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Monetary and Fiscal Policy - What Does It Mean to Consumers?

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by Hyman P. Minsky

Editor's Note: The current controversy over appropriate monetary and fiscal policy stances was dramatized for the television-viewing public in September, 1974 when Dr. Arthur Burns was the target of considerable criticism for the tight money policy of the Federal Reserve.

What did this exchange mean? Did you wish you knew more about the issues? We asked Professor Hyman Minsky of Washington University to write this article to help explain the role of these policies in the economy. We also asked Dr. Gwen Bymers, a family economist, to give insights into applying this information to the consumer. Dr. Bymers comments are highlighted for you in large type on each page.

As a result of a revolution in economic thought which took place in the 1930's, economists since World War II have believed that the government can and should intervene to steer the economy so that a close approximation to full employment and reasonable price stability is achieved. The tools that are used to achieve these goals are monetary and fiscal policy.

① In the first twenty years after World War II, the United States and the rest of the advanced capitalist economies achieved a closer approximation to full employment and price stability than had been true in the pre-war era. Monetary and fiscal policy seemed to do the job. In the years since 1965, inflation has accelerated to the present two-digit level, unemployment has flirted with the unsatisfactory 6 percent range, and the stock and other financial markets have been unsettled. These developments throw doubt upon whether monetary and fiscal policy, as conventionally structured, can do the job in the economic and financial environment that now rules.

② *Monetary Policy and the Federal Reserve System*

Monetary policy, which is the responsibility of the Federal Reserve System, works by affecting the rate of growth of the money supply and the terms upon which business, households and government units

③ can borrow. In the United States, the largest proportion (77 percent in 1973) of the conventionally defined money supply consists of bank deposits subject to check (demand deposits); the remainder is currency. Our banking system is a fractional reserve banking system. This means that by law or by administrative ruling, banks are required to keep designated percentages of their various types of deposits in special accounts, either at a Federal Reserve Bank, or if the bank is not a member of the Federal Reserve, at some approved bank. Because the banks which are members of the Federal Reserve System have a large percentage of total bank assets in the United States (79 percent at end of 1973), the Federal Reserve System can, by controlling the amount of reserve deposits it makes available, control the volume of demand and time deposits outstanding.

Demand and time deposits are the raw material which banks use to make bank loans and buy investments. Thus, when the Federal Reserve System increases bank reserves, commercial banks will create additional demand deposits as they lend or invest more. The borrowers from the bank, or the sellers of the securities to the banks, will use the deposit they obtain to buy goods, hire workers or acquire financial assets. Thus, an increase in the rate of growth of bank reserves by the Federal Reserve System will tend to increase the rate of growth of total demand, employment, and

① *Monetary policy determines money supply and the availability of credit to household and to industry. It is the responsibility of the Federal Reserve banking system. Fiscal policy refers to government taxing and spending. When government spends just what it receives in taxes, we speak of a balanced budget. When it spends more, there is a deficit.*

② *Practically speaking, it means household and families may have to learn to live with a less stable and less predictable system than we have had for the past 30 years.*

③ *Prospective home owners have had to pay as high as 11 percent interest, if they were lucky enough to find mortgage money, this past fall.*

prices. If unemployment is the major

④ concern, the policy rule is that the Federal Reserve is to act to increase effective bank reserves, whereas if inflation is the main concern, the Federal Reserve is to cut back on bank reserves.

⑤ *Fiscal Policy and Government Spending*

Fiscal policy refers to the use of Federal Government taxing and spending programs to affect income, employment and prices. The thrust of fiscal policy is jointly determined by the Congress and the Administration. Because particular spending items, such as defense, social security and education, are desired for themselves, and because the tax programs reflect conflicts and compromises among various interests, the overall thrust of fiscal policy can very well be different than that called for by the ruling employment and price situation.

④ *This is reflected in more or fewer job openings or the availability of fewer part-time positions for students and family members.*

⑤ *Total demand equals dollar spending of consumer, government and industry.*

If the aim is to expand output and employment, some combination of a rise in spending or a cut in taxes is indicated; the budget should move toward a deficit. If the aim is to fight inflation, the indicated policy is to combine lower spending with higher taxes; the budget should move toward a surplus.

The Need for Coordination

As both monetary and fiscal policy affect total demand, it is obviously desirable that they be coordinated. If the need is for expansion, the policy rule is to increase the growth of the money supply and the budget should move toward a deficit; whereas if constrant is needed, the growth of the money supply should be decreased and the budget should move toward a surplus. Inasmuch as the Board of Governors of the Federal Reserve System can move quickly, while a change in government spending and taxes requires action by Congress, as well as the Administration, the consensus is that

⑥ monetary policy is more flexible. On the other hand, it was long held that monetary policy may be more effective in constraining demand than in inducing expansion; however Fiscal Policy was viewed as being capable of stimulating demand under all circumstances.

