FISCAL POLICY AND MONETARY POLICY IN RELATION TO INFLATION.

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I can remember a time when the subject on which I am to speak would have been thought to be outside the bounds of a conference on Public Finance; though in view of Andreades' monetary interests, for a conference that was held in his honour it might even then have been allowed. May I say that I got my own first notions of monetary history from Andreades' *History of the Bank of England*, and that I still feel it to have been an admirable introduction? The modern reader, if he starts with Clapham, must find it much harder to «see the wood for the trees». He might well, with advantage, still start from Andreades, and then go on to the Ashton and Sayers essays, before he turns to Clapham.

But as things are to-day, there is no doubt that my subject is a Public Finance subject; it is so much at the centre of Public Finance problems that it cannot be avoided. It may however be useful to begin by considering just how it has forced its may in.

Public Finance—in the sense of the subject on which lectures are given and textbooks are written—has always been about policy: budgetary policy, policy about the revenue and expenditure of government, in the first place. Monetary policy was regarded, traditionally, as a separate matter. The most obvious reason why it was taken to be separate was the separation of the relevant decision-making. Public Finance decisions were those which formed the Government's budget; monetary decisions were those made by the banking system, or Central Bank. And it was not only true that the people who made the decisions were different, and that the instruments which they used (taxes on the one hand, interest rates on the other) were different; it was also true, in classical gold standard days, that the objectives of policy were different. The Central Bank had the special duty of maintaining currency stability, in the sense of convertibility of the national money, at a fairly fixed rate, into an international money. The objectives of budgetary policy, though in themselves quite various, had nothing to do with this convertibility, save to the extent that it assumed (not very explicitly, perhaps) that the Central Bank

was doing its job. Monetary action by the Government was indeed not excluded, in times of crisis, when the Bank get into trouble; but in normal times there was, in quite a Mentesquieu sense, *separation of powers*.

All that now seems far away; but it remains important (it will, I think, be important for this conference) for us to realise that the extent to which different countries have departed from the Montesquieu model have differed quite a lot. The first step on the road away from it has indeed been taken by all alike. The former monetary objective, exchange stability, if not wholly abandoned, has been at least demoted. Depreciation, on the exchanges, is still regarded as a danger signal; but it has taken second place, as a thing to be avoided, to inflation—inflation of the internal level of prices, in some sense or other. That has happened everywhere; but beyond that there is a parting of the ways.

It is not inevitable, say some, that because the objective has changed its character, the means that are adopted for attaining it, or for striving towards it, should also be changed. So there is a still a case for separation of powers. Monetary policy, even of the new type, should still be left to the Bank; the Government, as before, should frame its budget within the limits which have been set by that monetary policy. You will recognise this doctrine as one aspect of what is called Monetarism; but it is wider than Monetarism, since one can hold to it without implying that the Quantity of Money (or a given rate of growth in the Quantity of Money) is the thing which the Bank should be trying to stabilise. A monetary policy the sole objective of which is the avoidance of inflation (and deflation), but which regards the Quantity of Money as no more than one out of many indicators, is at least conceivable.

Whether one is a monetarist, or whether one is a quasimonetarist (in the sense just described), one will desire to maintain the separation of powers, or at least of function. Now it is clear, if one looks about the world, that there is more separation in some countries than in others. There are some, such as Germany (and I think I may say the United States) where some degree of separateness is deeply embedded in political arrangements, having even some degree of constitutional sanction. There are others, such as Britain, where steps have been taken to ensure non-separateness; for the nationalisation of the Bank of England (in 1946) was surely intended to have just that effect. It did have a good deal of that effect. But the issue of separateness is not purely a constitutional issue; it is also a matter of personality and of strength of will. A Central Bank may be nominally independent, yet it may get into the habit of responding so meekly to the representations that are made to it (even though those representations have no legal force) that its independence is in practice lost. On the other hand it may be nominally dependent, yet still exercise such leadership as to make it within its own field the dominant partner. These things can happen, and on occasion they have happened. They serve to remind us that separation of function is not simply a constitutional issue.

