

THE MONETARY-FISCAL POLICY MIX: IMPLICATIONS FOR MACROECONOMIC PERFORMANCE

The Monetary-Fiscal Policy Mix: Implications for the Short Run

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In recent years, the policy mix—defined as the contemporaneous joint state of monetary and fiscal policy—has conditioned the patterns of the business cycle, set up numerous imbalances in macroeconomic and microeconomic behavior, and is laying the groundwork for future economic performance. Restrictive monetary and fiscal policies produced back-to-back economic downturns in 1980 and 1981–82. From 1982 to 1985, massive fiscal stimulus against a backdrop of monetary growth targeting by the Federal Reserve comprised a “loose fiscal-tight money” policy mix. Subsequently, an actual and prospective tightening of the federal budget and suspension of monetary growth targeting suggest a shift in the policy mix to a “tight fiscal-easier money” combination.

In this paper, the policy mix of the 1980's first half—in the context of an open economy with flexible exchange rates—is characterized. Some of the important economic and financial effects are identified. Among these are 1) higher nominal and real interest rates than otherwise would have been the case; 2) a strong domestic currency; 3) lower inflation rates; 4) a large and growing trade deficit; 5) an unbalanced composition of economic activity across sectors and industries; and 6) a depressed industrial sector. Some of the changes in economic performance to be expected as the policy mix is shifted in response to the Gramm-Rudman-Hollings balanced-budget statute also are shown.

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I. Policy Mix Alternatives, the 1980 to 1985 Episode, and the Analytical Framework

There are four possible policy mix alternatives: loose fiscal-easy money; loose fiscal-tight money; tight fiscal-easy money; and tight fiscal-tight money.

The actual patterns for the fiscal-monetary policy mix since the mid-1950's are illustrated in Figure 1. The ease or tightness of monetary policy is measured by an index constructed as a weighted average of the ratio of free reserves to total reserves, normalized at zero. For fiscal policy, an index based on changes in the full-employment budget deficit relative to nominal *GNP* is used.

During periods of economic slack, a loose fiscal-easy money policy combination has been followed. A loose fiscal-easy money policy is highly stimulative, since it consists of both budget stimulus and rapid growth in bank reserves. When inflationary pressures were dominant, a mixture of tight fiscal-tight monetary policy usually was relied upon.

Loose fiscal-tight money or tight fiscal-easy money policy mixes were never applied in the U.S. economy for any length of time before the 1980's. Between 1981 and 1985, a different policy mix is indicated—one that was loose fiscal-tight money. The genesis of this policy mix lies in the Reaganomics fiscal policies set in 1981 and the new approach to monetary policy—the New Fed Policy (*NFP*)—of October 1979.

Tax reductions proposed by the administration totaled \$750 billion over 1981 to 1986. To the current services base of the Carter Administration was added \$237.4 billion for defense outlays over the same period.

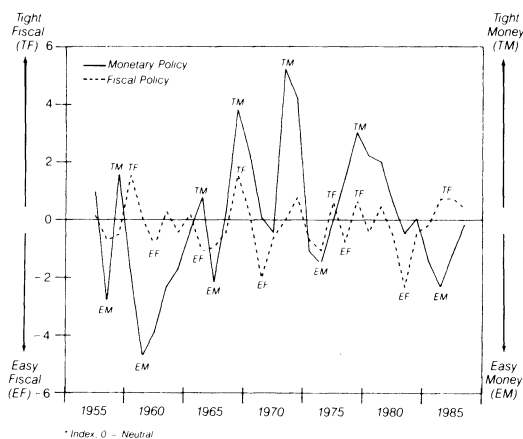


FIGURE 1. POLICY MIX BAROMETER:
HISTORY AND FORECAST

Massive reductions in nondefense spending were planned, totaling \$585 billion, so that the net difference, tax cuts plus added defense spending less nondefense reductions, was almost \$400 billion.

