Don't Mix Monetary and Fiscal Policy: Why Return to an Old, Flawed Framework?

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In recent decades, significant strides have been made in the conduct of monetary policy, as the Federal Reserve has successfully pursued the objective of stable, low inflation as a foundation for sustained economic expansion. During the same period, the objectives of fiscal policy have evolved toward deficit reduction, while activist, short-run stabilization initiatives have been suppressed. The Fed's credible, low-inflation monetary policy and the reduction of the government's purchases as a share of national output and the freeing of those resources for private uses have contributed significantly to robust economic and financial performance. But the resulting budget surpluses now elicit significant new spending initiatives. As politicians debate how to "spend the surpluses," renewed calls that monetary policy will need to be adjusted to fiscal policy changes represent a replay of a monetary/fiscal policy mix framework that has led to macroeconomic policy mistakes in the past and, if pursued, could again unhinge the foundations for sustained healthy economic expansion.

A Flawed Framework

The notion that monetary policy should be adjusted to fiscal policy to achieve desired economic performance, presently suggesting that the Federal Reserve will need to "tighten monetary policy" in response to expected "stimulative fiscal policy," is based on certain assumptions about the roles and effects of fiscal and monetary policy that are simply wrong. This framework is misguided, whether the economy is characterized as "old" or "new," or whether the govern-

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ment budget is in deficit or surplus. It assumes that fiscal policy and monetary policy have the same—or at least substitutable—economic effects, and that the timing of their lagged impacts is predictable. Further, it assumes that fiscal policy can be adequately characterized by the size of the budget deficit. Nothing in macroeconomics could be further from the truth, confirmed repeatedly through history. Moreover, the resurfacing of the fiscal/monetary policy mix framework draws the macroeconomic policy debate back into short-run stabilization considerations at the expense of long-run objectives. Such digressions have a track record of being destabilizing.

Monetary policy and fiscal policy have very different economic effects, and these differences must be reflected in their objectives. Fiscal policy determines the allocation of national resources between the public and private sectors and influences long-run economic output by altering incentives to consume, save, and invest. A change in fiscal policy is not capable of generating a permanent shift in aggregate demand. And the magnitude and timing of the impacts of fiscal policy are highly unpredictable, so that fiscal policy is ill-suited as a short-run stabilization tool. Moreover, standard measures of fiscal thrust based on changes in the size of deficits or surpluses are misleading and unreliable. Depending on how taxes or spending are changed, similar-sized changes in the budget may have different effects on supply or demand. This suggests that except in extreme situations, fiscal policy must pursue equitable and efficient tax and spending structures consistent with maximum sustainable long-run economic growth, and avoid the pitfalls of attempts to stabilize short-run economic fluctuations.

In contrast, monetary policy is not capable of permanently changing productivity or output, but as an aggregate demand tool, it creates inflation (deflation) by generating excess (insufficient) demand relative to productive capacity, which may distort economic behavior and disrupt expansion. While monetary policy affects aggregate demand and short-run economic activity with lags that vary, its lags are significantly more predictable than those of fiscal policy. Presently, with myriad spending and tax initiatives under consideration, the Federal Reserve must pursue price stability independent of fiscal policy. This requires providing sufficient money supply such that the growth in aggregate demand is in line with aggregate supply (productive capacity). It must not be sidetracked from its long-run objective of price stability, or jeopardize its credibility by giving the impression that monetary policy would be adjusted to somehow "complement" fiscal policy.

Fiscal Policy

The federal budget has been transformed dramatically since the cash-flow deficit peaked at 6 percent of GDP in Fiscal Year 1983. Since then, spending has receded from 23.5 percent to 19.1 percent of GDP (FY 1999), reflecting primarily declining outlays for national defense and discretionary programs and the cumulative impact of declining inflation expectations on the growth of net interest outlays. Tax receipts have risen sharply, from 17.4 percent of GDP to 20.0 percent, their highest share in recent history, boosted by legislated tax hikes and robust economic growth and associated capital gains. While tax receipts have soared, government purchases, which directly absorb national resources, have shrunk as a portion of national output, while transfer payments have expanded about twice as rapidly as purchases.

