Monetarism Versus Fiscalism: Towards Reconciliation*

The comparative effectiveness of monetary policy versus fiscal policy persists as a subject of widely noted discussion. In particular, recent exchanges between Milton Friedman (1969 and 1970) and Anna Schwartz (1969) on the one hand, and Lord Kaldor (1970 and 1970a) and A. B. Cramp (1970 and 1971) on the other hand, have gone a long way to spell out the contrasting positions. A subsequent attempt at reconciling the differences between Monetarism and Fiscalism was made by J. R. Wagner (1974). Wagner's attempt, in turn, has since been briefly challenged and dismissed by M. Parkin (1974, p. 656).

Thus, apparently conflicting hypotheses have been offered to explain the relative potency of monetary versus fiscal policy. Accordingly, it seems useful to reexamine the problem and to place the current controversy in perspective by bringing to bear pertinent work in public-finance theory as well as in monetary theory. In so doing, we find that not only is a reconciliation between Monetarism and Fiscalism possible but that, in the crucial case of the antidote to depression, Monetarism and Fiscalism coincide.

Section I takes Wagner's attempt at reconciliation as a point of departure for probing the method by which the stock of money is changed. Section II analyzes the conceptual distinction between an expansionary monetary policy and an expansionary fiscal policy. Section III examines implications of a controverted method for monetary expansion included in Friedman's theoretical analysis. Section IV expounds the Chicago School's public-finance approach to the combatting of depression. Section V reexamines Keynes's treatment of the means for generating monetary expansion, and Section VI contains a few concluding remarks.

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I. The Transmission Mechanism

In the Monetarist position as articulated in Friedman's version of the quantity theory, a basic tenet is the existence of a stable demand function for money showing only little responsiveness to changes in the rate of interest. Thus, a low or negligible interest elasticity of the demand for money is fundamental to the Monetarist claim of the preferability of monetary policy. Addressing himself to the significance of this elasticity coefficient (Ei), Wagner suggests that (Ei) is of dual importance for the logical analysis underlying the Monetarist position. The role of (Ei) in terms of the demand for real balances (the Marshallian k) has been recognized by Monetarists in that a low (Ei) makes for a more effective monetary policy. At the same time, however, the Monetarist position does not take explicit account of another crucial aspect of (Ei), namely: what Wagner designates the "transmission mechanism", i.e., the method by which the monetary authorities make changes in the stock of money.

Hence, in his attempt at reconciliation between the Monetarist and Keynesian positions, Wagner purports to avoid the biased view of the merits of monetary policy that disregard of the transmission mechanism brings about. For as he sees it, the "effect of a low (Ei) on the Cambridge k will increase the potency of monetary policy: while the effect of a low (Ei) on the transmission mechanism will inhibit its implementation". (Wagner, p. 157.) In particular, Wagner (*ibid.*) describes the inhibiting effects of monetary policy in the following terms:

> "These inhibiting effects exist whenever the change in the money supply is accomplished through open market operations, or by changing the discount rate of the central bank. They are not relevant if an increase in the money supply is brought about (a) by a governmental deficit, or (b) by scattering money from a helicopter. My contention is that so long as the supply of money is regulated by changing the rate of interest (either through changes in the re-discount rates or through open market operations), this second relationship regarding the elasticity coefficient must be taken into account, as well as the first one. Thus the inelasticity of the demand for money function does not in itself provide *a priori* evidence as to the relative efficacy of monetary policy."

Critical to assessment of Wagner's contention is the consideration of alternative methods of monetary expansion. Accordingly, we seek next to identify the essentials of the transmission mechanism in terms of its implications for the potency of monetary policy.

II. The Conceptual Distinction

Consider the distinction between increasing the money supply by changing the rate of interest and increasing the money supply by a governmental deficit. The difference involved corresponds to the standard distinction between an expansionary *monetary* policy and an expansionary *fiscal* policy. Correspondingly, consider the argument that increasing the money supply by changing the rate of interest is less effective than increasing the money supply by a governmental deficit. This argument is tantamount to the contention that an expansionary fiscal policy is more effective than an expansionary monetary policy in counteracting unemployment. In particular, the notion that deficit financing is a potent antidote to recession or depression is premised not upon government borrowing *per se* but rather upon government borrowing *concomitant* with a corresponding increase in the money stock.

Hence, the expansionary potency of government borrowing in the face of unemployment derives not from superimposing the government's demand for cash upon the existing private demand for cash. In and of itself, the government's borrowing would tend to raise the rate of interest (and tighten the other conditions of cash availability to private borrowers). In other words, government borrowing for financing a governmental deficit is *per se* restrictive. This restrictive outcome is avoided when the borrowing is accompanied by the creation of money sufficient to offset the volume of government borrowing itself.