For the first two years of the program, fiscal policy was either restrictive or not stimulative, with a -\$2.7 billion net decrement in fiscal year 1981 and only a \$12.4 billion increment in fiscal year 1982. From 1983 to 1986, however, some \$29.3 billion to \$190 billion of fiscal stimulus, measured as the difference between planned injections and subtractions, was indicated.

The essence of the *NFP* was to target monetary growth through bank reserves, freeing interest rates to seek levels consistent with the demand and supply of funds. The deficit stimulus and ensuing heavy Treasury financing, given monetary growth targeting, suggested "permanently" higher nominal and real interest rates as a consequence.

What is to be expected under such a policy mix? Large federal budget deficits suggest increased real economic growth, lower unemployment, more borrowing, and potentially higher inflation. An enlarged *GNP* leads to increased transactions requirements for money, which causes higher nominal and real interest rates. The higher interest rates

dampen activity in rate sensitive areas, partially offsetting the fiscal stimulus. In an open economy with flexible exchange rates, stronger growth and higher interest rates strengthen the domestic currency. The inflationary tendencies of the stimulative fiscal policy are mitigated as a result—which further enhances the real returns on financial assets and strengthens the domestic currency, in a kind of "virtuous" cycle.

Because of strong economic growth and a strong currency, imports increase and exports decrease, resulting in a worsening trade deficit. If capital flows impact more than the tradeable goods balance, the domestic currency rises and further worsens the trade deficit. High interest rates also erode the financial positions of households, businesses, and depository institutions, and increase the fragility of the financial system. Debt positions become more onerous, and, if accompanied by falling asset prices, a debt deflation may occur.

So long as huge federal budget deficits remain and other countries do not aggressively stimulate their economies, the process continues until foreign trade weakens so much that domestic economic growth slows. When that happens—the case for the U.S. economy in the second half of 1984 and in 1985—short-term interest rates automatically drop and the value of the domestic currency declines. The eventual result is a lopsided, unbalanced economy, with numerous problems—including chronic federal budget deficits, an overvalued domestic currency, permanent erosion in the relative market shares of the industrial sector, stagnant economic growth, high unemployment, still-too-high inflation, high real interest rates, and a fallout of failures in beleaguered sectors, industries, and financial institutions. Higher inflation is expected and expected real returns on dollar-denominated assets fall. The domestic currency drops in value. Stagflation is an eventual likely possibility. Even a turn toward protectionist policies is a logical consequence.

A tight fiscal-easier monetary policy mix could be expected to have effects opposite to those described above.

II. Policy Mix Impacts—Financial, Macroeconomic, and Sectoral

The federal budget deficits of recent years reached postwar peaks as a result of the fiscal stimulus. On a unified budget basis, the deficit in fiscal year 1984 was \$185.3 billion or 5.2 percent of *GNP*; in fiscal year 1985, it was \$211.9 billion or 5.5 percent of *GNP*. Full-employment budget deficits also indicate considerable stimulus in 1984 and 1985, rising to \$117.1 billion in 1984 from \$77.8 billion the year before, and reaching \$149.7 billion in 1985.

At the root of the persistent federal budget deficits were the large tax cuts adopted in 1981. In that year, budget receipts represented 21.1 percent of *GNP*. By the third quarter of 1985, the fraction was down to 19.7 percent. This lower ratio translates into a net loss of \$54 billion in federal revenues—an amount equal to 28 percent of the \$193 billion NIPA deficit estimated for 1985.

In financing the enormous budget deficits, the federal government has absorbed a growing share of the nation's saving. In 1980, the \$61.2 billion budget deficit represented 15.1 percent of the \$404.8 billion in gross saving in the United States. In the third quarter of 1985, the deficit, at \$214.1 billion (SAAR), was 39.7 percent of the \$506.8 billion of gross saving.

