

# MONETARY POLICY AS A FISCAL INSTRUMENT

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## Introduction and Summary Recommendations

The depression of the 1930s resulted in the creation of many federal agencies that served reasonably well for several decades. Beginning late in the 1970s and continuing into the 1980s, a thorough review and reassessment of the performance of most government agencies has been underway. In the areas of transportation, communications, and banking, significant reforms have been instituted. In other areas they are under consideration. It is entirely appropriate that the U.S. approach to central banking also be reconsidered. The Banking Act of 1935 considerably altered the powers and responsibilities of the Federal Reserve, mainly because the design of 1913 had not prevented the Great Depression. Now we know that the present design was not successful in preventing the great inflation of the 1960s and 1970s. In view of the massive current and prospective federal deficits, it is natural to desire institutional safeguards against the possibility of the fiscal environment resulting in a permanently high inflation era.

The three instruments of monetary policy—the discount window, reserve requirements, and open market operations—are obvious candidates for possible changes. The following reforms should be evaluated:

*Discount Window*—A floating “penalty rate” on loans by Federal Reserve Banks to private depository institutions should be required. There is no justification for subsidized lending rates to the borrowing banks.

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*Reserve Requirements*—The current structure is a major improvement over the former tiered structure. Further reforms would include elimination of reserve requirements on “large non-personal time deposits” and removal of the differential between the reserve requirements on the first \$29.8 million of transactions liabilities and the reserve ratio applicable to larger amounts. The existing reserve requirement of 12 percent on large transactions liabilities is higher than necessary for monetary policy purposes and should be reduced. The forgone earnings to banks on such idle reserves amounts to a tax or “franchise fee” on banks. The payment of interest on reserves by the Federal Reserve Banks would eliminate this tax.

*Open Market Operations*—It is essential to recognize an open market purchase as a monetization of debt. Security purchases by the Fed reduce the real net national debt. The effect of such transactions is to finance government by creating new money. Under current arrangements there are no constraints on the amount of debt monetization that can occur. In view of the large fiscal deficits, maintaining a noninflationary environment would require that the Fed monetize a smaller and smaller share of the real national debt each year. There is no reason to expect that will happen in a purely discretionary policy regime. Some constraint on the monetary authorities’ ability to monetize debt should be instituted.

As an interim solution, pending more fundamental reconsiderations of the Federal Reserve’s powers, a proposal by Professor Axel Leijonhufvud in testimony before the Joint Economic Committee of Congress, deserves consideration. Namely, “Congress should legislate a *maximum* for the monetary base that the Federal Reserve could have in existence at any given time.” This ceiling for the base would grow at a very slow rate—the difference between long-run real output growth and the trend growth of base velocity, with some allowance for currency growth.

## Historical Perspective of the Federal Reserve System

Following the banking panic of 1907, a presidential commission was appointed to study the causes of the collapse of banking institutions and to suggest measures designed to prevent recurrence of such an event. Several studies and extended congressional hearings were conducted, resulting in two primary alternative approaches to central banking. Finally, in 1913, the Congress passed the Federal Reserve Act creating a system of twelve “bankers’ banks,” supervised by a Board of Governors. At that time, the United States was on a

gold standard so the primary functions of these banks were to be the “lender of last resort” by way of the discount window, to provide for the issuance of new, more stable, national currency and to facilitate the clearing of checks.

This was the third attempt to establish a central bank in the United States, the first two each lasting only 20 years in the late 18th and early 19th centuries. The new, 20th-century central bank—the Federal Reserve System—was confronted with its first major financial crises when it was less than 20 years old and was still concerned with survival. Scholars have argued that the Federal Reserve not only did not prevent the Great Depression of the 1930s, but the behavior of the Federal Reserve caused the stock market collapse of 1929 to be transmitted to the banking system and ultimately the real economy, resulting in a very long and deep economic contraction.

