Monetary and fiscal policy should be merged, which in turn changes the role of central banks

Musgrave, Ralph S.

25 April 2011

Monetary and fiscal policy should be merged, which in turn changes the role of central banks.

Ralph S. Musgrave.

Summary.

Keeping monetary and fiscal policy separate causes economic distortions, thus the two should be merged. That is, in a recession for example, the government and central bank should simply spend more (and/or collect less tax), and fund the latter from new or "printed" money.

Merging monetary and fiscal policy necessitates a different relationship or split of responsibilities as between governments and central banks, but this is not a big problem. Plus the new relationship dispenses with an illogical element in the current typical relationship, namely that both central bank and government influence aggregate demand.

Definitions.

Where government and central bank as a combined unit are referred to below, this will be called the "government and central bank" (GCB). Otherwise, the word government refers to parliament plus treasury alone, and the phrase "central bank" refers to the central bank alone.

The phrase “net spend” refers to where government (or GCB) spends more than it collects in tax. Whether this is effected by cutting taxes or spending more (or both) is a political decision, not considered here.

Introduction.

The recession which started in 2007-8, like many recessions, was sparked off by excessive and irresponsible borrowing. The world responded by cutting interest rates to an all-time low with a view to bringing stimulus via increased borrowing: on the face of it, an absurdity.

However pointing to absurdities or self-contradictions in a system does not prove that the system is not the best available: it must be shown that the system has fundamental flaws which do not plague some alternative and better system. And indeed the purpose of this paper is to point out the fundamental flaws in the existing system for regulating aggregate demand, and set out a better system.

Keynes and Abba Lerner advocated that where additional aggregate demand was required, GCB should spend more, and fund this extra spending from borrowing or creating extra money. And conversely, when inflation loomed, GCB should do the opposite, for example, rein in money via additional tax and “unprint” or extinguish such money.

I will argue in this paper, first that the above borrowing is pointless: that is, in a recession, GCB should simply create or “print” extra money and net spend it without funding this extra net expenditure from borrowing or tax.

I will also argue that if printing extra money and raising net spending by the same amount become the only or the main tool for regulating aggregate demand, this has two implications. First it implies abolishing monetary and fiscal policies as separate entities, and that in turn implies abolishing interest rate adjustments, since the latter is monetary policy pure and simple. And second, abolishing the distinction between monetary and fiscal policy implies a different relationship or split of responsibilities between central bank and government.

These two changes (merging fiscal and monetary policy and changing the role of central banks) do not involve any significant problems: in fact the results of these changes are entirely beneficial. In particular, merging monetary and fiscal policy disposes of a problem that is inherent in keeping the two policies separate, namely that the separation involves distorting the economy in numerous ways. Plus the new relationship dispenses with an illogical element in the current typical relationship, namely that both central bank and government can influence aggregate demand.

This paper says nothing new in the sense that it basically just advocates Abba Lerner’s “money pump”. However, some of the points made below are hopefully new, as follows. First, a couple of mistakes made by Lerner about interest rates are dealt with. Second, there are the above mentioned points about merging fiscal and monetary policy and the resulting change for central banks, and hopefully some of this is new.

I have written this paper with countries which issue their own currency in mind. The points made below obviously have implications for common currency areas, but these implications are not considered here.

The futility of "borrow and spend".

Governments borrow for various reasons, but the one that is relevant here is what might be called Keynsian "borrow and spend" with a view to stimulus.

The idea that government borrowing is pointless (for stimulus and other purposes) is not new. Friedman (1948) and Mosler (2010) advocated a "zero borrowing" regime.

I also advocated the idea (Musgrave (2010)). So I'll just summarise the arguments here rather than set them out in detail. The arguments are thus.

First, when GCB borrows, it borrows something (money) which GCB itself has created and which it can create in limitless amounts. Thus for a sovereign currency issuing country to borrow units of its currency is similar to, and as pointless as a dairy farmer buying milk in a shop.

Second, borrowing is deflationary. Given that the object of the exercise is the opposite of deflation, i.e. stimulus, it is hard to see the point of the borrowing. "Borrow and spend" is a bit like throwing a mixture of petrol and water on a fire.

Third, the extent of the above deflationary effect (i.e. crowding out) is uncertain. Crowding out would not matter if there were agreement on the extent of the problem. But there is a lack of agreement. Thus introducing crowding out first introduces uncertainty. Second, if crowding out is a serious problem - say 90% of borrow and spend is nullified by crowding out - the expansion in the national debt for given stimulus is likely to be much larger than the expansion in the monetary base required for the same stimulus. This large increase in the debt for given stimulus is hardly desirable, particularly in view of recent concerns about the size of national debts. Indeed, it is possible that the recent large increases in national debts combined with resulting increases in demand which have been scarcely enough to counter the recession, are explained by crowding out.

