Monetarism and Fiscalism (*) (**)

Introduction

Monetarism and Fiscalism have emerged as two alternative stabilization strategies that are in contention at this time. Monetarism — the Monetarist doctrine — seeks to control the monetary aggregates in order to stabilize the growth in money income, while Fiscalism — the Fiscalist doctrine — centers its policies on controlling the degree of stimulus or restraint in the budget. Monetarists base their stabilization policy on the quantity theory of money and emphasize the importance of changes in the money

(*) Financial support from the National Science Foundation and from Wayne State University is gratefully acknowledged. I would like to acknowledge the very valuable comments I received from Dr. Clark Warburton — a key figure in the post-Keynesian rehabilitation of monetarism in the United States.

(**) I offer my apologies in advance for the use of the terms Monetarism, Fiscalism, Monetarists and Fiscalists, but I have not been able to find better terminology. The term Fiscalist is not a particularly good one, since it is intended to cover a large group of modern Keynesians ranging from Radcliffe Fiscalists to the neo-classical Fiscalists who share a common view in emphasizing the strategic importance of fiscal policy in stabilization; and this group may also include some who favor fiscal policy to shift the balance between private and public goods, and possibly other reasons. In any event, the Fiscalist group is, by far, the larger group and more heterogeneous than the Monetarist group. Also, neo-classical Fiscalists are, in their analytical framework, closer to the Monetarists than to the Radcliffe Fiscalists or the neo-stagnationists. Some of those that I include in the Fiscalist camp will object, with some justification, on the grounds that while they prefer an income-expenditure model to the quantity theory, they are not committed to either fiscal or monetary policy but are pragmatists searching for the best stabilization strategy. In spite of these obvious limitations, the term Fiscalist is intended to describe the broad range of views of those who base themselves on income-expenditure theory, gauge monetary policy in terms of interest rate movements, and stress the role of fiscal policy in stabilization. This still leaves a substantial group that cannot be classified readily, and who may be close to the Monetarists at one time and closer to the Fiscalists at another time. The term Monetarist is intended to cover the group who base their stabilization policies on the modern quantity theory. Professor James Tobin has pointed out to me that the Monetarism-Fiscalism dichotomy is not entirely symmetric, and that some Fiscalists do incorporate a major role for monetary policy in their stabilization framework. It may, therefore, be better to base the dichotomy on analytic grounds and distinguish between quantity theorists and income-expenditure theorists.

stock and its rate of growth, while Fiscalists base their policies on an income-expenditure model and emphasize the importance of budgetary surpluses and deficits measured in terms of the full-employment surplus (1).

In addition to this fundamental difference concerning stabilization strategy, Monetarists and Fiscalists appear to have diverging views on many other issues. To illustrate: Monetarists emphasize the importance of a relatively stable demand for money, postulate a link from money to prices and from prices to wages, and distinguish between *nominal* and *real* representations for variables that may be sensitive to price level changes; Fiscalists, in turn, emphasize the relative stability of the consumption function and savings ratio, link money to interest rates and often explain prices in terms of autonomous, or independent, changes in wages or markups, and frequently substitute nominal variables *in lieu* of real variables. Similarly, in policy discussions we find the following related differences: Monetarists postulate that monetary actions involve long and variable lags, calibrate monetary actions in terms of the monetary aggregates, and typically favor rules (or guidelines) for money stock growth; Fiscalists, seemingly less concerned with lags, have favored discretion, activism, and fine-tuning, and gauge the thrust of monetary policy in terms of market interest rates.

(1) The Fiscalist analysis of the U.S. economy in the early 1960's is presented in Council of Economic Advisers, *The American Economy in 1961: Problems and Policies* (Washington, 1961) and P. A. Samuelson, *Stability and Growth in the American Economy*, 1962 Wicksell Lectures (Stockholm, 1962). For an articulate statement of the accommodative Fiscalists approach, see W. W. Heller, *New Dimensions of Political Economy* (Norton, 1966). See also W. W. Heller (ed.), *Perspectives on Economic Growth* (Random House, 1968), and A. Okun, *The Political Economy of Prosperity* (Brookings, 1970). For the neo-classical synthesis and its application to stabilization policy in the U.S. in the early 1960's, see J. Tobin, *The Intellectual Revolution in U.S. Economic Policy Making* (The University of Essex, 1968). While there may still be some Radcliffe Fiscalists in the U.S., this group has declined both in numbers and in influence.

The classic statement of the pre-Keynesian Monetarist theory is, of course, in I. Fisher, *The Purchasing Power of Money* (Macmillan, 1911). For statements of the modern Quantity theory see L. W. Mints, *History of Banking Theory* (Chicago, 1945) and *Monetary Policy in a Competitive Society* (McGraw-Hill, 1951). Clark Warburton's selected papers for 1945-1953 in *Depression, Inflation and Monetary Policy* (Johns Hopkins Press, 1966); M. Friedman (ed.), *Studies in Quantity Theory of Money* (Chicago, 1958); M. Friedman and A. Schwartz, *A Monetary History of the United States* (Princeton, 1963); M. Friedman, *The Optimum Quantity of Money* (Adline, 1969); D. Patinkin, *Money Interest and Prices*, 2nd. ed. (Harper, 1965); and H. G. Johnson, *Essays in Monetary Economics* (Harvard, 1967). See also D. I. Fand, "A Monetarist Model of the Monetary Process", in the *Journal of Finance*, May 1970.

The quantity theory of the Monetarists, stressing the money stock, and the income-expenditure theory of the Fiscalists, featuring the interest rate transmission mechanism and stressing the significance of budgetary changes, help explain the fundamentally different roles that they assign to monetary and fiscal policy as stabilization instruments. Other differences are not necessarily derived from their respective analytical frameworks, and may, in fact, reflect either accidental or transitory factors. Is there any inherent relation between an activist philosophy, a policy orientation favoring discretion, and a fiscalism strategy in macroeconomic policy? Is there any necessary relation between activism and the emphasis on budgetary changes in stabilization policy? More specifically, may one conceive of a world in which Fiscalists favored guidelines or rules, governing the annual changes in the budget, while Monetarists favored activism, discretion and finely-tuned changes in the money stock (2)?

In this paper we examine the substantive differences between Monetarists and Fiscalists concerning the theory of money, the theory of interest rates and prices, the theory of fiscal policy, and their respective views on rules, guidelines, discretion and etc. We then use this analysis of their aggregative theories to identify some essential analytical and policy differences between Monetarists and Fiscalists, from any other differences that reflect transitory factors, and may therefore diminish in time.

I. The analysis of money

Monetarists and Fiscalists have substantially different theories of money which may be illustrated by briefly reviewing the distinction between the supply determined nominal money stock and the demand determined stock of real cash balances. Monetarists follow the classical tradition in their theoretical analysis and treat the nominal money stock as a kind of veil and stress that its influence is primarily on nominal variables, with very little permanent impact on the real endogenous variables. But

(2) Not all Fiscalists favor activism or fine-tuning. Thus Samuelson, in a recent discussion, has pointed out that once the existence of lags is introduced explicitly into the model, it does tend to weaken the case for activism and fine-tuning. See A. F. Burns and P. A. Samuelson, *Full-Employment, Guideposts and Economic Stability* (Washington, 1967). See also A. M. Okun, *The Political Economy of Prosperity* (Brookings, 1970), pp. 109-115 for his interpretation of fine-tuning.

as they move from monetary theory into the analysis of business cycles and stabilization policy, the money stock is somehow transformed into a powerful lever for determining income, employment, and the price level. In their policy recommendations, Monetarists leave no doubt that they regard control of the money stock as the key not only to curbing inflation but also to preventing depressions (3).

The notion that nominal money is a veil seems at cross purposes with the simultaneous policy emphasis on money as the key variable for stabilization. The theoretical proposition that changes in money will not, substantially, affect any of the real endogenous variables seems at variance with the policy recommendation to impose either rules or policy guidelines on monetary growth in order to stabilize the economy. The first statement suggests that monetary changes will affect only nominal variables, while the second statement seems to suggest that changes in nominal money may be the key for achieving our macroeconomic goals.