Contrary to congressional mandate, the Federal Reserve Banks did not perform as lenders of last resort. The failure of about half the banks in the country in just a few years time might not have occurred if the Fed had not permitted the money supply to contract by one-third in four years. As deflation and economic contraction set in, interest rates dropped very sharply. Behaving like good bankers—but not central bankers—the Federal Reserve refused to purchase financial instruments with a very low yield fearing that once recovery occurred and interest rates began to rise they would suffer a capital loss, and the viability of the institution would be at stake.

In a nutshell, the Reserve Banks were so concerned about their own survival that they did not ensure the survival of private commercial banks. The result was depression. In the late 1930s, recovery was well under way at a time that the central bank doubled the level of reserve requirements causing a very substantial shock to the economic system and precipitating a severe recession. That occasion was the last time the “sledge hammer approach” to monetary policy—the use of reserve requirement manipulation—was attempted.

Following World War II, a period of general economic prosperity with relatively low inflation and interest rates occurred for several reasons. One was that throughout the 1950s and 1960s the outstanding stock of real government debt declined relative to national income and relative to stocks of private productive assets. The world was basically on a dollar standard and, through the operation of the Bretton Woods fixed exchange rate system, a regime of relative monetary discipline was in operation. However, in the late 1960s the combination of military expenditures for the Vietnam War plus greatly increased social expenditures on “Great Society” programs caused a

period of increased national indebtedness, higher inflation, and higher interest rates.

President Lyndon Johnson removed some of the disciplining arrangements in the system in several steps. First, the gold cover on demand deposits was removed, followed by a removal of the gold cover on Federal Reserve currency outstanding. Then, the London gold pool was formally ended in 1968 and the world no longer was bound, *de facto*, to a gold/dollar exchange system. The combination of the 10 percent surtax on personal and corporate incomes in 1968 and 1969, together with the highly restrictive monetary policy of 1969, helped to strengthen the U.S. dollar and to paper over the fundamental weakness in the financial system, although these policy actions resulted in the 1970 recession.

Recovery from recession in 1971 was too vigorous as a result of a strong dose of monetary stimulus late in 1970 and during the first half of 1971. As a consequence, President Nixon, in the summer of 1971, adopted domestic wage and price controls and also floated the dollar on foreign exchange markets. In December of 1971, the Smithsonian Agreement was an attempt to patch the system together and to maintain what remained of the Bretton Woods fixed-exchange-rates system. However, an extremely expansionary monetary policy during 1972, while the economic system was constrained by the operation of a pervasive set of wage and price controls, meant that the fixed-exchange-rates system of the postwar period was doomed. Finally, early in 1973, the United States and other major industrialized countries agreed to abandon attempts to maintain exchange rates between currencies. Since that time the United States has been in a purely discretionary monetary policy environment.

Beginning in early 1975, Congress has been interested in providing some discipline to monetary affairs by urging the Federal Reserve to adopt, announce, and achieve targets for various monetary aggregates. So far, there has been limited success with monetary targeting and there continues to be considerable debate in economic as well as political circles about the feasibility and likely effects of monetary targeting. It is generally accepted that the long-run trend rate of inflation is a function of the trend rate of monetary growth. A sustained inflation is not possible without an accommodating monetary policy. However, the relative importance of alternative monetary and credit aggregates is still a matter of some controversy.

### Central Bank Debt Monetization—Reconciling the “Mix” of Monetary and Fiscal Policies

It is standard in the freshman economics course to teach that all government spending must be paid for by taxing, borrowing, or print-

ing money. Habitual deficit spending is a modern phenomenon since well-developed financial markets that permitted the frequent issuance of marketable interest bearing debt did not exist prior to the 20th century. However, debasing the national currency has been a common method of financing government since the time of the Romans, and has long been recognized as simply another way of taxing people. Especially during wars, inflation has been viewed as one of the most efficient methods by which the government gains command over resources. Even today, many countries rely heavily on the inflation tax to finance government.