The alleged reasons for government borrowing.

Keynes and Lerner both believed that extra government net spending was needed in a recession. As to the choice between funding this expenditure from borrowing versus printing, Keynes was on the face of it fairly indifferent between the two, while Lerner favoured printing.

As to whether Keynes was really indifferent as between the two options, there is some evidence that in public he favoured the borrowing option only because he regarded himself as being surrounded by economic illiterates under the illusion that creating extra money necessarily leads to inflation.

As distinct from borrowing for stimulus purposes, Lerner thought borrowing would still be desirable so as to control inflation. Lerner (1943) claimed that “The second law of Functional Finance is that the government should borrow money only if it is desirable that the public should have less money and more government bonds…This might be desirable if otherwise the rate of interest would be reduced too low . . . and thus induce too much investment, thus bringing about inflation.”

This argument contains a contradiction, as follows. Keynes, Lerner and indeed most economists agree that extra spending brings extra demand, which, if it goes too far, will cause excess inflation. Now if inflation really is a problem, then clearly raised interest rates may solve the problem. But why not just cut spending? In other words, to implement excess spending, and then ameliorate the problem by raising interest rates is bizarre to put it politely.

The only possible justification for the above interest rate policy is that adjusting interest rates works more quickly than adjusting spending. Certainly interest rates can be adjusted at the flick of a switch, but that in itself does not influence the economy for a year or so. Thus what might be called “speed of implementation” is irrelevant: the important question is the lag between the decision to influence the economy and the actual effect on the economy. And there does not seem to be much difference between fiscal and monetary policy here. Thus the argument for using interest rate adjustments rather than spending adjustments to rein in excess demand looks weak.

A second argument that seems to have been put by Lerner for government borrowing is that this would enable governments to adjust interest rates and thus bring about the optimum amount of investment (according to Colander (2002, p.2)). I take this to mean “optimum” in the sense of “optimum total amount of investment for purposes other than controlling inflation”.

This idea is just plain unrealistic. That is, the idea that politicians, bureaucrats or economists actually know what the optimum level of investment is, is laughable. Moreover, there are large uncertainties involved in any investment. Plus most investments involve large costs in addition to interest rate costs. Thus altering interest rates by a percentage point or two does not have a big influence on the amount that businesses invest.

Of course the difference between central banks' base rate in a recession as compared to more normal times is more than "a percentage point or two". But that is near irrelevant for households seeking a mortgage or for businesses, because it is primarily long term investments involved here, thus it is long term interest rates that are relevant. And long term rates do not vary by more than the above "percentage point or two".

To summarise so far, hopefully it has been established that where stimulus is needed, GCB should simply net spend more, and do so without borrowing to cover that spending.

The next problem or set of problems to be considered are the distortions that result from separating fiscal and monetary policy.

Distortions.

Before considering the specific ways in which different fiscal and monetary policies distort economies, a word about why distortions matter is in order.

There is nothing wrong with distorting an economy in the sense of making a permanent change where government has decided on that change (e.g. spending more on state education). These sorts of changes will raise unemployment while people shift from one sector of the economy to another. But that is unavoidable.

It is quite a different matter where a change or distortion is effected, only to be reversed a few months or years later, as is normally the case with anti-recessionary monetary or fiscal policies. The initial change has an unemployment raising effect;

then a short time later the unemployment raising effect continues, as the change is reversed!

Various specific and distortionary anti-recessionary policies will now be examined.

Interest rate adjustments involve distortion.

Adjusting interest rates is one of the main elements in monetary policy. But this distorts the economy in several ways, as follow.

i) Constantly making artificial changes to interest rates must result in an interest rate which is not the free market rate most of the time.

The basic purpose of interest is to optimise the relationship between lenders and borrowers. That is, borrowers in their own opinion derive benefits from borrowing, while lenders undergo a cost, namely foregone consumption. If the latter cost and benefits can be equalised, at least at the margin, then the relevant economy will enjoy the optimum amount of lending and borrowing.

It is generally accepted that interfering with the free market is not justified unless market failure can be demonstrated, and secondly, it can be demonstrated that having the state make the relevant decisions results in a better outcome than the market.

Now there may well be specific instances of market failure when it comes to lending and borrowing, e.g. loan sharks or "No Income No Job or Assets" mortgages. But I know of no evidence that for the bulk of borrowing and lending, the market gets interest rates wrong. Thus artificial interferences with the rate of interest will result on a non-optimum amount borrowing.

ii) Interest rate adjustments work only via entities that are significantly reliant on variable rate borrowing. Thus for example, come an interest rate cut, a firm that is heavily reliant on variable rate borrowing will benefit, while firms that are in other respects identical except that they don't rely on variable rate borrowing will not benefit. This constitutes a distortion.