To resolve this paradox we note first that the nominal money stock may affect nominal variables such as money income, the money wage, and the price level without necessarily exerting any *direct* influence on such endogenous variables as the real wage or the long term rate of economic growth. There are however two circumstances in which changes in nominal money stock may have a significant impact on the real economy: thus, in an economy where output can easily expand, where prices are stable, and where markets are cleared through quantity adjustments rather than price movements, an increase in nominal money may bring about an increase in real output and employment; at the other extreme, in an economy where output can no longer expand, where

(3) The statement that Monetarists view nominal money as a veil needs to be qualified in the following sense. Some recent growth models suggest that alternative monetary policies, incorporating different rates of growth for the money stock, may affect some of the steady state values of the endogenous variables in the real economy. For a recent discussion of these issues in the context of money and growth models see A. Marty, "The Optimal Rate of Growth of Money" and J. Tobin, "Notes on Optimal Monetary Growth", in the *Journal of Political Economy*, August 1968, and the two papers by R. Clower and H. G. Johnson on "*Is There An Optimal Money Supply?*" in a forthcoming symposium on this subject. See also J. L. Stein, "Monetary Growth Theory in Perspective", *The American Economic Review*, March 1970 and his references to the papers by F. Hahn, H. G. Johnson, D. Patinkin, B. Pesek and T. Savings, J. Tobin and H. Uzawa.

markets are cleared through price changes, strict control of nominal money may be the key to price stability irrespective of whether the endogenous variables in the real economy are affected by the changes in monetary growth rates. In these two cases, control of nominal money may be the key policy for stabilizing income and employment and preventing both depressions and inflations.

The analysis of these cases may be illuminated if we follow the Monetarist distinction between supply-determined policy variables and demand-determined endogenous variables. The money stock is viewed as determined primarily by the conditions of supply since Monetarists assume a fairly close link between the monetary base (or high-powered money) and the stock of money held by the public. The real money stock, on the other hand, is treated as an endogenous variable determined by the interaction of the real and financial sectors and given by the demand function for real balances. The crucial distinction is that the monetary authorities can control the nominal money stock and treat it as an (instrumental) variable for implementing policy, but cannot control the real money stock to achieve policy objectives (4).

The sharp distinction drawn between the supply determined nominal money stock and the demand determined real money stock — a key feature of monetarism — endows the authorities with effective control over the nominal money stock, while severely limiting the extent, and the circumstances, in which they may hope to influence the real value of this stock. If the former assumption extends their control over nominal variables, the latter assumption severely limits their influence and control on endogenous variables such as the real money stock (5).

The Monetarists' analysis of money in these cases may be summarized as follows. (1) The monetary authorities can effectively

(4) The proposition that the quantity of nominal money is determined by conditions of supply is not intended to rule out the possibility that some changes in the quantity of money may result from shifts in the demand for money. What it does attempt to say is that the central bank can exercise effective control over the nominal money stock through its control of the monetary base. See D. I. Fand, "Some Implications of Money Supply Analysis", *The American Economic Review*, May 1967.

(5) Many Fiscalist models do not distinguish between nominal and real balances, and even the large scale models do not impose well defined equilibrium conditions restricting the quantity of real balances. The Fiscalist model may, in this sense, allow the authorities less control over nominal balances and greater control over real balances, as compared to the Monetarist model.

control the nominal money stock and its rate of growth for policy purposes, but cannot, in general, control the real balances. (2) Attempts by the authorities to increase real balances by printing nominal money, will generally fail and serve only to raise prices and generate inflation. (3) The singular case where the authorities can hope to permanently raise real balances by printing money requires that prices are stable, that the economy has a substantial volume of unused resources, and that markets are cleared through quantity adjustments. (4) The hypothesis that the stock of real balances is an endogenous variable (and relatively invariant to policy actions by the authorities) implies that an increase in nominal money will bring about permanently higher prices, rather than lower interest rates.

The Monetarists' linking of nominal money with prices follows from the assumption that the real money stock must satisfy the demand for real balances. The endogeneity of real cash balances is derived from the money demand function and serves as the basis for developing a relation between nominal money and the price level. This linking of money and prices through the demand for real balances contrasts sharply with the Fiscalists' liquidity preference theory which uses the same money demand function to develop a theory relating money and interest rates.

II. The analysis of interest rates and prices

Monetarists and Fiscalists have substantially different theories of the interest rate and of the price level. The Monetarists have a monetary theory of the price level, a non-monetary theory of the (real) interest rate, and distinguish between real rates and market interest rates, while Fiscalists tend to have a monetary theory of the interest rate and a non-monetary theory of the price level. Fiscalists assume that an increase (or accelerated growth) in nominal money lowers interest rates (and/or raises output), which may tend to minimize its effect on prices; Monetarists assume that monetary growth will raise prices (6) (and/or output), which tends to minimize its permanent effect on real rates.

(6) The statement that the Fiscalists have a monetary theory of the interest rate and a non-monetary theory of the price level needs to be modified somewhat when we consider the large scale econometric models. But while these models do allow for some feedback

Monetarists and Fiscalists also disagree about the theoretically negative, but historically positive, association between money and interest rates. The income-expenditure theory postulates that an increase in nominal money will have a direct, and immediate, effect on interest rates but not on prices, and thus rationalize a negative *ceteris paribus* association between money and interest rate movements. In contrast, the quantity theory assumption, that the real value of the money stock is an endogenous variable — relating money and prices — provides a basis for rationalizing the historical movements of money, prices, and interest rates. The positive association between interest rates and prices is interpreted as a *mutatis mutandis* relation, where the induced income and price expectation effects of monetary growth offset the initial negative liquidity effects (7).

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from money to prices, they still retain the negative association between money and interest rates, and the monetary effects on the price level appear to be attenuated.

Thus, simulation experiments with the FRB-MIT Model starting with 1964 (1) indicate that a $1 billion increase in reserves will raise the price deflator by 0.1 of a point after four quarters, by 0.5 of a point after 8 quarters and by a full point after twelve quarters. This rise of one point in the deflator is a result of an increase in reserves of approximately 5%, an increase in M_1 of approximately $5 billion, and an increase in M_2 of approximately $11-14 billion. These same simulation experiments also indicate that a $1 billion increase in reserves lowers the Treasury bill rate and the corporate bond rate for periods up to (and possibly beyond) 20 quarters. For unborrowed reserves, the reduction in bill rate, after 20 quarters, is 19 basis points while the reduction in the bond rate is 15 points; for total reserves, the reductions in the bill rates and the bond rate are 58 and 26 basis points respectively. See G. Kaufman and R.D. Laurent, "Simulating Policy Strategies in the FRB-MIT Model Under Two Alternative Monetary Policy Regimes", a Staff Memorandum, Federal Reserve Bank of Chicago, October 1969.

This suggests that even the large scale models retain the main features of the simpler Fiscalist models, in highlighting the effect of money on interest rates and deemphasizing its effect on prices. These results do not seem to approximate the more classical results. See D.I. Fand, "Some Issues in Monetary Economics", in this *Review*, September 1969.

(7) To illustrate the price level theory incorporated in the large econometric models, we cite the following account of the method used in the FRB-MIT Model:

> "Prices are assumed to be a variable markup over wages, with excise taxes completely shifted onto consumers. The variables determining the markup are the productivity trend which allows producers to maintain profit shares even though wages rise faster than prices, farm and import prices, which measure other costs, and the ratio of unfilled orders to shipments, which indicates demand shifts".

See F. de Leeuw and E. Gramlich, "The Channels of Monetary Policy", *Federal Reserve Bulletin*, June 1969.

Two comments on this kind of microeconomic non-monetary price level theory may be noted: first, as a microeconomic theory it seeks to explain *rising* prices with a mechanism that may rationalize *high* prices. Second, as a non-monetary theory it seeks to explain

The Monetarists' theory of interest rates emphasizes the importance of price expectations on market rates by distinguishing between *nominal* rates and *real* rates; and it utilizes this link between money and prices to rationalize the positive association of monetary growth, commodity prices and market interest rates. Monetarists also distinguish between *high* rates when the rate of inflation is fully anticipated and *rising* rates to clarify the relation between market rates and rising prices. These important concepts of nominal rates and real rates, of *high* (low) rates and *rising* (falling) rates, and their relation to rising (falling) prices and monetary growth were developed by Irving Fisher in the 1890's (8).

