

Research Department

# Federal Reserve Bank of San Francisco

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## Reconciling Monetary and Fiscal Policy

The nation's policymakers in the 1980's must resolve two major economic issues—how to lower inflation, and how to raise productivity and real growth rates. Some analysts have proposed that monetary policy focus exclusively on lowering money-supply growth and thereby reducing inflation, while fiscal policy focuses exclusively on reducing taxes and thereby creating the incentives for improved productivity and growth. This raises a major public-policy issue—can we effectively segment monetary policy for one purpose and fiscal policy for another?

The policy dilemma can be further divided—how much of a reduction in the tax rate will lead to an increase in the government deficit, and how much of an increase in the deficit will lead to an increase in the money supply and/or inflation? The answers to these questions will determine whether both of the admirable public-policy goals of reduced inflation and increased productivity can be achieved simultaneously, or whether one must take precedence over the other.

### Tax rates and deficits

Some supply-side economists, using the "Laffer curve" approach, argue that a reduction in tax rates will stimulate sufficient increases in work effort and investment incentives, so that the tax base will rise in proportion to the decline in the tax rate. As a consequence, a reduction in tax rates would not diminish tax revenues, and therefore the deficit would not expand.

The historical evidence suggests, however, that several years must pass before a reduction in tax rates brings about enough of a positive revenue response so that the deficit is neutralized. Thus, in the short run (specifically 1981), a decline in tax rates should lead to an increased deficit in the absence of parallel reductions in government spending. The revenue-depressing effect might not be significant if the tax cut takes the form of a reduc-

tion in capital-gains taxes or in top-bracket income-tax rates. But few economists would dispute that a broad-based cut in income-tax rates (as in the Kemp-Roth bill) would at least initially increase the deficit.

### Deficits and inflation

Many economists argue that a reduction in tax rates will not aggravate inflation, even though it leads to an initial rise in the deficit. They argue, first, that deficits in and of themselves will not contribute to inflation, which is primarily a monetary rather than a fiscal phenomenon. They argue, secondly, that some countries with very large deficits have shown greater ability than the U.S. in lowering inflation. Such countries—primarily Germany and Japan—have successfully lowered their money-supply growth even in the face of large deficits.

The first of these propositions can be demonstrated by examining the relationship between money-supply growth and inflation, with the money data plotted with a two-year lag to reflect the assumption that money affects prices with a lag of about that length (Chart 1). Over the 1950-65 period, money grew at an average rate of less than 2 percent and generally decelerated over that period—and the same was true of the inflation rate. Over the 1965-80 period, in contrast, money grew at an average rate of more than 6 percent and generally accelerated over that period.

The money-inflation relationship obviously is not perfect in any short period of time. A host of special factors can cause the inflation rate in any one year to deviate from the money-supply growth rate of two years previously. The most important of these factors—the oil-price shocks—may have added about 2 percent to the U.S. inflation rate in 1974-75 and somewhat less than 2 percent in the 1979-80 period. Further, the evidence suggests that the deficit by itself does not directly influence the inflation rate. Since inflation is determined

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primarily by monetary conditions, the deficit must affect inflation through its effect on money-supply growth.

#### Deficits and money

In principle, any government deficit can be financed either by creating money or by selling government securities to the public. The latter approach can be effective only where there exists a well-developed financial market. Most less-developed countries possess rather rudimentary financial markets, and so find it difficult to channel private savings into purchases of government securities. For most such countries, therefore, creation of money provides the only source of financing a government deficit.

The developed countries of Europe, Japan and the United States, in contrast, can follow the alternative approach. Their well-developed financial markets are capable of channeling private savings into purchases of government debt, and so make it possible for them to avoid the money-creation approach. Germany and Japan in particular exhibited much higher personal savings rates than the U.S. during the decade of the 1970's—14 percent for Germany, 20 percent for Japan, and only 7 percent for the U.S. The expansion of German and Japanese government deficits in the second half of the 1970's occurred in the face of a 4-to-5 percent drop in the share of domestic investment. As a result, government demand substituted for private demand for funds—and this, along with an unchanged savings rate, allowed domestic monetary contraction to occur without putting major pressure on domestic financial markets.

The U.S. unfortunately has behaved more like an underdeveloped country in this regard. With a lower savings rate than either Germany or Japan, this country has found it difficult to mobilize private savings to purchase government debt. As a result, the debt-money creation relationship has been much closer here than in Germany or Japan (Chart 2). In the 1950-65 period, both the government debt and the money supply increased at

less than 2-percent average annual rates. In the 1965-80 period, however, government debt grew at a 7½-percent annual average rate while the money supply grew at a 6½-percent rate.

Money creation paralleled debt creation closely in almost every single year of the past generation—the only major exception being the 1975-76 period. The 1974-75 recession was so severe that it reduced private credit demands at just the time when government credit demands were surging. As a result, financial markets were able in this episode to mobilize private savings to purchase government debt, without leading to a parallel increase in the money supply.

#### Policy dilemma

These considerations are at the heart of the policy dilemma facing fiscal and monetary policymakers in 1981. In Congressional appearances this week, Chairman Volcker announced an M-1B target growth range for 1981 of 3½ to 6 percent, with a 4¾-percent midpoint—down substantially from the 7½-percent average growth of the past four years. (M-1B equals currency plus transaction accounts at all depository institutions). Meanwhile, the government debt could grow by 9 to 10 percent in 1981 if Congress adopts the Administration's tax-cut plan but makes no major cuts in current spending. Thus, we are entering a period with a potential deceleration in money-supply growth and a likely acceleration in deficit growth—certainly an unusual pattern in historical terms.

