"HOW SHOULD MONETARY POLICY RESPOND TO FISCAL RESTRAINT?"

Remarks by Thomas C. Melzer
Paducah Rotary Club
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After months of haggling, hundreds of hours of debate and intense political lobbying, Congress and the President recently agreed to a nearly $500 billion, five-year, deficit-reduction package. This compromise was forged out of a growing national concern about the size of the deficit and its harmful effects. Now that the deal has been struck, however, there have been cries from all quarters--the Administration, Congress and some in the private sector--for the Federal Reserve to step in and counter the imagined adverse effects of forthcoming fiscal restraint.

Today, I would like to discuss the question of whether, in principle, the Fed should respond to these pleas; namely, should monetary policy be eased in the face of fiscal restraint. But before doing this, we need to consider what are, in fact, the effects of deficit reduction on the economy.

A government deficit can be reduced by raising taxes, cutting spending or, as the current deficit-reduction package contemplates, doing both. While it is difficult to determine the size of this package, initial estimates suggest that it will have a modest effect on the deficit. The proposed spending cuts, with the exception of those for defense, are from "planned" rather than current levels.

Consequently, they do not reflect real reductions in the level of government spending. Indeed, there is no guarantee that the spending cuts will even materialize.

Nonetheless, to the extent that cuts in government spending are realized, they will _initially_ reduce the overall demand for goods and services. Likewise, increased taxes on gasoline, alcohol, luxuries and some people's incomes will _initially_ reduce overall spending, as well as spending on these taxed items. Therefore, it is reasonable to expect that such cuts in spending and increases in taxes will reduce the overall level of output and employment. Indeed, there is some evidence that changes in deficit spending have such short-run effects.

These short-run effects occur, in part, as individuals who are laid off take time to find employment in other sectors of the economy. But ultimately these people do find jobs. Thus, the short-run effects of a reduction in the deficit are truly that; they do not last. Indeed, the evidence is strong that changes in deficit spending have no lasting effects on the level of output, employment, the rate of inflation or even interest rates. Thus, despite what most people clearly believe, the size of the deficit, or the size of changes in the deficit, just does not matter in the long run.

How can this be? How can public opinion be so wrong about what is likely to occur if deficits are reduced? The problem is that we have been taught to believe a myth. For decades, prevailing economic theory led us to believe that the effects of government spending on the economy differed significantly depending upon whether they were financed by taxes or by issuing government debt. But this is not the case.

We all understand that tax-financed spending redistributes income from one individual to another and causes resources to be reallocated from the production of some goods and services to the production of others. However, common sense tells us that tax-financed spending has no effect on the overall level of economic activity. The increase in government spending is offset by spending reductions of those who are taxed.

Certainly less well-known, however, is that, in the long run, exactly the same conclusion holds for deficit-financed government spending. Why are people so confused? Primarily for two reasons. First, the costs of government spending are more easily hidden when it is funded by deficits--it is hard to tell who is really paying the bill in this case. Nevertheless, someone is, just as taxpayers obviously do when spending is financed with taxes. This is necessarily true because deficit spending has no effect on output in the long run. The amount of goods and services available is the same with or without deficit spending. Consequently, the bottom line is that government can spend more only if someone else spends less. It is really only a question of whether we pay now or later.

Then too, public officials, the press and even some economists talk only about the short-run effects of a change in fiscal policy. Because their emphasis is on the immediate consequences of such a change, they place little, if any, attention on the absence of long-run effects. Consequently, many people firmly believe that the economy would be characterized by a perpetual state of under-employment without the stimulus of deficit spending. Of course, this reinforces their belief that deficit-financed government spending is "costless." But, as I noted, costless deficit spending is a myth. Inevitably, the costs are paid by someone initially--and the taxpayer ultimately.

Clearly, then, monetary policy should ignore fiscal actions in the long run. But what about the short run? Should monetary policy be eased to offset the short-run effects of fiscal restraint? My answer to this question is "No!"