Given that the purpose of an interest rate cut is to boost the whole economy, not just parts of the economy, interest rate cuts are clearly not a very good tool for the job.

iii) Even if every firm and household borrowed the same amount relative to turnover, interest rate adjustments would influence investment decisions in ways that are harmful, and for the following reasons.

If there were some evidence that at the start of recession, the total amount of investment was below optimum, then interest rate reductions at the start of a recession would make sense. But unfortunately the evidence is that the amount of investment at the start of recessions is excessive, not deficient. This was certainly the case with the recent recession where ludicrous and unsustainable levels of investment in both residential and commercial property were one of the main roots of the problem (as mentioned at the outset above).

And not only was this obviously the case with the recent recession, but there are plenty of economists who argue that this "excess investment" is the norm just before recessions (e.g. Huerta do Soto (1998)).Thus dropping interest rates at the start of a recession is wholly illogical.

It is true that after two or three years of recession, the stock of capital equipment may fall to less than the level that would obtain at full employment. Indeed, America's stock of capital equipment fell during part of the recent recession. But the latter point does not make the case for using interest rates to ameliorate recessions. That is, if an economy is two or three years into a recession, a straight rise in demand would induce employers to expand investment. So why it is necessary for politicians or central banks to give employers any sort of special incentive to invest is a mystery.

Or perhaps there is no mystery here. Perhaps it is simply that politicians, central bankers and economists seriously think they know better than the average business when and when not to invest. So far as most entrepreneurs are concerned, politicians, bankers and economists can take their views on investment, and feed them into the nearest shredder.

The above point can be put another way, as follows. Altering interest rates alters the amount that employers invest relative to turnover. Now where is the evidence that the latter ratio (investment to turnover) suddenly changes just because an economy is well into a recession rather than at the start of a recession or not in a recession at all? The very idea is a joke.

iv) Adjusting interest rates results in hot money flowing in or out of a country, which in turn changes the value of the country's currency on foreign exchange markets. And this in turn makes life difficult for exporters and importers.

Of course adjusting demand in a merged monetary and fiscal policy scenario would not leave the value of the relevant country's currency totally unaffected, but this is unavoidable. That is, where demand rises for any reason (e.g. increased consumer confidence), that will tend to draw in imports, which in turn will tend to reduce the price of the relevant country's currency. That effect is, to repeat, unavoidable.

v) It is precisely variations in demand for capital equipment which is one of the main causes of economic instability (via the accelerator). Thus trying to vary demand for capital equipment with a view to stabilising an economy is not a smart move.

Quantitative easing.

Quantitative easing is a monetary policy. But its main effect is to increase asset prices, which in turn increases spending by the rich. But unfortunately, this is not an effective policy in that the propensity of the rich to change their spending habits when their income or assets change in value is significantly smaller than is the case for the poor. That is distortionary. In other words anti recessionary measures should be neutral as between rich, poor and all other groups. Or to put it a third way, altering the incomes of the rich relative to the incomes of the poor is a perfectly legitimate change to make. But it is illogical to use this sort of change as an anti-recessionary tool.

The distortions caused by fiscal policy.

Some fiscal changes deliberately alter the structure or shape of an economy, and to that extent could be called distortionary, but are nevertheless justified. Examples include a decision to raise direct taxes at the expense of indirect taxes or to spend more on state education.

These types of changes are perfectly legitimate. But they are not of much relevance here. That is, there is no good reason, in attempting to combat a recession to concentrate, for example, on education.

In contrast, there are various fiscal changes much more suited to combating a recession precisely because they do not concentrate on particular sectors of the economy, and are thus not distortionary. Examples include cutting a payroll tax or cutting a sales tax. (The UK temporarily cut its sales tax (VAT) during the recent recession).

For example, cutting employees' contribution to a payroll tax affects every employee in the country. That of course leaves out various groups like pensioners and the unemployed. But it would not be difficult to alter the take home pay of both the latter groups at the same time as altering the take home pay of employees. Indeed, in the UK, pensioners pay is given a temporary boost in the middle of winter to help them pay heating costs (plus this varies with the severity of the winter).

However, even if fiscal policy is as non-distortionary as possible, using fiscal policy alone (i.e. without monetary policy) is still distortionary, and for the following reasons.

Where government spends more, and funds this with increased borrowing, this is pure fiscal policy. But the interest rate hike that ensues is itself distortionary, for reasons given above (unless you believe that the latter borrowing involves no crowding whatever).

The fundamental reason for distortions.

If there was a significant tendency for people with brown hair to have more car accidents than people with black hair, there would have to be some explanation. Likewise, if there are several instances of fiscal or monetary policies when implemented in isolation having a distortionary effect, there must be some explanation. The explanation is quite simple and is as follows.

What is required in a recession is an OVERALL expansion in the economy. That is, the existence of a recession is not a reason to favour one sector of the economy above any other. Thus any policy which DOES favour some sectors more than others is ipso facto distortionary.