These rather simple rules for monetary and fiscal policy worked quite well in the first twenty years after World War II. Between 1948 and 1965 consumer prices increased at a modest annual rate of 1.6 percent. Unemployment, although at times uncomfortably high, was on the average low by historical standards. Between 1965 and 1973 prices increased at a compound annual rate of 4.4 percent, and after 1969 unemployment rates were on the average higher than they were earlier in the post-war epoch. However, beginning in 1966 the effectiveness of monetary and fiscal policy in controlling demand seems to have diminished.

The Policies in Action

In the 1920's, as the Federal Reserve learned how its operations affected banks, the belief grew that the Federal Reserve could control the overall behavior of the economy. As a result the Federal Reserve now has two responsibilities: to cooperate with the budget posture adopted by the government to control the economy, and if the necessity arises, to support the financial system so as to prevent panics and crises.

As a result of the Great Depression of the 1930's and the financial changes that took place during World War II, the financial system was very robust when the War ended. A robust financial system is one in which the amount of private debt is small in relation to both corporation and household incomes and in which private economic units hold a great deal of safe financial assets (government debt and money) relative to their debts. The extended era of relatively good times between the end of World War II and 1965 saw a large increase in private indebtedness and a large growth in nonbank financial institutions, so that by 1966, the financial system was much more fragile than it had been immediately after the War.

This transformation of an initially robust financial system into an increasingly fragile one was accelerated by the emphasis, after 1960, upon speeding up economic growth. This meant that monetary

⑦ and fiscal policies were directed at increasing investment as a proportion of income. A policy which emphasizes economic growth through private investment requires that the tax system be changed to facilitate corporate saving, thus increasing investment and monetary growth in order to enable banks to finance investments. By requiring that money be made easy, this effort to stimulate growth encourages not only debt financing of private investment by firms, but also an increase in household debt financing of durable goods and housing purchases. An emphasis upon accelerating economic growth encourages financial development which makes the financial system more fragile.

In 1966, with prices rising at a rate of more than 3 percent per year and unemployment below 4 percent, the Federal Reserve acted to constrain inflation by cutting down on the growth of bank reserves. However, before the monetary constraint affected income, employment and prices, a sharp rise in interest rates took place. This led to serious difficulties for many savings and loan associations. As banks operate by making loan commitments in advance of making loans, many banks were forced to sell investments, particularly municipal securities, to get the funds needed by their loan commitments. A sharp drop in Municipal Security prices took place which led to large losses by a number of leading banks. As a near-crisis atmosphere developed, the Federal Reserve backed away from monetary constraint and increased the rate at which reserves were supplied to the banking system.

In 1969-1970, with prices rising at a rate in excess of 5½ percent per year, the Federal Reserve again slowed the rate at which it supplied reserves. In 1974, the Federal Reserve tried to cut down on the rate of growth of the money supply in an effort to fight inflation. Due to the resulting high interest rates, a number of leading financial and corporate enterprises were in a serious financial bind—and the stock market fell more than 40 percent from its level some eighteen months earlier.

There is at this writing a great deal of pressure upon the Federal Reserve to ease its monetary constraints because of fear of a financial panic. The Federal Reserve is limited in what it can do to constrain demand by a fear that it could trigger a financial crisis much more serious than those threatened in 1966 and 1970.

The standard prescription for the use of monetary policy in an inflationary period assumes that monetary constraint would have its impact only upon demand; however, the developments over the past nine years have shown that in the financial environment now ruling, monetary constraint is likely to trigger a threatened financial crisis before it has a substantial impact upon the excess demand that leads to inflation. Thus the simple rules for

⑧ monetary policy that were laid down in the 1930's do not seem to be working in the 1970's. What the Federal Reserve does in an attempt to halt inflation seemingly tends to lead to financial disturbances, and what the Federal Reserve does to put the financial disturbances at rest seems to fuel the inflationary fires.

In October of 1974 we had two-digit inflation and unemployment of about six percent. The inflation signaled a need for constraining fiscal measures; the unemployment rate signaled a need for expansionary fiscal policy. It is clear that tax and spending policies that only look at the totals, and do not specify the structure of the tax and spending changes, are not going to help us out of this type of dilemma.

We now know that the simple, even precise, rules for monetary and fiscal policies used to steer aggregate output, employment and prices in the 1945-1965 era may no longer be applicable. Whereas a decade ago economists in government positions were arguing that the economy could be fine-tuned, it is now clear that the American economy is too complex to be controlled by a simple formula.

⑥ *Practically speaking, this means that when money is tight people spend less, but with an easing of money supply, consumer attitudes and confidence are more important in determining their spending. When the government spends more than it collects in taxes, this appears in the form of additional funds to be spent.*

⑦ *To consumers, this means economic growth can be generated through debt financing just as households can sometimes get ahead by first going into debt. However, the system, like the household, then becomes more vulnerable to economic ups and downs.*

⑧ *People spend more in anticipation of future inflation. This almost insures future price rises.*