To raise the required funds, the Treasury has become a formidable competitor in the capital markets. In 1980, \$79.2 billion, or 23 percent of the \$334.7 billion raised by all nonfinancial sectors in the United States, was raised. For 1985, the federal share was near 35 percent. If the federal government share had returned to its 1980 position, or 23 percent, the borrowing requirement would have been roughly \$199 billion—or about \$99 billion less than the amount projected.

The impacts of high and rising expected future deficits on long-term interest rates appear in the unusually high levels that have persisted since 1981. The importance of the role played by monetary policy is indicated through a decided break in interest rate behavior before and after the New Fed Policy of October 1979.

The strong federal government competition for funds in the face of monetary growth targeting by the Federal Reserve made interest rates on U.S. government securities considerably more volatile compared with yields on private obligations. Between September 1979 and October 1981, yields on long-term U.S. government and Aaa corporate bonds rose and fell roughly in step. However, since late 1981—when the stimulus of the budget picked up and began to clash against monetary policy—changes in yields on U.S. government bonds greatly exceeded those on corporate obligations.

The strong competition for funds in the U.S. capital markets resulted in a marked climb in U.S. interest rates compared with yields in other countries, providing relatively more favorable returns on U.S. government bonds than the obligations of many foreign governments. In September 1979, long-term U.S. government bonds were yielding 9.26 percent. At the same time, yields in the United States exceeded those in the Netherlands (by 0.2 percentage points), Germany (by 1.2 percentage points), Switzerland (by 5.4 percentage points), and Japan (by 1.0 percentage point). In late November 1985, the margins favoring U.S. government bonds were: Netherlands, 2.78 percentage points; Germany, 3.17 percentage points; Switzerland, 5.01 percentage points; and Japan, 3.36 percentage points.

The combination of a loose fiscal-tight money policy mix and higher interest rates produced a very sharp appreciation in the dollar. At the peak of its appreciation in February 1985, the U.S. dollar was 62 percent above the March 1973 benchmark and 92 percent above the trough in 1980. By September 18—just prior to the joint decision of the United States, France, Japan, Germany, and the U.K. to intervene in the foreign exchange markets—the dollar had depreciated by 12.4 percent. By mid-December 1985, a further dollar depreciation of 11.8 percent had occurred.

With strong growth in the U.S. economy in 1983 and 1984 and continuing rises in the dollar, it has been no surprise to see massive declines in the U.S. merchandise trade bal-

ance and in real net exports over the last few years.

In 1980, imports of merchandise represented 9.3 percent of the U.S. *GNP*, and exports equaled 8.4 percent. The foreign trade gap was $-\$24.1$ billion, or 0.9 percent of *GNP*. In the third quarter of 1985, exports had shrunk to 5.4 percent of *GNP*, and imports were 8.9 percent. The corresponding trade deficit had risen to $-\$138.1$ billion—equal to 3.5 percent of *GNP*.

Another impact of the policy mix has been much lower inflation, with dollar appreciation having a surprisingly large impact on U.S. inflation during 1981 to 1985. Considerable slack in the U.S. and world economies permitted the rise in the dollar to drive inflation lower by anywhere from 3 to 6 percentage points.

The sectoral performance of the U.S. economy also reflects the policy mix. Substantial rises in consumption and business fixed investment were registered, an apparent consequence of the tax cuts for households and businesses. Between 1982:4 and 1985:3, business capital spending rose 34.8 percent, well in excess of the average 22.9 percent rise over the same period of expansion in four previous episodes. Consumption outlays were up 14.2 percent, somewhat greater than the average experience in most other expansions.

III. Policy Mix and the U.S. Industrial Sector

The large appreciation in the dollar from July 1980 to February 1985 made U.S. exports extraordinarily expensive and created difficulty in competing abroad. Foreign products valued in other currencies have been relatively cheap. The differentials sparked an enormous expansion of imports into the United States and greatly diminished the role of the U.S. industrial sector in the world economy.