Moreover, what is required in a recession is an increase in aggregate demand, and effecting the latter involves boosting the source of all demand: that is, first, the consumer, and second government spending. In fact the latter (government spending) is essentially a form of consumer spending in the sense that consumers vote at election time to have part of their income confiscated by government and spent on various communal or pubic goods: maintaining law and order, state education, etc.

So in a recession, the aim should be to expand government spending and consumer spending by the same percentage.

A new relationship between central banks and governments.

Under current or conventional arrangements, most central banks adjust interest rates or make other monetary adjustments, while governments make fiscal adjustments.

However, in a merged fiscal and monetary scenario, the two obviously cannot act independently. That is, when it is decided to raise government spending by $X a year, that implies the creation of $X of additional monetary base. The former is fiscal and the latter is monetary. What to do?

A possible way of effecting the above would be to have finance ministers and/or other politicians sitting in the same room as supposedly independent central bank staff when making changes to total government spending. But that probably involves having politicians too close to the printing press.

A solution to this problem is to have the central bank responsible for deciding whether inflation is subdued enough to allow more government net spending, while political parties and parliaments decide the obviously political questions, such as how GDP should be split as between public and private spending, and how the public portion should be spent.

The latter split of responsibilities as between governments and central banks is a perfectly logical division of labour. That is, the decision on how big a threat inflation poses is a technical one, and is best taken by technicians, that is economists. Of course economists' record in predicting inflation levels a year or two hence is far from perfect. But they are better at it than politicians. Plus economists have no motive to bias their forecasts, or ignore the forecasts and advocate more spending than they think is warranted by inflation.

In contrast, and as mentioned above, the decision as to how GDP should be split as between public and private spending is a purely political decision, as are decisions on the make-up of public spending. The latter sort of decision should be taken by politicians and the democratic process.

Indeed, this split of responsibilities makes more sense than current arrangements for the following reasons. Allowing governments to abstain from collecting enough tax and borrow instead is generally regarded as having a stimulatory effect. But central banks also take a position on the "stimulus / deflation" scale. So we have two organisations with a say on the stimulus

/ deflation question. This makes about as much sense as having a car with two steering wheels, each of which is controlled by a different person.

Put another way, while an independent central bank keeps politicians away from the money printing press in the narrowest sense of the word “money”, it does not keep politicians away from a slightly different type of printing press: the “debt printing press”. And this has proved a huge problem over the last decade or so: that is, many countries’ national debts have ballooned recently to record levels. The above re-arrangement of responsibilities as between governments and central banks would solve this problem.

Of course that is not to say that all of the above “ballooning debt” is wholly unjustified. For example if you believe that Keynsian “borrow and spend” works, and that it is the best option for stimulus purposes, then you will believe that part of the debt is justified (although one of the central claims of this paper is that there is a better option than Keynsian borrow and spend).

On the other hand a significant portion of many counties’ current debt stems from attempts by politicians to ingratiate themselves with voters by borrowing as a substitute for tax. This form of borrowing is wholly unjustified, and the merged fiscal and monetary policy advocated here ought to prevent this form of borrowing.

Fiscal committees.

Having claimed above that central banks alone should be responsible for the degree of stimulus or deflation applied to an economy, this is not to say that this decision absolutely has to be in the hands of central banks. The important point, as mentioned above, is that the decision is in the hands of experts who are independent of politicians. Whether those experts are part of a central bank or not is probably not too important.

Indeed committees or organisations which consist at least partially of such experts already exist in some countries in the form of so called fiscal committees. And in the US there is the Congressional Budget Office, though the latter is far too close to political parties to be called “independent” at the moment. And in the UK, there is the Office for Budget Responsibility.

However, the existence of THREE bodies, government, central bank AND a fiscal committee does not make sense. To repeat, there are just two types of decision and thus two bodies required. First there are the strictly political decisions, like the proportion of GDP devoted to public spending. And second, there is the technical decision, namely whether inflation is subdued enough to warrant more aggregate demand.

References.

Colander, D., (2002). *Functional Finance, New Classical Economics, and the Great Great Grandsons*. Middlebury College Economics Discussion Paper No. 02-34.

Friedman, M., (1948). A monetary and fiscal framework for economic stability. *American Economic Review*, 38(3): 245-264.

Huerta de Soto, J., (1998). *Money, Bank Credit and Economic Cycles*, Ludwig von Mises Institute.

Lerner, A., (1943). Functional finance and the federal debt. In: D.C.Colander ed. *Selected Economic Writings of Abba P.Lerner*. New York University Press.

Mosler, W., (2010). *Proposals for the banking system.* Huffington Post, 21st January.

Musgrave, R.S., (2010). *Government borrowing is near pointless*. Munich Personal Archive Paper No. 23785.