The Frank E. Seidman Distinguished Award In Political Economy

Acceptance Paper By

ROBERT M. SOLOW

Recipient of the 1983 Award

Fiscal and Monetary Policy— Coordination or Conflict?

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Mel G. Grinspan
Director

ROBERT M. SOLOW
Recipient of the Tenth Annual Frank E. Seidman Distinguished Award in Political Economy

Memphis, Tennessee, September 29, 1983

Dr. Solow, a native of Brooklyn, is Institute Professor and Professor of Economics at the Massachusetts Institute of Technology. He received his doctorate from Harvard University in 1951.

In his 34 years as an economist, Dr. Solow has been widely recognized for his many articles about economic theory, economic development and the economy of exhaustible resources. His innovative approach to the study of economics has formed the base from which many economists approach the long-term development problems of less developed countries. In his earlier years, Dr. Solow presented his views on the factors affecting growth of national income which provided the theoretical foundation of what is now standard economic analysis.

Dr. Solow is a recipient of Harvard's David A. Wells Prize and the John Bates Clark Medal of the American Economic Association, an organization he served as president. He has been an important member of many public commissions and panels and served, for one year, on the staff of the President's Council of Economic Advisers. He has been awarded many honorary degrees and other academic honors.

Fiscal and Monetary Policy—Coordination or Conflict?

Robert M. Solow

Evidence from satellites has made it pretty definite that life as we know it does not exist on Mars. That does not conclusively rule out the possibility, however, that there are economists on Mars. If a Martian economist were observing the conduct of economic policy in the United States—especially during the past few years, but much the same would be true of other periods—she would surely be sending back some very puzzled reports. She would certainly have noticed that fiscal policy and monetary policy are the two main instruments—really the only instruments—we have for managing our economy as a whole. Obviously there are many other things we do by way of taxation, subsidization, and regulation that affect one branch of economic activity or another, for better or worse. But so far as macroeconomic performance goes, fiscal and monetary policy are what we have, to be used or not used, individually or together, to accomplish broad purposes.

The Martian observer would no doubt be wondering why we have set our system up so that the makers of fiscal policy and the makers of monetary policy can be at loggerheads, and in fact seem to be at loggerheads at least as often as they pursue a consistent—let alone coordinated—strategy. I will only have to remind you how often in the recent past, not to mention the immediate present, the Congress and the Federal Reserve, or the Executive Branch and the Federal Reserve, have behaved like and sounded like adversaries and not like partners. I doubt that any other important nation can make that claim. I want to discuss how and why this happens, what the consequences are for the conduct of macroeconomic policy, and how we might try to make the system work a little better in the future, without potentially divisive effort at major structural reform.

I shall start by explaining what fiscal and monetary policy are, how they are supposed to act to affect the economy, and what they are supposed to accomplish. I am neither the first nor the last terrestrial economist to try a little public education on these matters, without much success. I don't know if they have better luck on Mars. Perhaps if economists were more nearly unanimous they would have more influence. Honesty compels me to warn you that there is sharp controversy within the economics profession on precisely the vital issues I want to discuss. I can promise you that my views are not outlandish or idiosyncratic, though not every macroeconomist would agree with them. Fortunately the doctrinal disputes within economics are not really critical for my main point about the coordination of fiscal and monetary policy. Many of those who would not go along with me on the right analysis of monetary and fiscal policy could nevertheless agree with what I want to say about the conduct of monetary and fiscal policy.

