Comment on "Blend of Fiscal and Monetary Policies" by Richard Musgrave

Allan H. Meltzer
Carnegie Mellon University, am05@andrew.cmu.edu

Follow this and additional works at: http://repository.cmu.edu/tepper
Part of the Economic Policy Commons, and the Industrial Organization Commons

Published In

This Response or Comment is brought to you for free and open access by Research Showcase @ CMU. It has been accepted for inclusion in Tepper School of Business by an authorized administrator of Research Showcase @ CMU. For more information, please contact research-showcase@andrew.cmu.edu.
COMMENTS
by Allan H. Meltzer

If Professor Musgrave had not stated his position so clearly, my task would be more difficult; our disagreements would be less obvious, and I would be left in the position of the discussant who must reply by saying, "Yes, but ..." Fortunately, Musgrave has put forward a clear and able statement of his views — views that are shared by many others in the academic profession and are so widely held within government that an alternative view is hard to find there. At one point in his paper, Musgrave notes that the late Eisenhower and the early Kennedy administration advocated the same mix of policies to achieve growth and stability. Apparently, there is the beginning of a political consensus.

In view of the frankness, clarity and ability with which Professor Musgrave has advanced his views and argued his case, I can do no less than try to reciprocate. The disagreement between us, while not complete, is so large that the area of agreement is insignificant in comparison. Moreover, the sources of our disagreements are, I believe, equally clear and equally obvious. Professor Musgrave and I reach different conclusions when we examine historical evidence; we disagree about who is responsible for choosing the goals of the society; we place a different value on the importance of economic freedom; that is, we do not agree about the relative importance that should be placed on private and governmental decisions in the allocation of resources. I believe these matters are all

Although the views expressed are my own, the analysis underlying them is based on joint research with Karl Brunner.
related and that they are mainly the result of using different theories and therefore interpreting facts differently. Let me, therefore, state what I regard as the basis for the disagreements between us and illustrate our different approaches by reference to some of the points made in Professor Musgrave's paper. Then I shall argue, briefly, why I believe that the evidence largely supports the less popular alternative view and suggests that the very policies that Professor Musgrave advocates are a main cause of the worldwide failure to achieve full employment of resources without inflation and a main source of the fluctuations in economic activity that he and I desire to avoid.

As I read Musgrave's paper, time and again I was struck by a difference in our approach. Each time he reached a point at which he thought a choice must be made between consumption and investment, between growth and balance of payments equilibrium, or between public and private investment, he argued for some form of selective control, some new or renewed action by government. The fact that relative prices would change and that the market would express the public's preferences for one or the other of these outcomes plays little or no role in his analysis. In fact, he goes much further. If private decisions reflected in relative price changes threaten to interfere with society's "growth target," the government should introduce selective tax incentives to encourage investment. If monetary and fiscal policies cannot achieve the target rates of unemployment and price change because of administered prices, wage-price guidelines or incomes policies should be used. If the objectives of domestic policy
conflict with the aims of our balance of payments, "selective controls can be constructed to deal with the situation." In short, as I read these rather popular suggestions, there is some combination of selective and general controls that will achieve all of our objectives. If not, we invent more selective controls.

Whose objectives are to be achieved? Society's objectives, as determined on the basis of a consensus within the Executive agencies of government? Or, society's objectives as expressed in the marketplace? What has happened to our objective of maintaining a large measure of economic freedom for example as expressed in the right to register preferences for and against growth or other goals and priorities selected by government by voting for an alternative allocation of resources in the marketplace?

At first glance, the answers to the questions I have just raised appear to depend on values, and doubtless there is an element of value judgment present. But I believe it is misleading to view the different answers that Professor Musgrave and I would be likely to give to the above questions as solely the result of different value systems. There is a clearcut difference in our approach to problems that should not be dismissed as a reflection of different goals for society. I am confident that Professor Musgrave and many others who reach similar conclusions would not wish to be cast as enemies of economic freedom, and I do not want to force them into that mold.

The difference between us is based mainly on the way in which we interpret facts, that is on the theories that we use. You may judge for
yourselves who is right by asking, which of the interpretations fits the facts best? Is it true, as is so often claimed, that to achieve the many goals that are described in Musgrave's paper requires more or less continuous adjustments of monetary and fiscal policies and a variety of selective controls as he says? Or, am I correct when I assert that the controls imposed by government and the almost continuous adjustment of monetary and fiscal policies make an important contribution to both inflation and unemployment and thus interfere with the economic system's efforts to secure stable growth, stable prices, and full use of resources? Is the popular view correct when it urges selective controls, wage-price guideposts, restrictions on foreign capital movements and a variety of other ad hoc devices as a means of achieving frequently stated goals? Or am I correct when I argue that in most cases these selective devices are a source of instability that hinder or prevent the economy from achieving many of the goals simultaneously?

The recent record of the U.S. economy provides excellent evidence with which to discriminate between the alternative views. Many of the controls that Musgrave and others desire to impose have been in effect during the past several years. For example, to control the balance of payments and to reduce the gold outflow, we have used a variety of formal and informal selective controls; to encourage growth and investment in capital goods, we have used tax credits and accelerated depreciation; to make inflation less apparent, we have relied upon that informal method of price control known as the wage-price guideposts, meanwhile abjuring
repeatedly that wage and price controls are to be avoided. Despite these efforts, and perhaps because of them, we have not maintained steady growth and employment, prevented inflation, or balanced our international accounts without a gold outflow. Although Presidents, Congressmen, and Secretaries of the Treasury have affirmed their allegiance to the present set of fixed exchange rates, they have used selective taxes and controls to change the exchange rate for particular types of transactions.