Nor is it simply a political issue. Whatever the degree of independence (*real* independence) a Central Bank pessesses, there remain limits to the kinds of action

that it can take, within its banking function. (It is of course possible that a bank may be used, by government, as an administrative organisation for completely non-banking purposes; but that we may put on one side) A bank, as a bank, is a financial intermediary; its business is lending and borrowing. Governments indeed are borrowers, and nowadays they also do a good deal of lending; but these are not the characteristic financial functions of government, which consist in the levying of taxes, and the spending of the proceeds of those taxes, on current account. Thus the issue of fiscal policy *versus* monetary policy, with which we are concerned, is only in part a question of the organisation, through which the policy, or control, should be exercised; it is mainly a question of the kind of control which is to be exercised, whether it is to be of the banking type, through lending and borrowing, or whether it is to be of the budgetary type, though taxing and spending.

Taxing and spending impinge on the income-expenditure account of the economy; borrowing and lending upon the capital account. One can state the issue in these terms, and it may be useful to do so, even though one runs the risk of raising those horrible questions of the Investment character of what purports to be Public Investment—so much of which, on critical examination, turns out to be Public Consumption disguised! There is however another aspect of the distinction, which is a least equally important.

People have to pay taxes; they do not have to lend. There is a corresponding element of obligation about most forms of government spending, which (though sometimes after a lag) are *bound* to put funds into circulation. A Bank, so long as it continues to operate in a normal banking manner, cannot, of its own volition, put funds into circulation; all it can do is to tempt people to borrow them. It is not easy to state this distinction so as to make it valid without exception or qualification; for the line between obligation and voluntariness is itself not a firm line; and there are many ways in which the association of obligation with the government's budget and voluntariness with banking policy gets, more or less deliberately, blurred. Something nevertheless remains; and what remains is important.

For it was because of its (at least apparently) more assured effectiveness that Fiscal Policy, or budgetary policy, gained its victory over monetary policy, first in the United States and Britain, and then in some other countries, during the years around 1950. The objective, of course, at that time was Employment, not monetary stability; and for the purpose of maintaining employment, direct action through government expenditure seemed decisively better. Government could act on employment directly, itself employing labour; all that could be done by the Bank was to facilitate the offer of employment by industry, offering to lend to industry on terms which it hoped would prove attractive. And it had surely been learned, from experience in the thirties, that there could be circumstances when no terms that a Bank could offer would be attractive enough.

But that was no more than a first step on a road which led a long way. To create employment, for the sake of creating employment, gives no assurance that

the employment will be productive, or even seem to be productive; even those who are taken into employment will require something better than that. It was easy to think of things which needed doing, but which would not be profitable in market terms; and of projects which were uncertainly profitable, so that they would not be undertaken if those who undertook them had to bear the risk of failure, though a case could be made for saying that with the State behind them they must come right given time. Thus it was that the responsibility of the State for employment led to a large expansion of the Public Sector, not just in times of Depression, but as a long-run trend.

One of the consequences of this requires particular attention. Since the expansion of the Public Sector took the form (it had to take the form) of starting projects—some small, but some quite large projects—the Public Sector itself became liable to fluctuations, of fundamentally the same character as the Private Sector had long experienced. Every project, such as the building of schools, of hospitals, of roads and so an, has a technically efficient shape ever time; to hurry it up, or to stretch it out, involves a less in efficiency. There is a strong tendency for the maximum employment that is given by such projects to be bunched, so that the employment which they give tends to fluctuate. But in a slack season, even when the slackness is due to bunching of Public Sector projects, a Government which has accepted responsibility for employment is bound to be under pressure to start new projects to take up the slack. For this reason (and often doubtless for other reasons) the expansion of the Public Sector centinues; and that means, in turn, that there must be occasions when its expansion puts a strain on the economy, taken as a whole. If, as is likely, the Public Sector is then held to have priority, the Private Sector must be contracted.

How is that to be done? The standard Fiscal Policy answer is that it is to be done by taxation. For taxation, on that line of thought, looked like being *the* effective method. By taxation the spending power, at the disposal of the Private Sector. should be reduced; and in the early days of Fiscal Policy, it seemed easy to calculate just how much it should be reduced. Allowance would have to be made for «leaks» (payment of taxes out of what would otherwise have been saved, and so on) but all that could be dealt with by econometrics. So if one had good enough statistics, and good enough mathematicians, all would be well. But experience has shown that it may not be as simple as that.