Fisher's theory, relating monetary growth, prices, and market rates helps rationalize the puzzling, though well documented, Gibson Paradox — the empirical association between high interest rates and high prices. The Fisher model postulates: that market rates are *high* (low) when prices are *rising* (falling); that market rates lag behind price level changes; that market rates are highly correlated with a weighted average of past price level changes. Gibson's empirical finding that *high* (low) rates accompany *high* (low) prices may then be rationalized by assuming a fairly long lag between interest rates and prices. The Fisher theory thus suggests a sequence in which (excessive) money stock growth will cause *rising* prices and ultimately *high* interest rates; it also suggests that these high nominal rates cannot be brought down unless we can slow down the rate of inflation (9).

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price level movements without restricting the behavior of the monetary aggregates. See D.I. Fand, "The Monetary Theory of Nine Recent Quarterly Econometric Models in the United States", forthcoming in *Journal of Money, Credit and Banking*, August 1970.

(8) To illustrate this point assume that the real rate, r, is 5 per cent and stays at that level, that the rate of inflation, i, is expected to continue indefinitely at a 20 per cent annual rate. When the rate of inflation is fully anticipated, the market rate, m, should settle at 26 per cent, as shown in the equation, $m = r + i + ri$.

(9) For an analysis of the Gibson Paradox see I. Fisher, *Appreciation and Interest* (Macmillan, 1930); *The Theory of Interest* (Macmillan, 1930); J.M. Keynes, *A Treatise on Money* (Macmillan, 1930); D. Meiselman, "Bond Yield and the Price Level: The Gibson Paradox Regained", in D. Carson (ed.), *Banking and Monetary Studies* (Irwin, 1963), and his "Money and Factor Proportions" (M.S., 1964). See also the summary of the Wicksell and Keynes Analysis in P. Cagan's, *Determination and Effect of Changes in the Stock of Money* (Columbia University Press, 1965); M. Friedman and A. Schwartz, *Trends in Money, Income and Prices* (M.S.) and D.I. Fand, "Keynesian Monetary Theories, Stabilization Policy, and the Recent Inflation", *Journal of Money, Credit and Banking*, August. 1969.

W.J. Yohe and D.S. Karnosky in a comprehensive article on "Interest Rates and Price Level Changes 1952-1969" in the *Review* Federal Reserve Bank of St. Louis, December

Monetarists following the Fisher model thus relate monetary growth rates, rising prices, rising rates, and ultimately high market rates. They define the following four interest rate concepts: (1) *market* rates, nominal interest rates that are sensitive to price movements and inflationary expectations; (2) *real* rates, market interest rates corrected for the expected rate of inflation; (3) *rising* rates, rising market rates when price expectations are accelerating to keep up with the actual rise of prices; and (4) *high* rates, stable market rates when the rate of inflation is fully anticipated and reflected in price expectations. To distinguish between *nominal* and *real* rates, Monetarists introduce a price expectation variable in order to rationalize a rise (fall) in market rates (relative to the real rate) when prices are rising (falling).

The liquidity preference theory of the Fiscalists tends to abstract from any direct link of monetary growth on prices and does not distinguish between market rates and real rates. Fiscalists do not, ordinarily, think of rising prices as a cause of rising market rates, do not, ordinarily, distinguish between *rising* rates and *high* rates, and do not accept the Fisher rationalization of a *mutatis mutandis* positive association of monetary growth, commodity prices, and market interest rates. To introduce these distinctions in an income-expenditure model would essentially undermine the interest rate transmission mechanism in which market interest rates serve as an indicator of monetary policy, a measure of the cost of capital, and a transmitter of monetary impulses. As a consequence, they tend to postulate an increase in the natural rate relative to the market rate, or an increase in the demand for money, causing market rates to rise in order to explain the positive association of interest rates and prices. Monetary growth, on this view, is not the cause of rising market rates; on the contrary, it is often viewed as preventing the rise in interest rates from reaching the higher levels it would have attained otherwise.

The consequences of denying the Fisherian theory relating monetary growth, prices and nominal interest rates may be far reaching. The reluctance to introduce a price expectations variable in the analysis of market rate movements and to distinguish between

1969, provide a succinct statement of the Fisher theory and a careful discussion of the theoretical aspects of the Gibson Paradox. They derive alternative estimates of the real rate, and relate this analysis to explain interest rate movements in recent years.

market rates and *real* rates has two subtle analytical consequences, with important substantive implications; first, Fiscalists must postulate successive upward shifts in the demand for money — or a series of autonomous increases in the natural rate — in order to explain a continuing rise in market interest rates, without introducing rising prices or price expectations as explanatory variables; second, Fiscalists must also postulate that the variability in *market* rates corresponds to changes in *real* rates, if they do not distinguish between *nominal* and *real* rates. These two sets of assumptions, taken together, suggest that *real* interest rates, rates of return, and the marginal productivity of capital, are highly volatile. This extremely important substantive conclusion that the real economy may be unstable follows from the assumption that market rates are relatively independent of past, present, and expected price level changes, and the further identification of *market* rate movements with changes in *real* rates. This conclusion clearly does not follow if we introduce the Fisherian interest rate concepts.

The Monetarists' theory enables us to explain the association of rising rates with inflation, of high rates with high prices, and of high and rising rates with excessive monetary growth. Because this rationalization is not available to the Fiscalists, they must hypothesize shifts in the demand for money, or increases in the natural rate, in order to explain the rise in market rates, at a time when the high rates of monetary growth should be causing rates to decline. The assumption that the observed variability in market rates corresponds to the underlying volatility of real rates, and the possible implication concerning the instability of the real economy, are therefore directly related to this analytical framework — and to the negative *ceteris paribus* liquidity preference relation between money and interest rates. They serve, therefore, to highlight and emphasize the extraordinary contribution of Fisher's theory relating money, prices, and interest rates.

III. The analysis of fiscal policy

Monetarists and Fiscalists disagree on the potential contribution of discretionary fiscal policy to short run stabilization, and on the relative importance to attach to the long run effects of fiscal action: Monetarists follow the older pre-Keynesian public-finance tradition, think of the budget as determining, in the long run,

the allocation of resources from the private to the public sectors — and as having only secondary importance in stabilization; Fiscalists follow the post-Keynesian fiscal policy tradition and view the budget decision as the key macroeconomic policy variable for controlling aggregate demand and for short run stabilization.

It is sometimes suggested that Monetarists exaggerate the importance of money, and, in consequence, downgrade the significance of fiscal policy. This, in our view, is only partially correct and may be quite misleading. The proposition that Monetarists downgrade fiscal policy has some limited validity, if the relative importance of policies is determined solely on the following criterion: the dependability (or reliability) of the short run aggregate demand associated with given (discretionary) changes in this set of policies. But to use this criterion for ranking the importance of alternative policies introduces a distorting oversimplification. Thus, if we use an alternative criterion and rank policies in terms of their permanent impact on key endogenous variables, Monetarists would appear to have a very healthy respect for fiscal policy; indeed it is precisely because fiscal actions may have such permanent effects that Monetarists are reluctant to favor discretionary changes even when confronted with so important a problem as stabilization policy. A second complicating factor is that the analytical frameworks that Monetarists and Fiscalists use to analyze fiscal policy are geared to emphasize either the short run stabilization or the long run allocation effects. As a consequence those who highlight the stabilization effects of fiscal actions may leave an impression that they tend to abstract from the longer run allocative effects. Yet if we seek a proper understanding of the Monetarists' position on fiscal policy, we need consider both the stabilization effects as well as the longer run allocative effects.

Our discussion of fiscal policy will proceed as follows: we first examine the views of Monetarists and Fiscalists with respect to the stabilization aspects of fiscal policy, and find genuine substantive disagreements. We then go on to examine some of these differences which, while they emerge in discussion of fiscal policy, may actually reflect the alternative definitions used implicitly to calibrate monetary policy. The next question that we explore is how Monetarists and Fiscalists assess the opportunity costs of using fiscal policy for stabilization; and it does appear that some

fiscal policy differences may actually reflect differing underlying judgements as to the role that monetary policy can play in stabilizing the economy. We conclude this discussion of fiscal policy by suggesting that there is a reversal of their views in long run analysis, with Monetarists favoring fiscal action while Fiscalists (*i.e.* the neo-classicists) tend more in the direction of monetary action.