Thus, in the comparison between an expansionary *fiscal* policy and an expansionary *monetary* policy it is implicitly assumed that both policies will permit the money stock to increase by a given amount. The distinctive potency of the expansionary *fiscal* policy derives from the government's subsequent expenditure of the funds borrowed, once the borrowing (i.e., the deficit-financing) operation

has been performed in tandem with the central bank's enlargement of the cash-reserve base so as to permit the concomitant increase of the money stock.

III. Money by Helicopter

Consider next the technique of scattering money to the population by air from a helicopter. Wagner's above quoted suggestion of this method evidently has its origin in Friedman's postulation of this "unique, miraculous event" (Friedman, 1969, p. 8) as an initial simplifying assumption in the course of Friedman's sequential exposition of his version of the quantity theory. Thus, Friedman (*ibid.*) subsequently complicates his exposition by postulating that "money rains down from heaven at a rate which produces a steady increase in the quantity of money". Consider, nevertheless, the significance of the technique of scattering money from a helicopter, in line with Kaldor's comment that "It is significant perhaps that when Friedman... does attempt a graphic description of how an increase in the money supply leads to a rise in prices and incomes, the money is scattered to the population from the air by helicopter." (Kaldor, 1970, p. 4.)

The unorthodox act of dividing among the general population a specified increase in the money stock amounts to an expansionary fiscal policy wherein an outright grant of cash (currency) is made to the populace at large just as the currency rolls off the printing presses. The unorthodoxy of this act does not detract from its expansionary *fiscal*-policy character. Rather, the unorthodoxy of the act arises from the generality of its cash-*giveaway* quality. In particular, we note that the unorthodoxy of the act does not arise from its presupposing the expansion of the stock of money. For we have already noted that, *in general*, an expansionary fiscal policy presupposes an expansionary monetary policy.

In other words, Friedman's reference to the method of cash distribution by helicopter was made not for the purposes of *policy* advocacy, but merely for the purpose of introducing an initial simplifying assumption into a theoretical chain of reasoning. In contrast, Wagner's suggestion of this method is ultimately meant for the purpose of *policy* advocacy. Yet as Kaldor intimates, the very fact that in a monetary-theory framework Friedman resorts to such a metaphoric assumption, vividly illustrates that at least at one notable point in the exposition of his version of the quantity theory, Friedman resorts to a premise that involves the combination of an expansionary *fiscal* policy with an expansionary *monetary* policy. Thus, even Friedman's version of the quantity theory is not devoid of an expansionary *fiscal*-policy component.

IV. The Chicago School of Public Finance

It turns out then that the division between the Fiscalist camp and the Monetarist camp may be narrowed down to the point, incisively made by Patinkin (1965, p. 237), that "The dynamic impact of an increase in the quantity of money depends on the way in which it is introduced into the economy." While contemporary Monetarists under Friedman's leadership are generally regarded as exponents of the efficacy of monetary policy, earlier adherents of the quantity theory even of the Chicago School have been quite eclectic as to the preferable way in which an increase in the quantity of money was to be engendered. In particular, as depicted by Patinkin (1972, pp. 97-98) in terms of his own exposure to the Chicago tradition of monetary theory, one of the summary-propositions of this theory sets out the conduct of contracyclical policy by means of changing M so as to offset changes in V, as follows.

> "The necessary variations in M can be generated either by open-market operations or by budgetary deficits. The latter method is more efficient, and in some cases might even be necessary. Budgetary deficits, in turn, can be generated by varying either government expenditures or tax receipts. From the viewpoint of contracyclical policy, this makes no difference — for either method changes M; but from the viewpoint of the general philosophy of the proper role of government in economic life, the variation of tax receipts is definitely preferable."

Patinkin's exposition is clearly borne out by reference to Henry C. Simons, the pioneering and most influential of the Chicago-School (pre-Friedman) exponents of the quantity theory. Simons (quoted by Patinkin, 1972, p. 110) pointed out that

> "Once a deflation has gotten under way, in a large modern economy, there is no significant limit which the decline of prices and employ-

> ment cannot exceed, if the central government fails to use its fiscal powers generously and deliberately to stop that decline. Only great government deficits can check the hoarding of lawful money and the destruction of money substitutes once a general movement has gotten under way."

Indeed, the Chicago-School approach, in the manner of Simons, to the field of public finance lives on in the work of its leading exponent, James M. Buchanan. Referring to periods of depression (as well as to periods of war), Buchanan (1958, p. 136) describes them as

> "Periods... in which government may employ public debt issue as a means of accomplishing the effects of direct currency creation. Government borrowing from the banking system during [such periods] is of this nature. If the government borrows from the system in such a way that the borrowing-expenditure process itself creates sufficient excess reserves to finance fully the banks' purchases of bonds, the results are substantially identical to an outright operation of the printing presses with the same subsequent expenditure of the funds."

Remarkably, Buchanan, having identified "outright operation of the printing presses" in a depression as a situation in which "the government is wise" (p. 129) and "rational" (p. 133), categorizes such a policy as "monetary policy" (p. 133). Yet conceptually he is referring to *fiscal* policy, for he takes pains to stress repeatedly that this creation of money "in the direct manner" must be considered (p. 133) as "*combined with the expenditure of the funds raised*" (the italics are Buchanan's). Manifestly, this is a case of an expansionary *fiscal* policy, *not* of *monetary* policy alone.

