiscal policy is one that clearly sets priorities and maps out a multiyear commitment for taxes and spending. The budget allocates resources between the public and private sectors and among competing claims within the public sector. These budget considerations are based upon a political and social consensus about public expenditure priorities and the proper division of functions between the private and public sectors. It is important that the financing of such objectives is communicated clearly, within long-term budget constraints, and with a tax structure that enables citizens to plan accordingly.

If we can agree that my description of sound monetary and fiscal policy is appropriate, how do we get from here to there? The road appears to be cluttered with many obstacles. For example, skeptics ask, can policymakers pursue a zero inflation policy in the current fiscal environment without incurring unacceptable economic costs? And, how should monetary authorities respond to the supposed inability of fiscal policymakers to fashion sound policy decisions? These are familiar questions and doubts that are frequently raised to thwart the pursuit of sound monetary policy.

#### ■ Is Zero Inflation Too Costly To Pursue?

Does current fiscal policy make price stability too costly to pursue? Many argue that the answer is yes: large federal budget deficits cause high interest rates, forcing the Fed to ease monetary policy in order to keep interest rates at levels consistent with full employment.

This argument is weak for two reasons. First, both the federal budget deficit and, more important, the growth rate of federal government spending, at least measured relative to the economy, have been falling for the past several years and should continue to do so. Second, even if fiscal policy choices were to put upward pressure on interest rates, it is far from clear that the Fed can do anything to alleviate this pressure.

#### ■ The Declining Size of Government

Despite some general reservations about the Gramm-Rudman-Hollings deficit reduction legislation, it is hard to escape the conclusion that the process has exerted at least a moderating influence on the growth of the federal government. In the two years preceding passage of the Gramm-Rudman-Hollings bill, the deficit averaged close to 5 percent of GNP; as of the end of fiscal year 1989, that number had fallen to under 3 percent.

An often-heard objection to the deficit statistic involves the claim, made with some justification, that a good deal of the progress in deficit reduction has been accomplished by strange accounting devices and various forms of budget

chicanery. Certainly there is some ground for those claims. But, after all, the reported deficit is itself based on somewhat arbitrary accounting conventions. Should contributions to the social security trust fund be regarded as tax collections or as loans from the working population? Should borrowing to finance public infrastructure be offset on the government books by the capital acquired with the borrowed funds? These are issues on which honest people can agree to disagree.

Many would argue that more important than the deficit question is the question of how much of the income generated by the U.S. economy is appropriated by the federal government and how that percentage has changed. In these terms the answer is unambiguous: net federal outlays, which rose to about 24 percent of GNP in the mid-1980s, have fallen every year since passage of the Gramm-Rudman-Hollings legislation, to about 20 percent in 1989.

Although important issues concerning the macroeconomic effects of transfer policies, tax structures, and the composition of government expenditures remain unresolved, it can be safely said that progress is being made toward alleviating concerns that are typically associated with deficit expenditure. While not ideal, the fiscal policy environment has become more conducive to the pursuit of price stability.

There is, of course, legitimate concern that the progress in deficit and expenditure reduction might cease or even be reversed, for any number of reasons. How should such a reversal influence

monetary policy? I return to an issue I raised earlier: even if fiscal policy choices were to put upward pressure on interest rates, and there is little consensus among economists that this is the case, it is far from clear that the Fed can do anything to ease that pressure.

It is important to emphasize the distinction between *real* and *nominal* interest rates. Real rates of return are based on the productivity of labor, capital, and other real assets in a society. In an inflationary environment, nominal rates of return include an inflation premium to compensate lenders for being repaid in money with reduced purchasing power. Ultimately, it is real interest rates that affect the consumption and production decisions of individuals and businesses and the allocation of resources over time.

Our economic experience since World War II fails to reveal a firm relationship between real interest rates and the growth rate of the monetary base, or the various other monetary aggregates that the Fed can control.

Again, it is important to focus on real interest rates. The correlation between monetary policy and nominal interest rates that dominates discussion in the financial press tells us next to nothing about the relationship between monetary growth and the real interest rates that govern the allocation of resources over time. Every movement in the federal funds rate does not produce equivalent changes in real interest rates, in the productivity of our capital stock, or in any of the other important real variables affecting economic activity. The fact that monetary policy exerts relatively direct control over the federal funds rate does not imply that real interest rates can, similarly, be controlled by monetary policy.

It is worth digressing for a moment to consider a relatively new issue that is making its way into fiscal policy discussions, and is leading some people to argue that a zero-inflation monetary policy would be hazardous. This issue is the so-called "peace dividend." The concern is that the thawing of tensions between the United States and the Soviet Union will result in budget savings and lower government outlays, especially in the military area, which will reduce aggregate demand and force the Fed to ease in an effort to maintain full employment in the economy.

I will ignore the obvious irony that both contractionary fiscal policy, in the form of lower government expenditures, and expansionary fiscal policy, as implied in the previous example by the contention that deficits are excessively large, are being separately invoked to justify expansionary monetary policy. I will instead simply reemphasize the points already made.

The first of those points is that government expenditures have been falling as a share of total output for several years. As noted earlier, net federal outlays as a share of GNP have fallen by more than three-and-a-half percentage points since 1986—a period during which economic growth has continued.

The second point is that the ability of the Fed to consistently and predictably control real variables is tenuous at best. Just as it is inappropriate to infer that monetary policy can change real interest rates, it is inappropriate to conclude that higher growth rates of money increase the overall level of economic activity.

The fallacy of automatically drawing this conclusion is nicely illustrated in a recent *Economic Commentary* published by the Federal Reserve Bank of Cleveland's research staff. It is a well-known fact that each December both the money supply and real activity swell. Is the increase in the money supply responsible for the increase in economic activity? Does the Fed cause Christmas? Certainly not. The annual fourth-quarter increase in the money supply is the Fed's response to economic activity, not a cause of it.