A. *Stabilization Aspects*

Monetarists typically emphasize the close relation between rates of monetary growth and changes in money income, and, for this reason, are sometimes viewed as suggesting that fiscal policy changes — *e.g.*, a rise in taxes holding government expenditures constant — will not have any effect on aggregate demand. Although this is a plausible deduction from some Monetarist statements, it is not, in my opinion, a correct statement. Monetarists must surely acknowledge (1) that an increase in taxes (holding government expenditures constant) which reduces the (privately held) money stock will certainly depress private expenditures, and (2) that an increase in taxes where both government expenditures and the monetary aggregates (or their rate of growth) are held constant, will tend to depress private spending. The increase in the surplus (or reduction in the deficit) causes market interest rates to fall, and reduces private spending if the demand for money is interest elastic. Indeed the reduction in private expenditures may be rationalized on monetary grounds, and does not even require a link between taxes, disposable income, and consumption expenditures along the lines of the income-expenditure theory.

What the Monetarists do question is whether a *mutatis mutandis* increase in taxes (that is, without any *ceteris paribus* restriction placed on government expenditure and the monetary growth) will necessarily reduce private spending and aggregate demand. They suggest (1) that the effect on consumption expenditures may be small and uncertain depending as it does on the impact of temporary changes in current disposable income on permanent income and on consumption; (2) that the tax increase will not reduce private spending if it is associated with an increase in government expenditures; and (3) that even if the net effect of the combined increase in taxes and expenditures is deflationary, this reduction

in aggregate demand may still be offset by the increase in the monetary aggregates.

The effect of a *mutatis mutandis* increase in taxes, where both government expenditures and the money stock do rise, must clearly be distinguished from a tax increase in which government expenditure and the monetary growth rates are both impounded in *ceteris paribus*. There is no theoretical disagreement concerning the need to specify restrictions on government expenditures in the analysis of proposed tax changes, and fiscal actions are for this, and other reasons, typically measured in terms of the full-employment surplus. But while the full-employment surplus measure does take account of both taxes and expenditures, it does not specify any requirements for the money stock or its rate of growth. Note too that the full-employment surplus is typically given as a dollar amount; it is not adjusted for changes in the price level, for differing rates of inflation, and it is defined in nominal terms and not in real terms (10).

Prior to 1968, Fiscalists probably would have rejected the view that a substantial rise in taxes would be offset by an increase in the monetary aggregates, in the face of sharply rising interest rates. Thus, the increase in taxes in the *Revenue and Control Act* of June 1968 coupled with rising interest rates was widely interpreted as a very restrictive action, with predictions of overkill, in spite of the accelerated growth in the monetary aggregates. The accelerating inflation since 1968 seems to suggest that the monetary aggregates rather than market rates may be relevant in determining the impact of monetary actions on private spending in such cases.

(10) There has been recent questioning concerning the full-employment surplus, its measurement, and the extent to which its behavior affects income and supports the multiplier theory. G. Terbough has pointed out that there is no obvious and apparent connection between changes in GNP and changes in the full-employment surplus. And the recent Andersen Jordan Study also raises similar questions concerning the aggregate demand effects of changes in the full-employment surplus. See G. TERBORGH, *The New Economics* (Washington, 1968) and L. C. ANDERSEN and J. JORDAN, "Monetary and Fiscal Actions: A Test of Their Relative Importance in Economic Stabilization", in *Review* Federal Reserve Bank of St. Louis, November 1968.

The full-employment surplus is usually expressed as a nominal quantity so that a surplus of $15 billion is presumably as restrictive for a 500 billion GNP as for 900 billion GNP, and it is not corrected for expected price changes. For a recent attempt to deal with some of these problems, and to adjust for the effects of inflation, see A. M. OKUN and N. TEETERS, "The Full-Employment Surplus Revisited" in a forthcoming Brookings publication.

It also seems reasonable to suppose that there is growing agreement on this point (11).

The escalation of inflationary pressures since June 1968 would seem to suggest that a *mutatis mutandis* increase in taxes coupled with a very substantial rise in market interest rates was offset by the increase in the monetary aggregates. Similarly, our experience in 1966 would also suggest that a substantial increase in the fiscal deficit was offset by the sharp deceleration in the monetary growth rates, leading to the minirecessions of early 1967.

This statement that fiscal surpluses can be offset by high monetary growth rates even when market interest rates are rising, as evidenced by our experience in 1968, incorporates a good deal of what the Monetarists need to say about the stabilization effects of fiscal actions; and it is surely not equivalent to saying that fiscal actions have no short run aggregate demand effects. To conclude that a *ceteris paribus* fiscal action has no short run effect on aggregate demand, one must be prepared to argue that substantial changes on either the revenue or expenditure side of the budget will have very little direct effect on investment spending even if accompanied by substantial interest rate changes in the capital markets, and will also have very little indirect effect on aggregate demand through changes in the desired holdings of real balances. But this can be true only in the exceptional case of a completely (interest) inelastic demand for money.

But Monetarists may still question whether the aggregate demand effects are small or large, whether or not they are subject to lags, whether these effects are dependable or easily predictable, and whether the long run allocation effects should be sacrificed for these short run stabilization gains. Finally, any doubts that

(11) The conjunction of a non-monetary theory of the price level together with a presumed negative association between money and interest rates may explain why the large models failed to alert policy officials to the dangers of accelerated monetary growth in 1967 and especially in 1968. The econometric models predict, of course, that accelerated monetary growth will intensify the inflationary pressures, but only when it is associated with falling market interest rates. Many forecasters relying on the econometric models interpreted the rising (and high) interest rates in the 2nd half of 1968 as manifesting tight money and predicted a substantial slowing in the GNP, because both monetary and fiscal policies were restrictive. The impact of inflationary expectations on nominal interest rates was apparently overlooked, and most of the non-monetary models failed to see the 1968 developments in proper perspective. See D. I. FAND, "A Monetary Interpretation of the Post-1965 Inflation in the United States", in this *Review*, June 1969.

one may have over the stabilization effects of a *ceteris paribus* fiscal action clearly do not carry over to a *mutatis mutandis* action, where changes in the monetary aggregates reinforce the fiscal action.

B. *The calibration of monetary policy*

The substantive issues between Monetarists and Fiscalists concerning the contribution of fiscal policy to short run stabilization may be somewhat exaggerated. Their differences do not always reflect contradictory, or different, analysis of the same question, but arise quite often because there is a genuine disagreement as to how to classify, or identify, fiscal and monetary actions. To illustrate, the rise in GNP following the tax cut in 1964 was related to the rise in disposable income in income-expenditure models and attributed to monetary growth in quantity theory models; and this difference in the analysis and interpretation of a given action can be traced, in turn, to the alternative definitions that Monetarists and Fiscalists use, often implicitly, to measure monetary actions (12).

Monetarists calibrate monetary action in terms of the growth rates of the monetary aggregates. Fiscalists, in contrast, calibrate monetary action in terms of market interest rates and frequently identify a constant monetary policy with stable interest rates. Accordingly, a fiscal deficit accompanied by stable interest rates is a *ceteris paribus* fiscal action in the important sense that the entire increase in income can be attributed to the deficit. But if interest rates are to be stable the government deficit must be

(12) To cite one example, Milton Friedman has analyzed this period as follows:

> "If you look at what happened to money, you will find that the temporal pattern of money supply conforms much better to the temporal pattern of nominal income than does the tax cut. There was a decided tapering off in the growth of money supply in early 1962 through about the first three-quarters of '62. This was reflected in the last part of '62 and early '63 by a tapering off in the economy. You then had a switch in monetary policy. It became more expansive — the quantity of money started growing — and lo and behold, about six or nine or ten months later, before the tax cut had taken effect, income started to rise at a more rapid rate".