According to commonly accepted Keynesian analysis, the dramatic reversal from budget deficit to unprecedented cash flow surplus was supposed to have generated recession. To the contrary, the economy has prospered. Even the presumed short-run negative economic impacts of deficit reduction (surplus expansion) have not been apparent. No matter how the budget deficits or surpluses are recalculated to measure fiscal thrust—for example, the cyclically adjusted budget, like the Congressional Budget Office's (CBO) standardized budget, or by removing net interest outlays—changes in the deficits or surpluses as a percent of GDP have failed woefully in predicting economic outcomes and have been unreliable guidelines for conducting macroeconomic policy. The Clinton tax hikes and spending cuts in 1993 (The Omnibus Budget Reconciliation Act of 1993) was followed by robust economic growth, contrary to standard forecasts. Following OBRA-93, the CBO (1993: 1) warned that the "tighter fiscal policy" had "reshaped the CBO's outlook," stating that "actions by the federal government to reduce the deficit will restrain growth somewhat for the balance of 1993 and through 1994." Since then, interpretations have changed, in confusing and even amusing ways. Recently, Clinton's tax hike of 1993 has been lauded by leading fiscal activists as stimulative. The dramatic reversal from the 1992 budget deficit of 4.7 percent of GDP ($290 billion) to an estimated cash flow surplus of 2.4 percent of GDP ($240 billion) in FY 2000 similarly has been associated with outsized economic growth. Did the Tax Reform Act of 1986 really have a neutral impact on the economy, just because static analysis projected no change in deficits, even though it dramatically lowered tax rates, broadened the tax base, and significantly altered economic behavior?

Not only do we not know the magnitudes or timing of the impacts of fiscal changes using standard accepted measures, we need to rely on some far-reaching and potentially inconsistent assumptions about the impact of deficit changes on interest rates to make the determination that the Keynesian multipliers are positive. Moreover, at any given time, gauging existing fiscal thrust is uncertain, even suspect. Consider present circumstances, with unprecedented surpluses, high taxes, but declining spending and government purchases as shares of GDP. Is fiscal thrust restrictive? If so, why has economic growth been so robust? As the Clinton tax hike was debated in 1993, were the large but narrowing budget deficit, high but slowing spending, and stable tax receipts restrictive, fiscally neutral, or stimulative? How do we evaluate the 1993 assessment of fiscal thrust in light of the after-the-fact upward reestimate of potential growth? These uncertainties form an unreliable foundation for conducting macroeconomic stabilization policy or attempting to achieve the proper monetary/fiscal policy mix.

In fact, eliminating the deficit was supposed to have provided a wide array of economic and financial outcomes—including a rise in national saving, a reduction in the bulging current account deficits of the 1980s, and lower real interest rates—that did not occur.

The dramatic shift from government deficits that drained national saving to cash flow surpluses that now add to saving has been fully offset by the sharp decline in private saving. While business saving has remained relatively unchanged as a percent of GDP, as the government has gone from dissaving 2.5 percent of GDP in 1992 to saving 4 percent of GDP (including federal, state, and local governments), household saving has fallen from 6.5 percent of GDP to 1.6 percent. This substitution of government saving for private saving and the neutral impact of the unprecedented swing in the government budget on national saving have been totally unanticipated by standard analysis. While it is uncertain to what degree this reversal reflects the sharp rise in household wealth-to-income ratios and consequent decline in the perceived need to save from current income, or whether households perceive less need to save because they believe the shift to government saving eventually will lower taxes, the outcome is strikingly consistent with the concept of Ricardian equivalence.

In the 1980s, one of the primary arguments for reducing the government's budget deficit was to reduce the large current account deficit and the associated heavy reliance on foreign capital. Implicit in the so-called "twin deficit" framework was the notion that reducing

the budget deficit would lower interest rates and thereby lower the U.S. dollar, which would stimulate exports and suppress imports, thus narrowing the trade deficit and close the current account deficit. The failure of deficit elimination to raise national saving was only one surprise in this flawed framework.