If an increase in taxation is to repress the activity of the Private Sector, it must either diminish Consumption or diminish Investment. I shall take it that an effect on Consumption is mainly looked for (as seems usually to be the case). Now if there is to be a reliable effect on consumption, three conditions are necessary. First, the consumer's spending must be limited by his income after tax; second, he must previously have been spending up to that limit; and thirdly, he must be unable to obtain an increase in pre-tax income which offsets the tax. The second of these conditions we have already allowed for; if a part of income was previously being saved, the tax may reduce saving, not consumption. Allowance

can be made for that; but the others remain. In practice, it has often been found, taxation on wage-earners cannot be increased without provoking demands for compensating increases in wages; while taxation on property incomes dors not necessarily diminish consumption from those incomes. For one of the main advantages which comes from the possession of capital is to have a «nest-egg» for use in emergencies; and a tax, imposed to meet a national emergency, is (from the point of the capitalist taxpayer) itself just one of those emergencies, against which he expects to use his capital to protest himself. Thus, both in the case of incomes from work, and in the case of incomes from property, there is a line of escape.

There is a line of escape, so long as the tax method is used by itself. For the worker's line of escape implies that he can get a rise in wages just by demanding it; and he cannot get it by demanding it (and even by striking for it) unless his employer is able to pay it. And the property-owner's line of escape implies that he can get the funds which he needs for spending beyond his income by drawing on reserves which he has been holding in a liquid form. If he cannot *realise* his capital, save at great sacrifice, he is effectively «locked in», in spite of the capital that he possesses. So the fiscal method, if it is to be fully effective, needs to be buttressed by devices of other kinds.

Accordingly, on this line of thought, one is led back to the monetary alternative. And this must surely be at least one of the reasons why opinion has moved back to the monetary alternative. So we must look at that again.

Opinion moved from monetarism to fiscalism, as we have seen, because it was found that banking policy could not give enough stimulus, when stimulus was wanted; as it was said in those days «you cannot push on a string». It was nevertheless not doubted, in those days, that banking policy could be used as a check, when that was wanted; you can pull on a string, even if you cannot push on it. So even if banking policy was found wanting as a stimulus, might not it, when a check was required, come into its own?

A bank cannot make people borrow from it. But it can deter borrowers; it can even refuse borrowers. It can endeavour to deter by charging a high rate of interest; or it may adopt the more forcful method of directly limiting the loans which it will grant «credit rationing». A general contraction of credit by the banking system, even if it is the latter method which is used, must however raise rates of interest on the market. For those who are restricted in their borrowing from the banks will endeavour to satisfy their needs from other sources, and that will tend to raise rates of interest quite generally. Thus control by banking must usually come back to control by interest; though the extent to which a given contraction of bank loans will raise interest rates is much influenced by the availability of liquid funds on the market (and in the case of a country from which, and to which, the international movement of funds is easy, this is a particularly important matter).

Nevertheless, even when there is a plethora of liquid funds on the market, it is possible for the banking system to force up the rate of interest, by itself coming in as a borrower. The deposit rates which are offered by the banks (and the other

rates, whatever form they take, at which the banking system absorbs funds); these are what set an effective minimum to the rate of interest. Interest rates cannot always be raised by restriction of bank *lending*; but if the method of borrowing is also used, the power to raise the rate of interest is much stronger.

That however leads on to the further question : is it always possible to check inflation by raising interest rates? Traditional, pre-Keynesian, theory took it for granted that it always is possible; and modern monetarists, I think, have come back to the same opinion. Yes when one observes what has happened to interest rates, in modern inflationary conditions—when they have soared to levels which in the old days would have been unthinkable and have still failed to stop inflation, the old doctrine seems less easy to accept. It does, at the least, need thinking through rather carefully.