The pervasive rise in imports has had an adverse impact on employment in the United States. From January 1980 through November 1985, total employment rose by 8 million persons. However, this net gain was the product of a 9.4 million increase in employment in service-producing industries and a

reduction of 1.4 million jobs in goods-producing industries. Within the latter, manufacturing jobs declined by 1.5 million, jobs in mining decreased by 42,000, and those in construction rose by 174,000.

The reductions in manufacturing employment were especially large in those industries subject to intense foreign competition. In percentage terms some of the decreases were: basic steel, 45.6 percent; textile mill products, 20.4 percent; fabricated metal products, 13.1 percent; and nonelectrical machinery, 15.7 percent. In contrast, employment in printing and publishing (mainly protected from imports) rose by 14.6 percent.

A more detailed view of the adverse impact of the trade deficit on the U.S. economy is provided by an examination of changes in import market shares, production, and employment for 72 Department of Commerce industry groups over the first half of the 1980's.

In 1979, imports accounted for an average of 11.6 percent of the domestic market of the 72 industry groups. The import market share ranged from a low of 0.9 percent (automotive stampings) to a high of 45.8 percent (rubber and plastic footwear). In 18 of the industry groups (one-quarter of the total), imports held under 5 percent of the domestic market, and in only 6 industries did the import share exceed 30 percent. By 1985, imports satisfied an average 16.4 percent of domestic demand across the 72 industry groups, ranging from a low of 1.7 percent (also automotive stampings) to a high of 53.4 percent (radio and TV receiving sets). In only 9 industries was the import share under 5 percent. It exceeded 30 percent in ten industries. By 1985, there were 33 industry groups where the import share was 15 percent or above—compared with only 12 in 1979.

The share of imports in the U.S. domestic market rose in 61 of the 72 industry groups between 1979 and 1985. Among the 61, the actual level of domestic production in 33 (54 percent) was below that achieved in 1979. The level of output was higher in 27 industry groups (44 percent) and unchanged in one case. In the 10 industry groups where the

import market share declined, 8 saw a rise in output while only 2 experienced a decrease in production.

The response of employment to changes in import market shares was quite different. Employment fell in 44 (72 percent) of the 61 industry groups in which the market share of imports increased. In 15 cases (25 percent), employment increased despite the climb in imports. In the 10 industries where the degree of import penetration decreased, 5 experienced a rise in employment, and 5 saw a reduction.

IV. The 1985 Twist in the Policy Mix and Future Implications

Two doses of budget tightening were effected during 1985, and the changed policy mix will modify the profile of economic performance. The first was from a compromise between the administration and Senate Republican leaders in early May when substantial reductions in spending were agreed upon. The second occurred as a result of the deliberations leading to and resulting in the adoption of the Gramm-Rudman-Hollings (GRH) deficit reduction legislation.

The GRH legislation established a process by which the deficits are to be gradually phased out by fiscal year 1991, either through voluntary measures on spending and taxes agreed upon by the Congress and administration, or involuntarily through automatic spending cuts. The administration and Congress can employ any means to reduce the deficits to the targeted ceilings, but, if agreement is not reached, across-the-board spending cuts in eligible categories of nondefense and defense will be made to achieve the target.

During 1985, monetary policy also shifted. The central bank made clear that monetary growth targeting would no longer be followed, given a break in the relationship between monetary growth, especially for *M1*, the rate of inflation, and real economic growth. With monetary velocity declining and off its trend path, the central bank officially decided to relegate monetary policy to a lesser position. The economy, inflation, and

TABLE 1—EFFECTS^a OF GRAMM-RUDMAN-HOLLINGS: (1986–90 Average)