On one interpretation, a main reason that production has fallen, that growth has slowed, that inflation has returned, and that the gold outflow persists and increases is that the government did not have enough selective controls. On the other interpretation—my interpretation—a main reason that we have not achieved these goals of policy is because the government's monetary and fiscal policies prevented us from doing so. As I view the record, it seems unmistakably clear that the very policies that Musgrave and many others now advocate have been tried repeatedly and have failed just as often.

Let me present some recent evidence to support my position more fully. During late 1965 and early 1966, while prices were rising, government officials either argued that there would be no inflation or urged unions and corporations to exercise restraint. As always at the start of inflation the government either attempted to shift the responsibility for the inflation to the private sector or denied that the rise in prices was more than a temporary disturbance. When the Federal Reserve raised the discount rate in December 1965, many officials, and economists
within and outside government, deplored the lack of policy coordination and ignored the extremely high rate of increase in the stock of money. The rise in the discount rate was a mild anti-inflationary action, entirely too modest to offset the rate at which the Federal Reserve increased the money supply. Moreover, during the winter of 1966, the Federal Reserve increased the rate of increase of the money supply and added to the inflationary pressures.

Inflation is always the result of a sustained policy of monetary expansion. Contrary to popular opinion, inflation is not produced by monopolies in labor or in business, by speculators, housewives, farmers, middlemen or by any of the other groups that are so frequently blamed. It is the result of government — not private — policies and particularly of government monetary policies. The inflation of 1966-67 does not differ in this regard from the inflations that we have had in the past or from the inflations that we are likely to have in the future, or from the inflations experienced in other countries. It, too, was the result of government policy and in particular of the central bank's monetary policy.

Through most of the first six months of 1966, the Federal Reserve actively fed the inflation. The growth rate of the money supply, currency and demand deposits, rose to approximately 6% per annum, about double the rate of increase that was desirable under the circumstances. In the summer of 1966, the Federal Reserve suddenly reversed its policy. The growth rate of the money supply fell, then the money supply fell. Within a very few months, monetary policy had switched from highly inflationary to highly
contractive. It remained highly contractive until late in December 1966 when it again reversed direction and suddenly became too expansive to be characterized as non-inflationary.

These wide swings in the direction of monetary policy were accompanied by smaller but nonetheless important changes in the expansive influence of fiscal policy. On my interpretation, the government's monetary and fiscal policies produced the inflation of 1966-67 and the very large changes in the size and direction of monetary policy produced the decline in industrial production, the reduction in employment and in the growth rate of output. The present high rate of monetary expansion and the very large and very sharp change in the rate of change of money mean that more inflation is to be expected.

Furthermore, on my interpretation, the government's policies are the principal reason that we will not achieve full use of resources without inflation in 1967 and that we will continue to experience a gold outflow. The inflationary policies that the government has pursued and is pursuing makes our exports relatively more expensive and our imports relatively cheaper and thus move us away from balance of payments equilibrium. The system of exchange controls and special taxes does not — indeed cannot — bring about permanent adjustment of the balance of payments without a gold loss. At best, these controls give policymakers time in which to adjust the balance of payments at the present fixed exchange rate by pursuing policies that are less inflationary than those pursued in other countries. But in recent years, the United States has
pursued inflationary policies and has not made wise use of the time purchased with direct controls and special taxes on foreign transactions.

The government's policies in 1966 likewise provide the main reason that output has grown very slowly and that industrial production has fallen in the first quarter of 1967. I have already indicated that the monetary and fiscal policies were inflationary until late spring or early summer. Once the Federal Reserve reversed direction and forced the stock of money to decline, it was to be expected that industrial production would decline and that unemployment would increase. The reason is that an anti-inflationary monetary policy does not succeed in stopping inflation unless it first has an effect on production and employment. Or, to put the point in another way, the effect of monetary policy on output is a part of the process by which monetary policy affects the price level and produces inflation, deflation or price stability.

The recent experience of the United States is by no means an isolated example. The policy that the British call "stop and go" is of the same kind and produced the same type of results. And these are not the only examples.

In my judgment, the very policies that Professor Musgrave and others so often advocate are a main cause of their failure to achieve their goals. The patchwork of direct controls, the extreme variability of monetary and fiscal operations, the exhortations that become threats and that are followed by laws, these and not the absence of sufficient power head the list of reasons that we and others fail to maintain full use of resources without inflation.
Finally, I would like to add that in a more complete discussion of the subject than I have been able to present, it would be worthwhile considering two other points that neither Musgrave nor I mentioned. One of these is the activities in which the government now engages and some of the rules that are now enforced at all levels of government. Many of these rules reduce the quantity of labor demanded or supplied at any wage rate and thus increase the proportion of the population that will not find employment at any maintained rate of change in prices. A second problem is the choice of goals and particularly the rough measure of equality that is often given to each of the goals. I find it difficult to understand how the maintenance of fixed exchange rates ever became a matter of the same importance as high employment and price stability. In fact, I must confess my lack of conviction that fixed exchange rates are desirable. But these are matters that are perhaps best left for another session.