Let us take fiscal policy first. Fiscal policy is made whenever the Congress and the President make or change the budget **program** and the tax **laws** of the Federal government. (State and local governments also make fiscal policy willy-nilly, but their motives are almost always pure housekeeping motives and their freedom to act is limited, so I will not pay attention to them.) I have emphasized budget **program** and tax **laws** to remind you of one of those commonplaces that we seem always to forget in our national fixation on last Wednesday's budget deficit. The policy decisions of the Federal government do not completely determine the actual expenditure and revenue outcome in any fiscal year. Some expenditure totals are determined by vote of Congress and signature of the President, at least up to the usual amount of slippage in the writing of checks. But others, like unemployment insurance benefit payments, or welfare expenditures, or interest payments on newly-floated bonds, depend on what happens in the economy during whatever period we are talking about. Even more so on the revenue side: the revenue actually collected by any set of income, profit, payroll and excise tax schedules is very sensitive to the level of incomes, profits, wages and salaries, and sales of taxable commodities, and those tax bases depend on all sorts of imperfectly foreseeable and partially understood events that happen out there in the economy, including some events that originate in other parts of the world. This is not a matter of splitting hairs. The standard estimate is that any strengthening of the economy to the extent measured, say, by a one-point reduction in the unemployment rate **automatically** reduces the Federal budget deficit by about 0.8% of GNP or, today, by between $25 and $30 billion. Changes in the speed of inflation and changes in the general level of interest rates also have an effect on the recorded outlays and revenues, and therefore on the deficit.

That being so, changes in recorded outlays and revenues, and therefore changes in the recorded budget deficit are very bad indicators of the direction and size of fiscal policy **actions**. In normal times, short-run changes in the deficit are dominated by passive changes of the kind I have just described, and thus tell us more about what events are doing to the budget than what the budget is doing to events. But we do need an indicator of the autonomous thrust of fiscal policy, at least we do if we want to talk about it and know what we are talking about. We would like to say that fiscal policy is expansionary if Congress and the President change the budget program and the tax laws in ways that would add to the net demand for goods and services if no external events intervened to offset or reinforce the effects of those actions. Fiscal policy is contractionary when the tax-and-budget program is changed so as to reduce the net demand for goods and services, other things equal. (I use the word "net" to remind you that any supply-side effects have to be taken into account; they are likely to be negligibly small in the short run.)

That sounds easy, but it can be very complicated in practice. A dollar spent on goods that do not directly replace private consumption or investment should count as a dollar; but a dollar spent on interest payments (which these days consist in large part of return of capital otherwise eroded by inflation) whose recipient may spend only a few cents and save the rest should count for considerably less. One could obviously make analogous distinctions on the tax side. Some taxes have a bigger effect on private spending than others, per dollar of revenue. For most purposes, however, we can get along with a simpler measure that counts dollars of expenditure and revenue all alike, and merely eliminates those passive changes in the totals that come about because of changes in the economy and not because of changes in fiscal policy. The routine is to estimate what the expenditure and revenue totals would be if the economy were at some "normal" standard of prosperity. The difference is called the "standard budget surplus or deficit". When the standard deficit rises, fiscal policy has moved in the expansionary direction; when it falls, fiscal policy has become more contractionary. This measure has been purified of the powerful effect that the state of the economy has on the budget totals themselves. The measurement is imperfect and hypothetical, and it could be improved by taking account of the more delicate considerations I have mentioned; but there is no serious argument about the numbers themselves.

There is more that could be said about fiscal policy; but this is a convenient place to make the transition to monetary policy. When the Federal Treasury takes in less revenue than it wishes to pay out, it must finance its deficit somehow, even as you and I. The resemblance ends there, however. Subtleties aside, there are two sources of finance for a Federal deficit. The Treasury can sell interest-bearing bonds to the private sector—to individuals, to trust funds, to financial institutions, or to corporate treasurers looking for a place to park some spare cash. Alternatively or simultaneously it can sell some bonds to the Federal Reserve System. This alternative is called "monetizing" a part of the deficit, because the Fed pays for bonds with what is called "base money' that enters circulation as the Federal government spends the proceeds. Our fractional-reserve banking system can build a considerably larger increment of "money supply" on the initial increment to the monetary base but that is a technicality that need not concern us. (I'm sure Southwestern has a Money-and-Banking course that would explain this to any member of the local community.) The monetized part of the deficit is interest-free to the government because the Federal Reserve returns to the Treasury most of its interest earning on its portfolio of government bonds.

Now just as the Fed can monetize part of the current deficit, it can choose at any time to monetize some of the already existing debt of the Federal government. It does so simply by buying bonds in the open market, from anyone who is willing to sell at the going price. As usual, the Fed pays for its purchases with base money, on which the banking system erects the money supply. That's what monetary policy is, phenomenologically speaking. That is what our observer from Mars sees the Federal Reserve actually **do**: buy and sell government bonds with base money.