Category	No Fed Ease	M1 Restored	GNP Restored
Fed. Gov't Spending (Bils. \$'s)			
<i>Ex Ante</i>	63	-63	-63
<i>Ex Post</i>	-89	-99	-110
Real <i>GNP</i> (% Chg.)	-1.0	-0.5	0.1
Nominal <i>GNP</i> (% Chg.)	-1.4	-0.9	0.0
Final Demand (Bils. '72 \$'s)			
Constant	-1.2	4.1	10.8
Bus. Fixed Invest.	-2.5	-0.1	3.1
Resid. Invest.	1.6	2.7	3.8
Net Exports	5.0	3.9	2.5
Housing Starts (Mils. of Units)	.070	.112	.152
Aaa Corp. Bonds (Basis Pts.)	-151	-168	-189
Fed. Funds Rate (Basis Pts.)	-145	-221	-294
Deficit (Bils. \$'s)	71	89	109

Source: Computer simulations with the Shearson Lehman Model of the U.S. economy. Econometric model simulations can only produce approximate outcomes—the central tendency of a distribution of possibilities given the change in policy and structure of the economy as assumed and estimated in the model, provided that the policy shock is within the range of historical experience.

^aChanges from baseline.

the dollar were elevated in the list of considerations for policy.

With prospective significant reductions in budget deficits seemingly set for coming years and a change in the approach to monetary policy by the Federal Reserve, the policy mix was twisted sharply toward a tighter budget and easier money.

Major differences in the pattern for the unified budget deficits, Treasury financing, and economic performance can be the result of the GRH legislation. Under GRH, the unified budget deficits could be near \$180 billion in fiscal year 1986, about \$150 billion in fiscal year 1987, and \$120 billion or so in fiscal year 1988. Total Treasury financing would decline from the \$197.3 billion in fiscal year 1985 to \$120.6 billion in fiscal year 1988, compared with \$170.1 billion for fiscal year 1988 before GRH. The structural budget deficits under GRH would decline sharply in fiscal years 1986, 1987, and 1988, indicating significant fiscal restraint. Before the GRH legislation, the structural budget deficits also

were expected to decline, but by much less. As a percentage of *GNP*, the full-employment budget deficit could drop to 1.0 percent by fiscal year 1988 instead of the 2.5 percent indicated prior to the legislation.

Some economic and financial market effects of GRH were simulated with the 300-equation Shearson Lehman Model of the U.S. economy (see Table 1). In the first case, it was assumed that the Federal Reserve does not provide any compensating easing. Under these circumstances, the tighter budget has a negative impact on real output, consumption, business fixed investment, and federal spending. However, interest rates are lower, the housing sector improves, and net exports are higher (col. 1).

In the second case (*M1* restored), the Federal Reserve returns *M1* to the pre-GRH path. The results include a smaller reduction in nominal and real *GNP* and in business fixed investment. The interest rate declines are larger, and the expansion of homebuilding activity is stronger. More of a cutback occurs in federal spending, and the gain in real net exports is somewhat weaker (col. 2).

Finally, in the third case (*GNP* restored), it was assumed that the Federal Reserve acts to return *GNP* to the pre-GRH baseline. This produces the most favorable outcome. In response, interest rates declined the most, and rate sensitive sectors (particularly hous-

ing and investment) show the most improvement. Consumer expenditures rise more strongly, and federal spending decreases relatively more from large savings of interest payments. On the other hand, the expansion of real net exports is less (col. 3).

V. Concluding Comments

This paper has analyzed the monetary-fiscal policy mix in the early 1980's and its implications for financial markets, the economy, and the U.S. industrial sector in the short and intermediate term. For much of the early 1980's, the policy mix could be characterized as a loose fiscal-tight money combination.

There are many messages to be drawn here. Perhaps the main one is that the policy mix, especially in an open economy with flexible exchange rates, must be monitored, analyzed, and understood as much as the individual state of monetary or fiscal policy itself, in order to grasp the likely patterns of behavior in the financial markets and the economy. The policy mix is an important ingredient in the business cycle. A similar message would apply to the rest of the world as well, not really considered here, with like patterns of behavior to be expected under similar configurations of the policy mix as have been analyzed for the U.S. economy.