See the M. Friedman - W. W. Heller dialogue, *Monetary vs. Fiscal Policy* (Norton, 1969), p. 56.

financed by the banking system through accelerated monetary growth — precisely what Monetarists define as an expansive monetary action. Thus, the substantial growth of income following the 1964 tax cut in the United States may be viewed as evidencing the power of either monetary or fiscal policy depending on which measure one uses to gauge the posture of monetary policy. Moreover since fiscal deficits (surpluses) and accelerated (decelerated) monetary growth tend to move together, it is only in such singular periods — as in 1966 and 1968 — when the monetary aggregates and the full-employment surplus move in opposite directions that we get any real test of their relative effects (13).

Observed differences with respect to the effects of a fiscal action may therefore reflect a genuine substantive difference concerning the effects of that action, or it may reflect different implicit definitions, adopted by Monetarists and Fiscalists, concerning the classification of that action. Thus, Monetarists and Fiscalists will often agree that a given action will be expansive or deflationary while at the same time evidencing considerable disagreement on the analysis and interpretation of the forces generating the expansion (contraction). To illustrate this point let us consider the following three cases: (1) an increase in taxes; (2) a deficit financed outside the banking system, and (3) a deficit financed through money creation (14).

(13) In the FRB-MIT Model, the posture of monetary policy is gauged in terms of changes in unborrowed reserves. Accordingly, when they compare two fiscal actions and seek to hold monetary policy constant, they run their simulations holding unborrowed reserves at a constant level. This procedure does not, however, hold either the money stock or its growth rate constant.

Thus, in the FRB-MIT Model published in 1968 they found that the defense spending multiplier is 3.2 in contrast to a personal tax cut multiplier of 4.2. The authors point out that these results are substantially different from the estimated multipliers in the Brookings, Wharton and Michigan models which they exhibit in table 6. Yet their own calculations show that the changes in demand deposits resulting from a change in the personal tax rate exceed those resulting from a change in defense expenditures as shown in Charts 3 and 9. It is therefore quite possible that their surprising results can be explained by this difference in monetary growth in the two cases. See F. de Leeuw and E. Gramlich, "The Federal Reserve-MIT Economic Model", *Federal Reserve Bulletin*, January 1968, pp. 27-29.

(14) In this analysis, I am considering a proposed increase in taxes to wipe out an impending deficit, and comparing it with the alternative of taking no tax action and having a deficit financed either outside the banking system, or through money creation. A similar analysis of a proposed tax to generate a surplus, would require a more extended discussion of the relevant alternatives.

1. An increase in taxes to keep up with the increase in expenditures and to avoid the necessity of a deficit, or of an increase in the deficit. To Fiscalists this way of dealing with the increase in expenditures in the budget will have the most deflationary effects on aggregate demand. While they do distinguish between a deficit financed outside the banking system and a deficit financed through money creation, the two kinds of deficits are viewed as being homogeneous relative to an increase in taxes which reduces disposable income. To the Monetarists a deficit financed outside the banking system and an increase in taxes may be homogeneous relative to a deficit financed through the banking system and associated with accelerated monetary growth.

2. A fiscal deficit financed through borrowing in the capital markets and associated with a constant money stock (or constant monetary growth). Since there is no money creation involved, Monetarists would be inclined to say that the effects may be small and possibly not very different from an alternative policy in which the deficit would be eliminated by an increase in taxes. They would suggest that the effects will depend on the interest elasticity of savings and investment, and on the interest elasticity of the demand for money; and they may also distinguish between a deficit resulting from an increase in expenditures and a deficit resulting from a reduction in taxes. Fiscalists would be inclined to treat this kind of a deficit — financed through non-bank borrowing — as being substantially different from the first policy considered in which the deficit is eliminated by an increase in taxes.

Some Fiscalists may abstract from the money stock effects and treat a deficit financed through the capital market as being essentially similar to a deficit financed through money creation. A deficit financed through the capital market does not involve any reduction in disposable income, and, for this reason, they may be inclined to view the borrowing case almost as if it were identical with the money creation case. But their analysis does emphasize the interest elasticity of investment and other expenditure functions, as well as the response of expenditures to changes in disposable income, and unless we assume, or require, a monetary policy which keeps interest rates stable — an accommodative policy — they would concede that a deficit financed through borrowing with a given rate of monetary growth is more restrictive than a deficit financed through money creation. The Monetarists, in sharp contrast, are inclined to treat the borrowing case almost as if it were identical with the taxing case. It would appear that both Monetarists and Fiscalists do agree that the expansionary effects of a deficit financed by borrowing will be smaller than for a deficit where accelerated monetary growth is reinforcing the income generating effects associated with the deficit.

3. A fiscal deficit financed through money creation and associated with stable interest rates. This case would probably evidence the greater disagreement in analysis and interpretation. But as we suggest, this disagreement is not really about the predicted effects of this action, but rather on how to allocate the expansion in income to the fiscal deficit and to monetary growth. Thus, to those who think of market interest rates as an appropriate measure of monetary action, this is the ideal, and pure, case of a fiscal action, and some Fiscalists do attribute the entire increase in income to the expansionary effects of fiscal deficits. On the other hand, if we calibrate monetary policy in terms of money stock growth rates, this is a monetary action that is also associated with a deficit. Monetarists may attribute most, if not all, of the increase in income to the monetary expansion, and argue further that this case cannot be cited as an example to illustrate the impact of a pure fiscal action on private spending.

Clearly, Monetarists and Fiscalists do agree that a fiscal deficit associated with money creation is unambiguously expansionary; and similarly for a surplus associated with decelerated monetary growth.

This analysis suggests that Monetarists and Fiscalists do not always disagree over the aggregate demand effects that are likely to follow from a particular action. Quite often their disagreement incorporates a basic, and often implicit, analytical difference as to whether a particular expansionary action is to be explained in terms of a fiscal multiplier or money multiplier. Thus, the analytical difference concerning the appropriate way to calibrate monetary policy explains a good deal of what may otherwise appear as differences with respect to the efficacy of fiscal policy. Accordingly, if we keep in mind this conceptual difference, we can explain away some of the fiscal policy differences; but some of the substantive differences concerning fiscal policy effects do remain,

and will not be resolved until we obtain additional research on the aggregate demand effects of alternative fiscal actions.

C. *The opportunity costs of using budget policy for stabilization*

Fiscalists who work with the income-expenditure theory would like to use the full-employment surplus as the key macroeconomic policy variable for controlling aggregate demand. To some extent this requires that we pay correspondingly less attention to the allocation function of the budget relative to its stabilization function.

The opportunity costs of introducing discretionary budget changes for stabilization purposes may not appear to be large, and may even be negative, if one concludes that monetary policy cannot be used effectively to stabilize the growth in aggregate demand; and this was a view common among stagnationists and other Fiscalists until very recently. In the early days of the Keynesian Revolution, it was widely believed that monetary policy had very little effect on aggregate demand, and the macroeconomic model that was widely used in those days was characterized by wage rigidity, by a potential liquidity trap, and by elasticity pessimism. There was a revival of monetary policy in the early 1950's, and the stagnationist fears of the 1930's appeared to be receding. Unfortunately, this revival was cut short when countercyclical monetary policy, as it was understood and practiced in the 1950's, appeared ineffective in stopping the mild inflations of the 1950's. For this reason, many Fiscalists concluded — at the close of the fifties — that monetary policy was apparently ineffective in dealing with the mild inflations of the advanced industrial countries associated with wage or cost push, markup, administered price, demand shift, and sectorial inflation. The Fiscalist view of history as it was manifest in the early 1960's could be summarized as follows: monetary policy had proven itself to be ineffective in dealing with the deep depressions of the 1930's; and it proved to be almost equally ineffective in dealing with the mild inflations that the industrialized countries experienced in the 1950's. Obviously, given these pessimistic views about monetary policy, there is very little cost, and considerable gain, in using budget policy for stabilization purposes.

The Monetarists have rejected this Fiscalist interpretation of the 1930's and the 1950's and hold to the view that monetary

policy may be used to stabilize the economy. They also argue that the historical evidence does not support the claims made for the multiplier analysis of fiscal policy, if we clearly distinguish in our empirical work between the *ceteris paribus* and the *mutatis mutandis* deficits. They view the budget in older, pre-Keynesian, public finance tradition as being primarily concerned with the allocation of resources from the private to the public sector, and they question whether it is good policy to constrain the important priorities in the budget decision by the overriding importance of short run stabilization goals — especially if the stabilization objectives can be achieved through monetary policy.