The dramatically widening current account deficit associated with a soaring budget surplus was completely unanticipated, and has revealed the "twin deficit" paradigm as a misguided framework for macroeconomic policy. While national saving has been relatively stable as a percent of GDP, the widening current account and trade deficits have been driven by the investment boom and surge in net capital inflows into the United States. Robust investment (it has risen to 15.2 percent of GDP from 9.2 percent in 1992) has outpaced national saving, while net capital inflows into the United States have been attracted by the high expected rates of return on U.S. dollar–denominated assets relative to assets denominated in foreign currencies. The relative attractiveness of U.S. dollar–denominated assets was accentuated by the Asian crisis that unfolded in late 1997; since then, the current account deficit has ballooned from approximately 1.5 percent of GDP to nearly 4.5 percent. Critically important, while the government's budget surpluses are mounting, the imported capital apparently is financing private investment. In the last 10 years, approximately 70 percent of the sharp rise in imported goods has been capital goods and industrial materials. This enhances productive capacity and presumably provides high rates of return relative to the costs of financing. Moreover, direct foreign investment has risen sharply and now constitutes the largest share of net capital inflows.

Nor has the shift from budget deficits to surpluses lowered interest rates, or at least not in the way anticipated. Real interest rates have risen, associated with robust economic performance and the high expected rates of return on investment, while inflationary expectations have receded.

Certainly, earlier concerns that rising government spending (purchases) would crowd out private investment were appropriate: reducing government purchases has freed resources for private sector uses, a factor contributing to the investment boom. It's also apparent that the tax and spending structures influence the allocation of resources and economic activity, and can affect long-run performance. But two points are blatantly clear: (1) short-run effects of fiscal policy are highly unpredictable, and (2) standard measures commonly used to estimate changes in fiscal thrust based on changes in budget deficits (surpluses) are unreliable.

Monetary Policy

Credible pursuit of price stability—a necessary foundation for healthy sustained economic expansion—requires a clear understanding of the role of monetary policy in the inflation process, as well as the Fed's capabilities and limitations. One obvious limitation is the Fed's ability to respond to fiscal policy with the objective of smoothing fluctuations.

Inflation is generated when the Fed provides too much money and generates excess demand relative to productive capacity. It is not generated by healthy economic growth or low unemployment. The Phillips curve and NAIRU frameworks are critically flawed and misleading because they do not distinguish between a change in the unemployment rate due to a change in demand or supply (productivity innovation or negative shock), and they do not capture the crucial role of the Fed's monetary policy in generating excess demand.

In the last decade, inflation has declined amid robust economic growth and declining unemployment rates because the Fed constrained nominal spending growth, which limited the flexibility of businesses to raise prices. Businesses responded by constraining wage compensation and increasing productivity and productive capacity. As a result, a rising portion of nominal GDP growth has been real output while inflation has been squeezed. Mounting evidence that healthy growth, low unemployment, and low inflation may be compatible seemingly has helped to distance the Fed from its Phillips curve tendencies and improve its understanding of the inflation process; witness recent Fed statements, in which concerns about inflation are expressed more in terms of excess demand than in terms of higher wage pressures.

The Fed must avoid being sidetracked from its long-run objectives; in the past, attempts to overmanage the economy by smoothing short-run fluctuations, calming financial market turmoil, stabilizing currency fluctuations, or responding to fiscal policy have been destabilizing. Moreover, the Fed must rely on the money supply rather than on the federal funds rate as an indicator of monetary thrust. In 1990, the Fed delayed months before lowering interest rates, using monetary policy as a carrot to encourage a fiscal policy compromise on deficit reduction. Eventually, a budget agreement was reached and the Fed lowered the federal funds rate, but in the interim, monetary policy effectively tightened as real money balances decelerated sharply. This was one factor that eventually led to recession. Holding monetary policy hostage to fiscal policy proved destabilizing. Focusing on money rather than interest rates is particularly important cur-

rently as policymakers debate the "old" versus "new" economy, since widespread uncertainty about sustainable growth greatly complicates the decision about the appropriate level of short-term interest rates.

Conclusion

Credibility is crucial to successful macroeconomic policy. Confusing signals must be avoided, both to the public and among policymakers. The perceived willingness of the Fed to adjust monetary policy to fiscal policy is potentially destabilizing not just because of the uncertainties of the timing of how a change in fiscal policy affects supply and demand (as well as the equilibrium level of real interest rates); it places the Fed's credibility at risk and may adversely influence fiscal policy decisions. So the "right mix" of monetary and fiscal policy is recognition of their different effects and separate pursuit of their unique roles.

Reference

Congressional Budget Office (1993) *The Economic and Budget Outlook.* Washington: U.S. Government Printing Office (September).