In major industrialized countries in the 20th century, a government's budget constraint is expressed by the following identity: expenditures minus tax revenue equals bonds plus base money. The "deficit" is equal to the net increase in the stock of government debt outstanding plus the net change in the monetary base. When the central bank acquires government debt, we say that the debt has been "monetized" because non-interest bearing government debt (base money) has been issued in exchange for the interest bearing debt. Open market purchases of government debt by a central bank simultaneously reduce the net interest expense of the government and increase the nation's money supply. If the amount of money in circulation rises faster than the *demand to hold* it for its monetary services, the purchasing power of the money units declines. What is being inflated is the quantity of money units in nominal terms, and the observed rise of the "price level" is actually a rising amount of money units needed to buy the same basket of goods.

One of the oldest and most reliable statistical relationships in economics is between the level of market interest rates and the rate of inflation. Periods of sustained high inflation in any country are characterized by high interest rates, while periods of low inflation have been periods of low interest rates. The reason is that lenders anticipate being paid back in lower purchasing power currency units, so they want more of them, while borrowers are willing to pay higher interest rates in the expectation that inflation will erode the real cost of the debt. The rate of anticipated future inflation may be higher or lower than recent past actual inflation if the combination of monetary and fiscal policies provides a basis for expecting an acceleration or deceleration of the rate of price increases.

Deficit financing by government leads to expectations that either future explicit taxes must go up, or the future inflation rate will go up. Bonds that are issued to finance current expenditures require that interest and principal be paid out of future tax revenue.

*Unattractive Choices*

Starting from the current situation in which the average interest rate on the outstanding debt is greater than the growth rate of national income, if non-interest expenditures in the budget rise as fast as national income (as they do with indexation), and explicit tax revenue also is a relatively stable ratio of national income (as it is under an indexed tax system), interest and principal on the debt can be paid only if one or more of several conditions is met:

- Non-interest expenditures are cut relative to national income;
- Explicit taxes are raised relative to national income;
- The debt is monetized through open market operations and the resulting debasement of the currency results in faster nominal growth of national income.

Market participants will assign probabilities to each of these possible outcomes, and market interest rates will reflect a median expectation with regard to the likely rate of inflation.

The rising average inflation rate of the 1960s and 1970s was accompanied by a rising level of interest rates. As new debt was issued and old (low-interest rate) debt matured, the average interest rate on the outstanding debt rose. The secular “disinflationary process” that got under way in 1981 means that nominal income growth will slow until price stability is eventually reached. But, since the average maturity of the outstanding debt is about four years, the average interest rate on the debt will fall only very slowly even if current nominal interest rates fall along with the decline of inflation. For the past several years, interest rates have not fallen as rapidly as has the reported rate of inflation, giving rise to two interpretations. One is that the long-run expected rate of inflation is higher than the observed rate, so the “inflation premium” in interest rates is relatively high. The other is that the “real” rate of interest has risen to historically high levels. If either the real interest rate on the debt is greater than real output growth (as debated by Sargent-Wallace and Darby) or the inflation premium in market rates is greater than actual inflation, nominal interest rates will be above nominal income growth.

*Arithmetic Trap*

In this environment, interest expense on the national debt must rise relative to national income. To illustrate the potential magnitude of the problem, assume that the inherited average interest cost or yield on the outstanding debt is 12 percent, and that additions to the stock of debt (deficits) will be financed at 12 percent. Further, assume that future nominal income growth is expected to average 9 percent (3–4 percent output growth and 5–6 percent inflation). Start with

GNP at \$3,600 billion and the debt at one-third that amount—\$1,200 billion—and the initial deficit equal to interest expense—\$144 billion. Using the “rule of 72,” GNP will double every 8 years, while the debt will double every 6 years. That means GNP will double three times in 24 years while the debt doubles four times. That means the national debt will rise from one-third of GNP to two-thirds, and the deficit will rise from 4 percent of GNP to 8 percent. These assumptions produce annual deficits of over \$2 trillion and a national debt of \$19 trillion in less than two-and-one-half decades. To repeat, this outcome was based on the assumption that non-interest expenditures and tax revenues are constant ratios of GNP.

Reducing non-interest expenditures (defense and social programs) as a share of GNP or raising tax revenue at the same rate as interest expense rises would prevent the catastrophe. However, a much simpler solution is available which does not require any hard choices and compromises by the president and Congress. By raising nominal GNP growth above the interest rate on the outstanding debt we can create an environment in which interest expense falls relative to national income. Then deficits would be a shrinking ratio of national income, or there would be more room for greater spending.