Waiving desirability for a moment, Monetarists also question the effectiveness of fiscal policy. They question whether these discretionary fiscal policy effects may not involve a fairly long lag, whether they can be realized quickly, and whether they are dependable, and easily predictable. The wisdom of using fiscal policy as a short run stabilization instrument, and its effectiveness in that role, are both questioned.

Monetarists conclude that fiscal policy changes are likely to have their permanent effects on the flow of resources from the private to the public sectors, and do not see the budget policy as an efficient stabilization instrument. At the same time, they also emphasize that a stabilizing monetary policy is itself a very important and powerful force in overcoming the destabilizing forces in the economy. In this respect they take issue with the Fiscalists who think of monetary policy as determining either the level of interest rates and/or the composition of liquid assets — as an accommodative instrument that may be used in implementing fiscal policy — but not one capable of a direct contribution to stabilization.

D. *The reversal of positions in long run analysis*

The Monetarists' view is that the *ceteris paribus* fiscal effects on aggregate demand may be uncertain and subject to lags, that these effects are not entirely dependable or easily predictable, and that the important long run allocation effects implicit in the budget decision should not be sacrificed for the alleged short run stabilization gains. For all these reasons, they do not view budget policy as an efficient stabilization instrument. Moreover, they also

hold that the need for such discretionary fiscal action may be less urgent, to the extent that a stabilizing monetary policy is itself a powerful factor in eliminating the very forces that generate instability in the private economy. Monetarists emphasize the key role of money in stabilization policy and disagree with the neo-classical Fiscalists who view monetary policy as playing an important role in determining real rates of return, with the Radcliffe Fiscalists who view monetary policy as affecting the composition of liquid assets, and with the accommodative Fiscalists who view monetary policy as a permissive instrument for implementing fiscal policy.

Fiscalists, on the other hand, conclude that budgetary actions do have an important role to play in controlling aggregate demand. They view fiscal policy as a relatively efficient short run stabilization instrument and, accordingly, place considerable weight on the contribution of discretionary fiscal policy to short run stabilization. As already indicated, there is a considerable range of views concerning monetary policy; Radcliffe Fiscalists think money policy affects the composition of liquid assets; accommodative Fiscalists, that it is primarily permissive; and neo-classical Fiscalists think of monetary policy as affecting rates of return and the long term rate of economic growth. All Fiscalists emphasize the short run stabilization role of fiscal policy. But the neo-classical Fiscalists, unlike the Radcliffe and other Fiscalists, provide a different analytical justification for this policy mix, and do not, in particular, downgrade the aggregate demand effects of monetary action in reaching this position.

If we move away from short run stabilization problems and focus on the longer run allocative effects of alternative policies, there appears to be a reversal of positions. Thus, suppose it was necessary for the Government to select a policy to effect a permanent change in the rate of capital formation. Monetarists would have to find some fiscal policy while (some) Fiscalists would seek to achieve this result with monetary policy. Although Monetarists believe that control of the money stock is the appropriate and preferred instrument for dealing with stabilization problems, they also believe that monetary actions have their permanent effects on prices. As a consequence it follows that fiscal policy may be the only instrument to bring about permanent changes in interest rates, capital formation (and possibly the long term rate of growth)

as well as permanently changing the resource flow from the private to the public sector. Similarly, while all Fiscalists emphasize the importance of changes in the full-employment surplus for short run stabilization, the neo-classical Fiscalists accept the hypothesis that appropriate monetary actions may bring about permanently lower interest rates along with a higher rate of capital formation, and economic growth.

Their respective views on the long term effects of monetary and fiscal policy appear as the mirror image of their positions on stabilization. Since Monetarists postulate that in the long run money is essentially a veil (having its permanent effects primarily on prices) they would of necessity have to rely on some kind of fiscal action if public policy required some change in interest rates and rates of return. In contrast the neo-classical Fiscalists argue that monetary actions may bring about permanent changes with respect to rates of return, capital formation, and economic growth. Thus, if we focus our attention on long run analysis Monetarists appear to emphasize the power of fiscal policy while the neo-classical Fiscalists seem to highlight the power of monetary policy. This suggests that Monetarists and Fiscalists cannot be adequately distinguished by the importance that each group attaches to either monetary or fiscal policy. Indeed both groups clearly believe that both policies are important. Where they do differ is in choosing their preferred policies for short run stabilization and for long run allocation.

One may question whether these differences between Monetarists and Fiscalists will continue to persist. Their differences in stabilization policy reflect to some extent the state of knowledge towards the end of the 1950's, when the monetary lag surfaced almost a decade before the relatively recent (post-1968 tax action) discovery of a similar lag in fiscal policy. The Fiscalists emphasis on budgetary actions for stabilization may have been based, in part, on the assumption that the fiscal policy lag is relatively minor. There is also a possibility that their differences concerning the long run effects of monetary actions may also be undergoing some transition. The hypothesis that monetary policy may affect capital formation and economic growth may appear much clearer in an economy where output can expand without any increase in prices, or if we confine our attention primarily to the short run. But if we consider the more general case, and not the special stagnation

case, and focus on the long run, the probabilities are increased that accelerated monetary growth will have its permanent effect mostly on prices rather than rates of return. In consequence, differences over both short run stabilization effects and the long run permanent effects of monetary and fiscal policy may tend to diminish somewhat in time, even if they do not disappear entirely.

Of course, one cannot be certain about these developments, even if there is a growing consensus that both monetary and fiscal policies are subject to long lags and even if the problems in the decades ahead involve economics at high rates of utilization rather than the economics of mature societies. The passage of time may diminish some differences but also introduce others. Also, some analysts may still wish to trade-off some of the longer run allocative functions of the budget in order to achieve some desired short run gains in stabilization. This may well be the future area of intellectual discourse between Monetarists and Fiscalists.

IV. Activism, discretion, fine-tuning, rules and guidelines

In this section we shall attempt to analyze the contrasting views of Monetarists and Fiscalists concerning rules, guidelines, discretion, and etc. We shall contend that many, if not all, of these differences can be explained in terms of the historical development of Monetarism and Fiscalism. In particular we stress three factors: (1) the chronological factor in the respective developments of Monetarism and Fiscalism, (2) the tradition of an independent central bank which tended to encourage the growth of fiscalism, and (3) the macroeconomic and large scale econometric models which, until quite recently, tended to deemphasize the impact of monetary policy on aggregate demand. This analysis suggests that the influence of these three factors may be diminishing over time. Accordingly we would not be surprised to find that their policy views with respect to activism, discretion, guidelines, will also diminish in time, even if they do not disappear entirely.

A. *The 1920's Monetarism and 1960's Fiscalism*

The Monetarist doctrine as it emerges in the 1970's differs quite substantially from the monetarism that first appeared in the 1920's. Latter day monetarism has gone through a maturation

process starting with an initial phase of exhilaration and euphoria in the 1920's, including a phase of depression and rejection in the 1930's and 1950's, a phase of recovery, rejuvenation, and reformulation in the 1960's and may now be ready to enter anew a phase of synthesis, hopefully combining analytical sophistication with maturity.

Monetarism first appeared on the national scene in the 1920's almost four decades earlier than Fiscalism, which made its official appearance as government policy with the rise of the New Economics in the early 1960's and is still in its childhood, chronologically speaking. A doctrine of monetary activism was articulated in the 1920's when it was discovered that open market operations could be used in conjunction with the rediscount mechanism to implement monetary policy. This discovery gave rise to very high hopes — almost blind faith — in the unlimited potential that could be realized through discretionary monetary policy (15).