If it were really in our power to consistently increase output by the mere creation of money, why not increase the money supply without bound, creating infinite wealth? The answer to this patently absurd question is obvious to everyone. To create money without bound would result in infinite inflation, not infinite wealth. But if a lot of new money will not deliver the goods, why do we think a little will? The very suggestion that we can reliably control real activity with monetary policy, the old Keynesian demand-management notion, suggests that we have yet to fully assimilate the lessons that recent economic history should have taught us.

#### ■ Is Sound Monetary Policy a Necessary Condition for Sound Fiscal Budget Policy?

I have argued that fiscal policy is not currently a serious impediment to the pursuit of price stability. While we each may have our own view about what appropriate fiscal policy is, it does seem to be moving in the appropriate direction. I am also highly skeptical that monetary authorities have the power or wisdom to undo poor fiscal policy choices.

Having claimed that sound fiscal policy is not a necessary condition for sound monetary policy, let me now shift the focus somewhat and pose the following question: Is sound monetary policy a necessary condition for sound fiscal policy?

Recall my definition of sound fiscal policy. Sound fiscal policy clearly sets priorities and maps out multi-year commitments for taxes and spending. Sound fiscal policy allocates resources between the public and private sectors and within the public sector on the basis of political and social consensus. And sound fiscal policy communicates each of these objectives clearly, within long-term budget constraints, so that private decision-making is consistent with efficient resource allocation.

The important question thus becomes, does the absence of a zero-inflation monetary policy interfere with the attainment of sound fiscal policy or, more generally, is a zero-inflation monetary policy conducive to the attainment of sound fiscal policy?

I have emphasized the necessity of formulating fiscal policy on the basis of objectives that are defined in the context of a long-term budget constraint. In order to realize this goal, fiscal policymakers, like decision-makers in business, require an environment in which the constraints and conditions are as predictable as possible. Such predictability is impossible when monetary policy results in variable and unpredictable inflation. By changing the real value of government debt, unforeseen changes in the rate of inflation redistribute wealth between the

private and public sectors and alter the long-term budget condition of the government. In response, fiscal policymakers must either continually revise their long-term planning assumptions or accept deviations from the originally planned allocation of resources between the private and public sectors.

Without an explicit policy rule that effectively precludes the financing of marginal expenditures through the inflation tax, fiscal and monetary authorities can become locked into what economist Thomas Sargent has described as a game of "policy chicken." A cynic might say that no Congressman worth his or her franking privilege would ever choose to take the heat from imposing budgetary discipline when there remains hope of an accommodating Fed. A more benevolent observer would note that the possibility of seeing the painstaking process of formulating long-term goals undone by the unforeseeable consequences of high and volatile inflation cannot fail to make an already difficult task infinitely more difficult and certainly cannot contribute to Congressional enthusiasm for making the tough long-term fiscal decisions.

#### ■ Inflation Can Undermine the Tax Structure

Many people have recognized the problems posed by variable and unpredictable inflation, but have argued that moderate inflation is of no concern as long as the rate is stable. I happen to believe that "stable inflation" is an oxymoron. But even if it isn't, the complications that inflation poses for the tax structure provide additional insight into why zero is the magic inflation rate.

The indexing provisions that have recently become part of the personal tax code are an explicit recognition of the fact that even stable rates of inflation can distort marginal tax rates, redirect economic activity in arbitrary ways, and interfere with the efficient allocation of resources. Despite some progress, however, the tax structure is anything but fully insulated from the effects of inflation. Capital gains, interest income earned by households, and depreciation allowances in the business sector are but a few of the examples often cited as areas in which tax rules are still distorted by inflation.

We could, of course, attempt to index all forms of income and expense arising from economic activity. But any such attempt would make the tax code even more complicated than it already is. Because of the difficulty associated with complete indexation, pressures for discrete changes in the tax code will inevitably build. The effort to restore special treatment for capital gains is a good example, which also illustrates that attempts to adjust the tax code may undermine the progress we have made in developing a tax system that is consistent with my definition of sound fiscal policy. There is one solution: make the issue moot by pursuing a monetary policy that sustains an average rate of inflation equal to zero.

#### ■ Conclusion

Sound economic policy, be it fiscal or monetary, must, at a minimum, be predictable. In the absence of predictability, the efficient functioning of the economy, and hence long-run prospects for economic growth, will be severely inhibited. For monetary policy, I believe that predictability translates into the aggressive pursuit of price stability.

The pursuit of sound monetary policy need not await further progress toward the establishment of desirable fiscal policies. The argument that monetary policy can offset the economic effects of fiscal policy choices is based on the idea that monetary policy can consistently and predictably control real interest rates and real economic activity. This idea is tenuous both theoretically and empirically. Furthermore, the progress that has been made on the deficit and government expenditure front suggests that conditions are indeed more favorable for the pursuit of a zero-inflation monetary policy.

Not only is it unnecessary for sound monetary policy choices to await sound fiscal policy choices, it is imperative that we adopt sound monetary policy first. Sound fiscal policy decisions, like sound private economic decisions, require the stable inflation environment that only the Fed can provide. In addition, the tax-related distortions and economic complexities associated with even stable positive rates of inflation argue strongly for a zero inflation goal.

What both monetary and fiscal policy must accomplish is the creation of an economic environment in which the rules of the game are well understood and designed to minimize interference with the realization of society's broader goals. Precisely because of its independence, the Fed has the unique ability to implement a policy regime that works toward these goals. Indeed, without a clear and committed price stability policy by the Fed, the probability of sustaining a clear and committed fiscal policy is reduced.

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