The first point to be made is indeed becoming well understood. High rates of interest are a deterrent to investment, in so far as there are projects which have a prospective yield which would cover a lower rate of interest but will not cover a higher. But the yield of a project is a stream of returns, extending from the present to various dates in the future; these returns are measured in money. Thus in conditions of inflation, when the inflation is expected to continue, the returns to be expected, at these future dates, are put up; they are put up in money terms. Thus a rate of interest which would be deterrent, indeed very deterrent, in conditions of stable prices, is much less so when prices are expected to go on rising. So it is that while in the old days, in Britain, a 6 % Bank Rate was regarded as very deterrent, now we cannot be sure that rates of 12 or 14 % will make much impact upon inflation.

The point is often put quite arithmetically. If prices are rising at x per cent per annum, a rate of interest of $r+x$ per cent is supposed to have the same effect as a rate of r per cent would have in conditions of stable prices. Thus if r would have been a deterrent rate, in conditions of stable prices, the rate must go to $r+x$ to have the same effect, when a pricerise at x per cent is established. From this point of view, the high rates which we have been experiencing have not been high enough. If interest rates had risen less, that would indeed have been still more inflationary. But the rise which has occurred, though (relatively to that) it has imposed some restriction, has not been enough to do what is required.

My own view, however, is that is too arithmetical. It is not the present rate of price-rise whien enters (at least for the most part) into calculations of profitability; it is the expected rate of price-rise, the rise which is expected to rule in the future. And that is a matter of psychology, not of statistics. It is not something which it is safe, or wise, to take as a datum, when making decisions about monetary policy. A *passive* policy, which just adapts the terms of bank lending to the state of the market, raising rates of interest to match what seems to be revealed as the state of expectation, does indeed take expectations as a datum. But an effective policy would have to go beyond that.

It can seek, and indeed must seek, to change expectations. But that is just where it runs into trouble. I do not myself doubt that it is possible (always, I think it is *technically* possible) for a sufficiently resolute banking policy to check, or even prevent, inflation of prices. But such a policy will not take the form of calculating, by some sophisticated method, what is the *minimum* rise in interest rates which will have the desired effect. It must take the form of making it clear that interest rates will go on being raised, not just once but again, until it is clear that they have taken effect; that the policy wlil be persisted in however far it has to go. That must be effective in stopping inflation; but stopping inflation will not be its only effect.

For once the adoption of that policy is believed in, the inflationary expectations will disappear, and are likely to disappear very quickly. But it will then be found that the rates of interest which were just sufficient to impose a check, given the inflationary expectations, become monstrously high, once the inflationary expectations have disappeared. So there will have to be a relaxation, a very quick relaxation, if the restrictive measures are not to have far too much effect. Yet the relaxation must not come so soon as to give the impression that, after all, the Bank did not mean business; for that would cause the inflationary expectations to light up again. This is a dilemma, an appalling dilemma. I do not find it all surprising that those who are in positions of responsibility are frightened of it.

The fact is, I am afraid, that while monetary policy is useful (even perhaps supremely useful) in *preventing* inflation, it is much less usable as a means of stopping inflation, once the inflation has gathered strength. One does not need to be a Keynesian to see that. It is sufficient to observe that once an economy has got adjusted to inflation—to a degree of inflation that is noticeable (such as nearly all countries,during these last years, have experienced)—a sudden change to a condition of price-stability would have many of the effects which would occur if, after a period of price-stability, prices started falling. For it will be noticed that in each case business would find itself saddled with a burden of debt which had not been allowed for, a most depressing burden of debt. A sudden stoppage of inflation would produce many of the symptoms of a nineteenth-century trade crisis. This, I think, is beginning to be understood; our politicians are beginning to talk of reducing inflation *slowly*. But I do not see that a deceleration of inflation could easily be brought about by monetary policy.

Is one therefore obliged to return, again, to fiscal measures? Not, certainly, to fiscal measures alone; for what was previously said about fiscal measures alone still holds. A combination of fiscal restraint with monetary restraint may however appear more promising. If the monetary restraint is strong enough, the routes by which the taxpayer can escape from fiscal pressure should be, at least to some extent, closed. In these terms the combination does look more promising.