The extremely optimistic assessments of the newly discovered central bank instruments stimulated an activist orientation to policy, which using current terminology, could be identified as a monetary fine-tuning doctrine. It may also be interesting to note that monetary activism developed in the 1920's — the period of social engineering in the United States. The very high hopes held out for monetary activism and fine-tuning in the 1920's were dashed, of course, by

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(15) The monetary activism and fine-tuning that emerged in the 1920's is described in the following statements by C. O. Hardy and L. W. Mints:

> "During the twenties economists developed an almost superstitious reverence for the supposed power of central banks to stabilize business through rediscount rates and open market operations. During the 30's there was a reaction against this view; some went to the other extreme and denied that central banking powers are strong enough to be of any value. Fiscal controls commanded the same sort of unquestioning allegiance that central bank controls had enjoyed in the twenties".

C. O. Hardy, "Fiscal Operations As Instruments of Economic Stabilization", *The American Economic Review*, 1948.

> "However, largely, but probably not exclusively, as a consequence of the price disturbance of the war years and the depression of 1921 there developed during the twenties a considerable amount of support for the position that the central bank should be charged with responsibilities of a broader kind. It was believed to an increasing extent that the central bank could and should so operate in general as to stabilize business conditions, and the more immediate and precise criterion of stabilizing the price level was frequently suggested".

L. W. Mints, *History of Banking Theory*, (University of Chicago Press, 1945, p. 271).

See also the discussion of the 1920's in L. W. Chandler, *Benjamin Strong, Central Banker* (Brookings, 1958), and M. Friedman and A. Schwartz, *A Monetary History of the United States, op. cit.*

the Great Depression and its aftermath. Whether the monetary pessimism that followed was justified or not, there can be no question that the over-reaction in the 1930's was extreme, and not unrelated to the exhilaration and euphoria of the 1920's. It was in this climate of opinion that the intellectual basis was being prepared for Radcliffism, although the official codification of this doctrine — that monetary policy hardly mattered — came later on in the 1950's in the Radcliffe Report.

The view that monetary policy was a relatively minor, and relatively unimportant instrument persisted during World War II and continued on in the Postwar years, when the Federal Reserve lost control over the money stock in the period when bond prices were pegged. The Accord between the Treasury and the Federal Reserve in 1951 took these restraints off the central bank, and opened up the possibility of a resurgence of monetary activism and the articulation of a monetary fine-tuning doctrine appropriate for the 1950's. But this revival was very short lived because monetary policy was held responsible for a succession of three recessions in the decade following the Accord. The inflationary recessions of the 1950's were generally viewed as examples of the so-called *New Inflation* associated with cost push and reflecting autonomous movements in aggregate supply, against which monetary policy was apparently helpless. Many economists therefore concluded that monetary policy was not only an ineffective weapon for preventing depressions — the lesson of the 1930's — but was also unable to prevent cost inflations — what many now come to regard as the lesson of the 1950's. The *New Inflation* of the 1950's was generally viewed as fairly strong evidence that a restrictive money policy was ineffective in stopping the inflationary rise in commodity prices resulting either from demand shifts, or a reduction in aggregate supply, even if it did result in a substantial increase in unemployment.

The Great Depression of the 1930's together with the inflationary recessions and the *New Inflation* of the 1950's brought about a complete loss of confidence in the role of monetary policy as a major weapon for preventing recessions or inflations. The death knell for monetary activism and fine-tuning was rung out so quickly in the 1950's in the Radcliffe report that there was hardly any chance to articulate a 1950's version. The rise and fall of monetary activism took place over the years 1920 to 1960 — a period of

some four decades. This sets the stage for the emergence of Fiscalism as official government policy in the 1960's.

Fiscalism appears on the national scene in the Kennedy administration as the economics of the New Frontier was being articulated, and reaches its heyday following the successful tax cut in 1964, widely interpreted as the outstanding success of fiscal activism. This — the golden period of fiscal activism — also witnessed the articulation of a fine-tuning doctrine. From the very start, fiscal activism was an integral part of the New Economics with its explicit and very strong commitment to economic growth. The best strategy to insure a high level of current activity, and to eliminate the $ 40-50 billion GNP gap between potential and actual output, was to promote policies to raise the long run rate of economic growth; and fiscal policy actions were to play a major role in shifting the policy stance away from a cyclical orientation towards growth (16)

This brief review of the two doctrines suggests that the Fiscalism that emerged in the 1960's is — in one sense at least — more nearly comparable with the enthusiastic pre-depression monetarism of the 1920's. The high aspiration levels of the youthful and exuberant fiscalism of the 1960's should not be compared with the middle-aged monetarism of the 1960's and 1970's which has been reformulated with the specific purpose of explaining the apparent monetary failures in the 1930's and 1950's. This maturing monetarism has obviously been sensitized to long and variable lags, is more modest in its aspirations, and consequently, finds greater appeal in a stabilization framework that emphasizes rules and guidelines rather than discretion.

Accordingly, it will not be surprising if the Fiscalism in the 1970's similarly gravitates away from discretion and fine-tuning and towards a guideline orientation and greater emphasis on automatic stabilizers. The apparent failure of the massive dose of fiscal restriction (in the *Revenue and Control Act* of June 1968)

(16) I believe that my dating of fiscalism as a development of the early 1960's may be questioned by some who find earlier (and pre-Keynesian) examples of fiscalism. This is especially so if we mean by fiscalism the recognition that changes in government spending could have short run aggregate demand and employment effects. As used in this paper, fiscalism implies a macroeconomic model, a particular view of the transmission mechanism, and a policy framework in which planned changes in the budget are selected so as to achieve the desired stabilization effects. And I therefore see it as a post-Keynesian development, and date it in the 1960's. See D.I. FAND, "Comment: The Impact of Monetary Policy in 1966", *Journal of Political Economy*, August 1968, pp. 825-830.

to cool down the economy in 1968 and 1969 has resulted in some disillusionment with fiscal fine-tuning and may have set in motion a probing reexamination of fiscal activism. If this does take place, the rise and fall of fiscal fine-tuning orientation to government policy may well be compressed into a period of five to ten years, in contrast to the thirty-five year period for monetary fine-tuning. If we may use the recent history of monetary theory as a guide for predicting developments in fiscal theory, it would suggest that a revised fiscal doctrine will concern itself more with lags, will tend more in the direction of automatic stabilizers and guidelines rather than fine-tuning techniques. In addition it seems reasonable to expect an attempt to reformulate the full-employment surplus theory so as to include both nominal and real values for the surplus, and to extend the theory of the surplus to take account of different rates of inflation (17).

B. *The independent central bank*

The tradition of an independent Federal Reserve is another factor which may help explain both the emergence and widespread acceptance of Fiscalism in the 1960's and its apparent association with activism. Many economists concluded at the end of the 1950's that the Government should promote and undertake expansionist economic policies. To accomplish this objective they developed fiscal programs to eliminate the output gap — between potential and actual output — in the hopes that they would be able to persuade the political authorities to follow these expansionist fiscal policies. It is entirely possible that the tradition of an independent central bank — independent of the executive branch — may have discouraged these economists from developing similar expansionist monetary policies.

When the Council of Economic Advisers (CEA) in the early 1960's was developing policies to implement President Kennedy's

(17) The CED stabilization budget is an example of a policy that combines guideline fiscalism with a mild form of monetary fine-tuning. Under this policy, we select a target value for the full-employment surplus at 96 per cent utilization, and then use counter-cyclical monetary policy to keep the economy on a path of high employment and stable prices. There is some scope for temporary modification of the rule and for discretionary fiscal action, if there should be a major change in the economy. But the CED rule rejects the idea of budgetary management in response to changing forecasts of economy conditions.

goal of a higher economic growth rate for the United States, it translated the growth and expansion objectives into a set of recommendations for fiscal stimulus rather than monetary expansion. This choice was, of course, in accord with the views of influential stagnationists; but it was also undoubtedly helped along considerably by the discovery of fiscal drag, on the one hand, and by a somewhat different concern that easy money would aggravate the balance of payments problems. It is also true that the President did not have any (official) direct control over the monetary actions of the independent Federal Reserve, but could at least make recommendations about the degree of stimulus in the budget. Accordingly, the CEA could hope to persuade the President to recommend a growth-oriented tax and expenditure package — an expansionist budget — to close the GNP gap and to promote expansion and stimulate economic growth. The CEA members and other Presidential advisers could attempt to persuade the independent Federal Reserve to move toward expansionist monetary policies, but it was presumably easier for them in the early 1960's to direct their energies towards expansionist fiscal actions.