There are several reasons for this. First, while coordinating monetary and fiscal policies sounds simple enough--merely ease monetary policy when fiscal policy is tightened and vice versa--in practice, the proper coordination of the two is virtually impossible to achieve. Why? Because monetary policy affects the economy with lags that are variable and hard to predict. Consequently, it is difficult to determine precisely the right time to ease monetary policy, and precisely the right amount of easing, to offset the effect of fiscal restraint on output and employment. As a result, mistakes will be made.

For example, easier monetary policy might impact the economy just as the temporary effects of fiscal restraint are waning. The result could be a very strong short-run expansion and, hence, future contraction, just the opposite of what the easing was trying to achieve. Poorly coordinated monetary and fiscal policies inevitably make the economy less stable, not more stable.

Second, regardless of the short-run outcome, easier monetary policy always leads to higher future inflation. Indeed, the financial innovations of the 1980s may have made us less certain about the exact linkages between money growth, output and inflation in the short run. But common sense and empirical evidence both tell us that money growth and inflation are highly correlated in the long run.

To illustrate, the inflation rate dropped dramatically in the early 1980s following the adoption of more restrictive monetary policy in 1979. And, following the sharp acceleration in money growth in the middle 1980s, inflation accelerated in 1987, though less sharply than expected. Finally, despite the temporary effects attributed to the oil price rise, there have been some positive developments recently. The seemingly persistent and unacceptably high "core" inflation rate of 4 to 5 percent of the past few years is beginning to respond to the more restrictive and steadier monetary policy since the middle of

1987. Over this approximately three-year period, money growth increased at about a 3 percent rate, down significantly from the nearly 11 percent rate of the previous three years. Many forecasters now believe that the "core" inflation rate will drop significantly over the next few years.

Finally, there would be yet another cost to a sudden shift to easier monetary policy in response to fiscal restraint. This cost is more subtle than the ones I have mentioned so far, but it is certainly as significant to the economy. The cost would be the loss of public confidence in the Federal Reserve's resolve to stabilize the price level. It would arise because nominal interest rates include a premium that reflects the market's expectation of inflation.

For example, if I want to earn a "real" 4 percent rate of return over the next year and expect the inflation rate to be 5 percent, I must get a nominal return of 9 percent on my investment. The inflation premium of 5 percent is just sufficient to compensate for the expected loss of purchasing power because of inflation. Obviously, the best way to keep nominal interest rates low is to reduce or eliminate any inflation premium. But this will not happen unless financial market participants believe that prices will remain stable. In other words, the Fed's commitment to price level stability must be seen by all as credible.

At present, as I have already noted, the outlook for inflation has improved significantly as a result of the

Federal Reserve's efforts over the past few years. These gains were achieved despite numerous requests for monetary policy to ease. Because the Fed generally resisted these requests, financial market participants have come increasingly to believe that the Fed will stick to its goal of stable prices.

But, of course, analysts are wary. They know that, in the past, policymakers have succumbed to political and economic pressures for "short-run" actions that have had disastrous longer-run consequences. They are wary because, in the past, monetary policy has alternated between ease and restraint, following whatever will-o'-the-wisp problem was deemed to be the most pressing one at the moment. And, especially, they remember just how badly many people got burned by unanticipated inflation in the late 1960s and throughout the 1970s. This skepticism has built an uncertainty premium into interest rates in the 1980s that still has not been removed.

Therefore, in my opinion, an ill-advised and, in the long run, ill-fated easing of monetary policy to offset the presumed short-run effect of fiscal restraint would simply undermine the hard-won credibility that the Federal Reserve is gaining. It would almost certainly be taken as a signal that monetary policy has once again fallen prey to the political "whims" of the moment. Much of what we have gained during the past three and a half years could be lost.

And for what? Simply to avoid a temporary and uncertain loss in income and employment--assuming, of course, that it occurs and that we are clever enough to offset it without destabilizing the economy. Surely, the risks of such a course of action are too great. If we fail, the economy will be less stable; the core rate of inflation will rise; and the credibility gains of the past few years will be wiped out. A simple cost/benefit analysis suggests that these costs far outweigh any conceivable short-run benefits such monetary policy actions might achieve. Instead, monetary policy should be focused on the one thing that it can deliver: long-run price stability.