Thus, the Chicago tradition of the quantity theory clearly belies the norm of confining the counteraction of depression to monetary policy alone: Monetarism as an antithesis of fiscalism is *not* the message from pre-Friedman Chicago. We also recall that even in the case of Friedman's version of the quantity theory, the method by which an increase in the quantity of money is engendered is not inconsequential; his helicopter metaphor, albeit only an initial simplifying assumption, is nothing other than an expansionary fiscal policy situated in the midst of his monetary analysis.

V. Keynes and the Choice of Technique

Finally, we turn to the choice of technique within the bounds of *monetary* policy proper. In the face of unemployment, is the choice among alternative techniques for generating an increase in the money stock, a matter of indifference? Wagner (p. 157) implies so much, at least "whenever the change in the money supply is accomplished through open market operations, or by changing the discount rate of the central bank." But are open-market operations and rediscounting equivalent instruments for expanding the money supply? Indeed, is the instrument of open-market operations itself a single, unidimensional method? Keynes in *The General Theory* held to the contrary. As Wagner notes, Keynes maintained that "... the banking system is in fact always able to purchase (or sell) bonds in exchange for cash by bidding the price of bonds up (or down) in the market by a modest amount..." (Keynes, p. 197, quoted by Wagner, p. 157.) But Keynes (p. 197) immediately went on to point out that "Where, however, (as in the United States, 1933-1934) open-market operations have been limited to the purchase of very short-dated securities, the effect may, of course, be mainly confined to the very short-term rates of interest and have but little reaction on the much more important long-term rate of interest."

Thus, Keynes's acknowledgment of the practicality of open-market operations included the recognition that this instrument is two-dimensional: (a) changing the volume of cash reserves, and (b) affecting interest rates within the particular maturity segment of the term structure of interest rates in which the open-market operations are conducted. In the context of depression, therefore, Keynes favored a policy of focusing the interest-rate impact of the central bank's expansionary open-market activity upon the long-term sector. By clear implication, then, Keynes preferred open-market operations to rediscount-rate reduction, the rediscount rate being a short-term rate. By the same logic, the reduction of cash-reserve requirements (which Keynes did not mention) would also be inferior to expansionary open-market operations involving the long-term sector, for the central bank does not directly affect any (let alone long-term) interest rate by its stroke-of-the-pen reduction of cash-reserve requirements. Such reduction leaves it up to the commercial banks to implement the monetary expansion.

VI. Conclusions

Considering the tenor of the rival pronouncements in light of the actual differences between Monetarism and Fiscalism that we have analyzed, the controversy between the two camps has been overdone. Crucial to the analysis is the comparison of alternative methods for generating monetary expansion. From this comparison, the following results ensue.

(1) Government borrowing for financing a budgetary deficit is *per se* restrictive. Accordingly, in the standard comparison between an expansionary fiscal policy and an expansionary monetary policy, it is necessary to posit that the deficit financing would be concomitant with an enlargement of the cash-reserve base sufficient to offset the volume of government borrowing itself.

(2) Friedman's controverted preliminary assumption of cash distribution by helicopter involves the combination of an expansionary fiscal policy with an expansionary monetary policy. Thus, even Friedman's version of the quantity theory of money is not without an expansionary fiscal policy component; and Kaldor's critical reference to the helicopter device can be viewed accordingly.

(3) Furthermore, the pre-Friedman Chicago tradition of the quantity theory does not confine the counteraction of depression to monetary policy alone. An expansionary fiscal-policy component is prominently allowed for in the Chicago tradition, as illustrated in the contributions of Simons, Patinkin and Buchanan.

(4) Keynes has been interpreted, e.g., by Wagner, as indifferent to the choice of the particular technique for generating monetary expansion in the face of unemployment. Yet Keynes, in fact, pronounced a distinct preference for expansionary open-market operations in the long-term sector. His much noted criticism of the conduct of monetary policy in depression is explicitly premised upon the central bank's confinement of open-market operations to the short-term sector.

In sum, although Keynes did not elaborate the comparison of alternative methods for expanding the volume of money, he clearly indicated the efficacy of open-market operations as the foremost technique for conducting an expansionary monetary policy. In turn,

as an antidote to depression, Keynes's advocacy of an expansionary fiscal policy harmonizes with the Simons-Buchanan-Patinkin version of the Chicago School's antidote to depression. Thus, with or without the benefit of Friedman's helicopter device, the basis for reconciliation between Keynes and the Chicago School is at hand. Indeed, for the case of depression, the cleavage between Fiscalism and Monetarism turns out to be non-existent. An expansionary fiscal policy, involving budgetary deficits financed by expansionary open-market operations, constitutes the common meeting ground for Fiscalism and Monetarism.

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