Yet even when the methods are combined there is still the same difficulty—the difficulty which we have just identified when dealing with monetary policy alone. An ineffective monetary restraint, even a not quite effective monetary restraint,

does not really close the fiscal loopholes; but if the monetary restraint is made effective, it can so easily be too effective; it can so easily overshoot the mark. It was for this kind of reason that, in a somewhat combative paper which I published a year ago, I stated myself to be more in sympathy with «political» methods of checking inflation than is usual among economists. As I put it in that place (1).

«One is led to be more charitable to the "social contract" and the "£2 limit" — and to the successors which it is only too likely will have to follow them — than one is tempted to be from one's economist's prejudices».

I still stand by that (after all quite careful) statement. But I must also accept the observation that is made by Marcus Miller, in an important article in the current AER (2), that incomes policy, in the way it operated in Britain, did at one critical point have a most unfortunate effect. The incomes policy actually in force, at the turn of 1973-4 (as he says).

«was designed under the presumption that the terms of trade would shift in favour of the United Kingdom over the year following October 1973. With wages and salaries subject to a ceiling of 7 per cent per annum and productivity growing at 3 per cent, it thus appeared reasonable to assume that prices would not rise by as much as 7 per cent; hence the policy allowed for compensation to be paid for increases in the price index above 7 per cent from the starting date of the policy».

If the terms of trade had behaved as expected, that arrangement might well have been useful; but by what actually happened—the Oil Squeeze and the contemporary rise in other import prices—it was completely blown up. As any economist can see, the adverse movement of the terms of trade should have led to a fall in real wages in Britain; but as a result of the incomes policy in force, there was an *automatic* rise in money wages, to such an extent that real wages actually rose, with the inflationary effects and balance-of-payments effects with which we have become only too familiar. There is no doubt about these facts; I fully accept them. But because British incomes policy was blown up by the Oil Squeeze, it does not follow that it was not sensible to try it. Many other things were blown up too.

You may well be feeling that many of the things I have been saying, so far, are among the things which have been blown up. For I have allowed myself, so far, to talk as if the inflation being considered was inflation of the old type, inflation that was ultimately reducible to over-expansion, so that by one method or the other, or by both, it was to be «cooled off». But it was already being found in the late sixties, in many countries, that inflation of prices was consistent with a low level of activity «stagflation» people called it. This naturally led to an additional disinclination to take anti-inflationary measures; since it was feared that anything which reduced inflation (granted to be too high) would also reduce employment (already felt to be too low). It was that state of affairs which led people to turn to incomes

1. «Whgt is wrong with Monetrism» (Loyde Bgnk Review, Oct. 1975.
2. American Economic Reyiew, September 1976, p. 513.

policies; they belong to that phase. I shall however not discuss them further; for I think that we have now passed into another phase, which is still more difficult to deal with.

The change in the terms of trade, which upset the incomes policy of Mr. Heath's government in Britain, was much than a British phenomenon; it was a world phenomenon. It could be expressed, in world terms, as a change in the terms of trade between industrial production, on the one hand, and primary production on the other. Not that all primary prices moved the same way; but though the rise in Oil prices was the most dramatic, it would certainly seem as if that was a part of something more general. It was the sudden discovery that supplies of materials, as well as of energy, were not so expansible as had been believed which precipitated the crisis.

Though the inflationary depression which followed has had several novel features, there are events in history which have something in common with it. Even in the nineteenth century there were temporary depressions due to ad harvests; and there is one more recent experience, the price-explosion associated with the Korean War, which has several similar features. I find it hard to believe that that price-explosion was «caused» by the war, which was after all not such a very large war; it is more convincingly interpreted as a consequence of industrial recovery (from the War which was indeed a large War) getting out of step with the recovery of primary production. On that occasion, the shortage of primary products proved to be short-lived; and so it may be again. But one cannot be sure.