This potential divergence between monetary and fiscal policy can lead to one of three alternative results. First, the deficit and money supply can grow as forecast, in which case the demand for funds will rise substantially while the supply of funds grows much more slowly. This result will tend to keep real interest rates at their current very high levels. Interest-sensitive industries—such as autos, housing, and home finance—thus will experience the same degree of financial pressure this year as they did in 1980. In addition,

other corporations and industries that survived 1980 successfully could now find themselves "crowded out" of long-term credit markets, and thus would be forced to reduce their investment in new plant and equipment.

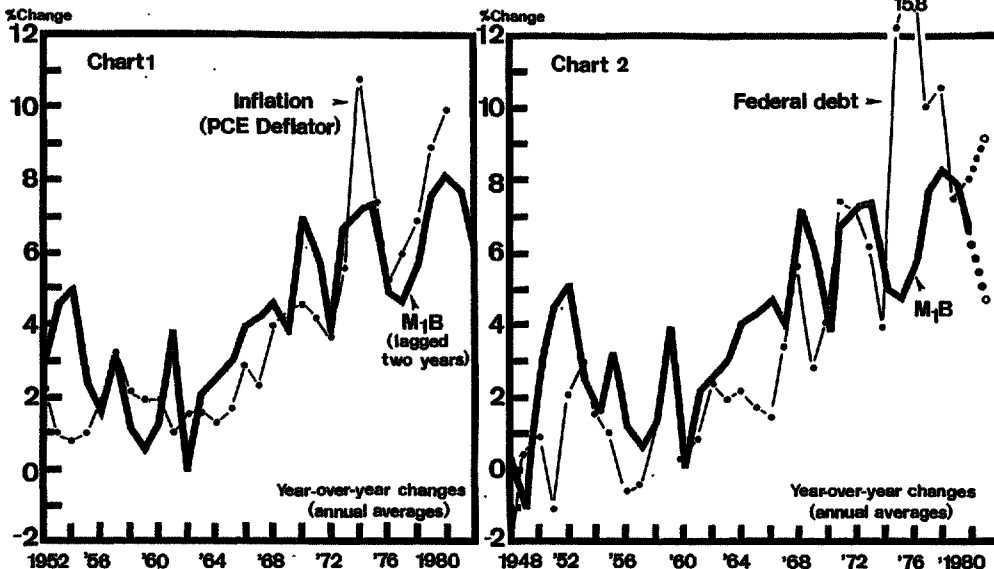
In a second scenario, the debt could grow as forecast but the money supply would overshoot its target range—as, for example, M-1B did during the 1977-80 period. But that eventuality would postpone, for yet another year, any significant progress in lowering money-caused inflation pressures. Furthermore, Federal Reserve accommodation of government deficit financing would reinforce the importance of the debt-money supply link in the minds of financial-market participants, and thus could raise inflation expectations if the markets believe that there is little chance of reducing the deficit. This, of course, would tend to boost long-term interest rates above their already high levels.

The third alternative would call for the money supply to hit its 1981 target and for the deficit to come in lower than forecast. But this could only be achieved if Congress fully imple-

ments the Administration's program of spending restraints at the same time it adopts the proposed tax reductions. This alternative would permit continued progress in lowering the inflation rate. It would also reduce pressures on financial markets, which in turn would permit real interest rates to come down from their current very high levels. This approach would ease current pressures on the auto, housing, and home-finance industries, and would also reduce the possibility of business investment being crowded out of financial markets.

All three of these alternative approaches involve substantial costs—but they exhaust the set of possible outcomes. Therefore, policymakers will be faced with a choice among a set of unpleasant alternatives. But if they don't make unpleasant decisions explicitly, such as by cutting government spending, they will make those unpleasant decisions implicitly, either by postponing the move toward reduced inflation or by maintaining heavy pressure on interest-sensitive industries and crowding out new investment.

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For 1981, dots represent estimated growth of debt and target growth of money.

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**BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT**  
 (Dollar amounts in millions)

Selected Assets and Liabilities	Amount Outstanding	Change from	Change from	
			Year	Year
Large Commercial Banks	2/11/81	2/4/81	Dollar	Percent
Loans (gross, adjusted) and investments*	146,265	- 708	8,070	5.8
Loans (gross, adjusted) — total#	123,675	- 741	7,938	6.9
Commercial and industrial	36,544	- 483	2,611	7.7
Real estate	50,959	99	6,500	14.6
Loans to individuals	23,542	- 96	- 890	- 3.6
Securities loans	1,391	22	296	27.0
U.S. Treasury securities*	6,904	36	- 60	- 0.9
Other securities*	15,686	- 3	192	1.2
Demand deposits — total#	42,263	- 506	- 1,476	- 3.4
Demand deposits — adjusted	30,140	441	- 1,143	- 3.7
Savings deposits — total	29,407	68	1,275	4.5
Time deposits — total#	76,497	- 54	17,155	28.9
Individuals, part. & corp.	67,021	- 29	16,374	32.3
(Large negotiable CD's)	29,827	- 193	8,488	39.8
<b>Weekly Averages of Daily Figures</b>	<b>Week ended 2/11/81</b>	<b>Week ended 2/4/81</b>	<b>Comparable year-ago period</b>	
<b>Member Bank Reserve Position</b>				
Excess Reserves (+)/Deficiency (-)	n.a.	n.a.	-	21
Borrowings	29	52	-	181
Net free reserves (+)/Net borrowed(-)	n.a.	n.a.	-	202

\* Excludes trading account securities.

# Includes items not shown separately.

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