The degree and extent to which the budget should tend either to restrict or expand aggregate demand, is clearly within the scope of the President's recommendations and is part of his budget message. Central bank policy was viewed as being relatively independent of the executive branch and of the political process, and there was also a feeling that the Federal Reserve was banker oriented and more " conservative ". As a consequence those who were seeking to redirect government policy to provide greater stimulus to the economy were almost constrained to find expansionist fiscal policies. This suggests that activism, and the desire to engage the government in expansionist policies, may have led to Fiscalism rather than vice versa.

C. *The analytical framework*

Finally, the income-expenditure models that were widely used in the period when fiscal fine-tuning was being enunciated, also seemed to favor the direct fiscal effects rather than the indirect monetary effects. These income-expenditure models did tend to suggest that fiscal actions have a strong direct effect on income while monetary actions operate indirectly through changes in

interest rates, and these effects on private expenditures could be weak. The Kennedy Council in the early 1960's could point to the theoretical models then popular as providing an analytical basis for its emphasis of fiscal policy, and for its detailed recommendations.

To illustrate how widespread was the idea that money really didn't matter, we have the following description given in a recent (1969) presentation of the FRB-MIT Model (18).

> "One of the most perplexing questions in macroeconomics is the importance of financial variables in influencing the real economy. Opinions on this question have varied greatly from decade to decade, and still vary from economist to economist. Whereas classical economists felt that monetary forces were quite important — indeed the only long run determinant of the price level — the standard Keynesian view during and after the Great Depression tended to deemphasize the role of money".
>
> "Historical evidence suggests that such autonomous monetary forces as gold discoveries and reserve requirement decisions played an important role in such major economic swings as the inflation of 1900-10, the Great Depression and the Contraction of 1936-37".
>
> . . . . . .
>
> "On the other hand, the evidence from several of the large econometric models — the Wharton School model, the Commerce Department model, the Michigan model, and to a lesser extent the Brookings model — is that monetary forces are rather unimportant in influencing total demand".

Some of these models were prepared in the 1960's, when there was some effort made to find monetary effects. This reveals the state of affairs in the early 1960's when the general view as to the efficacy of monetary policy was probably at a historic low.

D. *Directions for the 1970's*

Fiscalism as a national policy is now in its first decade, in contrast to Monetarism which is in its fifth decade. But while Monetarism has been around for a much longer period, the two doctrines may be much closer in a psychological sense, both having experienced humiliating encounters with activism, discretion and

(18) See F. DE LEEUW and E. GRAMLICH, "The Channels of Monetary Policy", *op. cit.*

fine-tuning. For monetary policy this process started in the 1920's and was completed in the late 1950's or early 1960's; for fiscal policy it started in the early 1960's and the cycle may have been completed at the close of the 1960's. In terms of the (psychological) trauma, both Monetarists and Fiscalists may be sadder but also wiser; and the association of fiscalism with activism and discretion and of monetarism with rules and guidelines, which I am suggesting may reflect this difference between youthful enthusiasm and middle-aged caution, is therefore likely to recede in the years ahead.

The tradition of an independent central bank may still continue to lead activists to Fiscalism. Here too we may note that this doctrine has been undergoing some change, and that the central bank here, as in other countries, has become much more responsive to the political process. Whether this tendency will continue in the future or not is a question that we cannot answer with any certainty; but there is reason to believe that this trend is not likely to be reversed, especially if the recent trend to view monetary policy as the senior partner in the stabilization framework continues in the future.

Similarly the more recent large scale models have tended to find greater and greater effects for monetary action. Governor Dewey Daane in a recent paper describes the findings of the FRB-MIT Model with respect to monetary policy as follows:

> "First, the model suggests that monetary policy is a more powerful tool of stabilization policy than most economists, except perhaps Milton Friedman, would have guessed — considerably more powerful, for example, than is indicated by most other large models of the economy. This result should warm the hearts of members of the monetarist school. I find it rather satisfying myself, since it would have been disheartening, indeed, if this study had concluded that central banking was just so much arm waving — in terms of its effects on GNP".

Professor J. S. Duesenberry in describing recent development states:

> "Fashions in economic policy can change as rapidly as fashions in dress. Only five years ago, economists — with the enthusiastic assistance of the press — were hailing the successes of fiscal policy, while monetary policy took a back seat. Most accounts of the economic expansion from 1961 through 1965 gave monetary policy credit for accommodating — *i.e.*, not getting in the way of the

expansion generated by fiscal policy — but did not give monetary policy a very active role. Today, a large number of economists are prepared to agree that monetary policy plays the dominant role in determining the movements of aggregate demand".

He also finds a swing towards monetary policy reflecting the fact:

"that swings in the growth in GNP have followed the swings in the growth of money supply to marked degree".

While this does not mean that all the differences between Monetarists and Fiscalists have been eliminated, it does suggest a considerable narrowing of their differences as they were manifest in the early 1960's (19) (20).

Conclusion

In this paper we have tried to analyze and identify some of the essential differences in the competing doctrines of Monetarism and Fiscalism. These differences may be found in the aggregative theories used by Monetarists and Fiscalists, and by examining their respective policy recommendations. Confining ourselves first to questions of theory, we find that the Monetarists and Fiscalists utilize distinctive theories of money, of the interest rate, and of the price level. In very general terms, the Fiscalist model is geared to the short run and may work quite well when the price level can be treated as a datum: but this model does run into difficulties when prices are rising and there is a need to distinguish between nominal and real representations of macroeconomic variables. The Monetarist model emphasizes permanent effects and long run analysis, distinguishes between nominal and real variables, highlights the key role of the price level, and can be reformulated to take account of rising prices. In saying that the Fiscalist model has thus far been mainly oriented toward short run analysis, we would like to note recent efforts to reformulate the analysis to take account of

(19) See Governor J. Dewey Daane, "New Frontier for the Monetarists", September 1969 and J. S. Dubsenberry, "Tactics and Targets of Monetary Policy", in *Controlling Monetary Aggregates* (Federal Reserve Bank of Boston, 1969).

(20) See also the discussion of the "neo-classical synthesis", in J. Tobin, *The Intellectual Revolution in U.S. Economic Policy-Making, op. cit.*, pp. 21-26.

rising prices, and to distinguish between nominal and real variables. This is clearly the kind of research effort that is needed.

Our analysis of the Monetarist and Fiscalist views of fiscal policy indicates substantial differences concerning the stabilization potential of fiscal action. But these differences may be narrowed somewhat if we limit ourselves to predicting the aggregate demand effects of a given action; and since the two groups use a different measure to calibrate monetary policy, they may frequently disagree as to whether a particular policy involves monetary or fiscal actions. Their respective views on fiscal policy are also influenced by two distinct interpretations of our monetary experiences since the 1920's, especially during the 1930's and the 1950's; and the two groups may, in consequence, reach substantially different conclusions in evaluating the opportunity costs of using budgetary policies for stabilization. We also note what appears as a reversal of their respective policy views as we move away from stabilization and focus on the long run allocative effects of fiscal action. Monetarists would, presumably, accept the view that fiscal action could effectuate a permanent change in the endogenous variables (*e.g.* rates of return), while some Fiscalists (the neoclassicists) would, presumably, advocate monetary action. Taking account of both the short run stabilization effects and the long run allocation effects suggests that some of the current differences in respect to fiscal policy may diminish in time.

We have also examined their respective views concerning activism, discretion, fine-tuning, rules and guidelines. We find that a complex series of factors have brought about an association of Fiscalism with activism and of Monetarism with guidelines: to begin with, in terms of historical development, the Fiscalism of the 1960's is more nearly comparable with the Monetarism of the 1920's; also the tradition of an independent central bank has (at least in the past) given many activists no other real alternative but to become Fiscalists; finally, the macroeconomic models that were current at the time the fiscal fine-tuning doctrine was enunciated tended to emphasize the direct fiscal effects rather than the indirect monetary effects. The influence of these three factors has been declining, and there is reason to believe that it will continue to decline. And this trend toward greater consensus will be strengthened if the recent view of monetary policy as a senior partner in stabilization policy persists in the future.

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