It will be useful to look at the problem in rather abstract terms. Suppose that «industry», when fully employed, or fully active, requires an input of 100 units of primary product, to support that level of activity. It has been active at nearly that level; but then, for whatever reason, the supply of primary product is contracted, so that no more than 90 units are available, *at unchanged price of primary product*. If the output of industry contracts, so that no more than the 90 units are absorbed, there is no reason why prices should change (or should change in any other way than they had been changing previously). Neither the price of primary product nor the prices of the goods into which it is an input need change, as a result of the change in availability. So (we may say) there is no inflation of prices, nor deflation of prices, but depression is acute. There is a fall in real output, in both sectors; and since prices are unchanged, this implies a fall in money income, or in the money value of output. In that sense there is deflation. From the monetarist point of view, there surely is deflation, since less money will be required to circulate the reduced money value of output, and the supply of money will presumably contract to match the diminished demand.

Almost everyone would want to find ways of raising output (and employment) above this disastrous level; but any attempt at expansion, whether the means adopted were monetary or fiscal, would be bound to raise prices. It would be realistic to suppose that any attempt at expansion, beyond the point of zero price-

inflation, would raise the price of the primary product quite sharply; and that this rise would then be passed through to other prices. There would in principle be some degree of expansion which would generate a value of output equal to that which would be attained if the 100 units of the primary product were available. In the «income» sense there would then be no inflation. But there would be price-inflation, and still there would be fall in real output below the full employment level. If one thinks of real output falling from 100 to (say) 92—not 90—while prices rise by the reciprocal of that fall, so from 100 to about 108, one gets the idea.

At this point there would be zero income-inflation. Though there is more employment than at the point of zero price-inflation, the degree of unemployment is still considerable. So why stop there? But with further expansion, though the effect on prices could be large, the effect on employment could well be small. For we are assuming that the higher price offered to the primary producers does not elicit very much in the way of increased output from them.

I have told this story in formal terms, making a model rather than a description. But does it not look as if it is something of this sort which has happened?

Of course it is true that in the practical case there are complications—many complications. In my model the input contraction impinged on a state of zero inflation; in practice there was already inflation, the input crisis just aggravated it. But that initial inflation was very different in different countries; in those where it was moderate, the aggravation was relatively manageable; much less so in the others. Even apart from that, there were differences in power of resistance. Total industrial output, from all industrial countries together, was constricted, but the constraint did not bind all countries equally. The stronger and more competitive its industry, the less it would be constricted; the chief constraint would fall on the others. Is not this, again, what we see?

I have insisted, and must again insist, that it is perfectly possible that these troubles will be temporary. Supplies may recover, as they did in the fifties; and when that happens the pressure will be eased. Even if that does not happen, if the constriction persists, ways will surely be found, in time, of living with it. My model, I think, is realistic; but it need not be taken pessimistically. It is very natural that industry, after the easy time which (we now see) it had in the sixties, should still be trying to carry on in the old ways, in these now conditions. The «fixed technical coefficients» which, it may have been noticed, are implied in my model, are realistic, I think, in the short run; but in the longer run there must surely be some variability. Ways will surely be found of employing labour productively, even while the primary product scarcity continues.

Thus I do not apologise for what may have seemed an old-fashioned approach to the problem I have been discussing the approach which I followed in the first part of this paper. I am sure that, the time will come when it will again be relevant, as it was quite certainly relevant a few years age. Even now there is a «trade-off» between inflation and unemployment (or depression). One can have

a little less of each by having more of the other; though we are most of us condemned to have more of both than we would like.

There is a further point which I would like to make in conclusion. You will remember what I said about the difficult of ending inflation : how the expectations which continued inflation engenders have got to be killed; how difficult it is to kill them without doing so rather suddenly; while a sudden change in the expectational climate must administer a shock, a shock that can do much *real* damage. There have nevertheless been examples in the past, fairly frequent examples, of inflation that has been ended without much of that damage. How was it done? I believe that in must cases it was stabilisation of the rate of exchange that came to the rescue. Stabilisation at a rate which leaves the currency (for the moment) undervalued leaves it possible for internal prices to rise a bit further, but (quite clearly) not so very much further; the transition from inflation to stability is thereby made very much easier. This is the why out which has often been taken; I do not see any which can hurt less. I am therefore greatly troubled that in these days of floating exchanges, exchanges kept floating on *principlel* it is so very largely closed. While I accept the technical case for floating, and especially for the «managed floating» which has been so ably championed by Prof. Zolotas, I do thinh that generalised floating has this major defect. I wish it were not so often overlooked.