Before this alternative starts to sound too attractive, some of its implications should be revealed. Raising nominal income growth above 12 percent can be easily accomplished by raising money growth to 9–10 percent. But, that would mean inflation rising to at least 8–9 percent for starters. Since rising inflation will be accompanied by rising interest rates, the average interest cost of the debt will start to rise. That will necessitate raising nominal income growth further, and so too the inflation rate. A constantly accelerating rate of inflation is the only way to keep ahead of interest costs. All this is not very hypothetical since that is pretty much the story of the period from the early 1960s to 1980. Given the short time horizon of most politicians, “a little more inflation” is not viewed as such an undesirable alternative—at least not compared to cutting spending or raising taxes.

In view of the inability of contemporary political systems to balance budgets, a fundamental proposition of modern history is that national debts are ultimately monetized. Non-interest bearing debt is issued by the central bank in exchange for interest bearing debt which is effectively canceled. Such monetization of debt through the creation of “high powered money” results in rising inflation, so the real value of the debt that is not monetized declines. Even with the indexation of the personal tax structure to eliminate “bracket creep,” the government still benefits from inflation.

## What to Do

If we start to search for solutions by accepting the proposition that the real federal budget is always balanced—there can be no deficit in an actuarial sense—we can put aside the dispute about raising taxes or not. If the government spends, a tax is levied. Now we can debate which taxes are most harmful to the economy. There are some explicit taxes that would be more harmful than the implicit tax of inflation, but few are more regressive, devisive, or dishonest. One reason for preferring *any* explicit tax over inflation is that Congress must vote for them and must either get the President's concurrence or be able to override his veto. Tying decisions to raise spending to companion decisions to either raise taxes or cut other spending is a way of getting politicians to come face to face with the real costs of their actions.

In the long run, failure to control federal spending would mean failure to contain inflation. However, even if we had a Balanced Budget Amendment to the Constitution or some type of spending limitation, the existing stock of debt still could be monetized at an inflationary rate.

As a possible institutional reform, suppose open market transactions by the Fed could be used only for “defensive” purposes—that is, to offset the effects of other transactions on the monetary base. Under such a set of arrangements, where the Fed would be required to hold the total monetary base constant over time, *all* government spending would have to be financed by either current explicit taxation or future explicit taxation. In other words, current deficits would have to be matched by future surpluses.

More realistically, if the rate at which the central bank could monetize debt were constrained to be equal to a rate consistent with the growth of currency and transactions deposits in a stable price level environment, the government would benefit from a relatively small amount of seigniorage from debt monetization, but debasing the currency would not be a significant method of government finance. Since a noninflationary growth of the monetary base would be only a few percent per year, about \$10 billion less debt would be monetized (at current levels) than would otherwise be the case. While the outstanding debt recently has been rising rapidly relative to national income and the stock of productive assets, the ratio is still low relative to the past 50 years.

Adopting a no-deficits fiscal policy immediately would mean the inherited debt would decline in absolute and relative terms (in a no-inflation environment) only as a result of real economic growth and



a few billion dollars per year of debt monetization, unless the government incurred surpluses at some point.

## Conclusion

My basic message is that meaningful monetary reform cannot precede reform of the fiscal regime. The United States entered a new fiscal regime sometime in the past decade when the stock of net national debt stopped falling relative to national income and began rising. This new fiscal regime carries with it an implied monetary regime that cannot be reformed and made noninflationary in isolation. Reform of the fiscal regime is a necessary, but not a sufficient condition for reform of the monetary regime. Reform of the monetary regime is neither necessary nor sufficient for reform of the fiscal regime.

All this is just another way of saying that monetary actions by the central bank are just another type of fiscal policy—a way to finance government. In the short run it is possible (and common) for monetary policy to be implemented independently of the fiscal regime. However, in the long run, the fiscal regime dictates the monetary policy actions. Habitual deficit financing ultimately is inflationary.