Now what does it matter? There are some differences of opinion about the most accurate and useful way to describe the effects of monetary policy, but I shall try to be eclectic. If an operator with a large stock of apples and pears were to sell apples and buy pears—in effect trade apples for pears—you would expect the price of pears to rise relative to the price of apples. If the Fed buys bonds for money, you would expect the dollar price of bonds to rise, and so it would. A rise in the price of an existing bond is the same thing as a fall in the rate of interest on such bonds. Such changes in interest rates tend to spread to other similar assets. So, by buying and selling government bonds in the open market, the Fed can push the whole range of interest rates down and up. Another way of saying the same thing is that an open market purchase of bonds creates a momentary shortage of bonds or surplus of money in the combined portfolio of the rest of the economy; and the market responds by bidding up the price of bonds, or bidding down the rate of interest.

One school of thought sees these induced changes in interest rates as the main link betwen monetary policy and the real economy of goods and services, production and income. Lower interest rates will stimulate and higher interest rates will inhibit those private expenditures that are, for obvious reasons, most sensitive to borrowing costs: houses, plant and equipment, maybe automobiles and other large consumer durables. Another school of thought prefers to de-emphasize interest rates and argue that a "felt surplus"—what economists prefer to call an "excess supply"—of money may also directly induce purchases of a wide range of goods and services directly along with purchases of securities. It is not a life-and-death matter which viewpoint we take.

In discussing fiscal policy, I described a policy move as expansionary if it had the effect of increasing the net demand for goods and services, other things equal, and as contractionary if it tended to reduce the demand for goods and services. The same general criterion should apply to monetary policy. The Fed makes an expansionary move when it buys some government bonds in exchange for monetary base, i.e. when it monetizes some of the existing federal debt. It makes a contractionary move when it sells government bonds and causes the money supply to fall. In the expansionary case interest rates fall, the wealth-owning public finds itself more liquid, and the demand for goods, for some goods at least, is likely to rise. Higher interest rates and a smaller money supply will work in the opposite direction.

Conscience requires that I make some qualifications here, although the use I want to make of all these ideas is pretty straight-forward. The first qualification parallels one that I emphasized in the case of fiscal policy. Interest rates, and even the money supply, will be affected by many other things that happen in the economy besides the actions of the Federal Reserve. They must be allowed for in trying to read the thrust of monetary policy from what actually happens in the money markets. It is not easy, especially because money market events may be very sensitive to vagrant expectations about the future. Some economists prefer to look primarily at the monetary base, which is more or less entirely in the Fed's hands. That serves a purpose; the cost is that it keeps us a couple of steps away from what directly affects the volume of spending on goods. The second qualification is that we have a way of distinguishing more expansionary from less expansionary, or more contractionary from less contractionary, but we have not defined a zero, a perfectly neutral monetary policy. That is a more subtle task, not suitable for mixed company. I mention it only to warn you against supposing that there is any simple, easily recognizable, way of "doing nothing". The idea would be to have the central bank provide just enough new liquidity to cover the economy's needs, including normal growth but without generating on its own hook any net change in the (proportional) demand for goods and services. The tricky part would arise in deciding how much of any ongoing inflation ought to be accommodated in a neutral monetary policy. The difficulties associated with these and other subtleties are what give "fine-tuning" a bad name; we have no need to face them.

There is one more general point to discuss. I have tried to explain what we mean by "expansionary" or "contractionary" monetary and fiscal policy, and why we mean that. Is "expansionary" the same thing as "inflationary" and does "contractionary" mean more or less the same thing as "anti-inflationary"? I think most economists read the evidence as saying that the answer depends on the current and recent state of the economy. If the unemployment rate is low and there is little margin of unused productive capacity, if business is buoyant and optimistic, then expansionary policy is likely to be translated very largely into wage and price increases, and hardly at all into increased output and employment. In the opposite case, if the economy has a lot of slack, if the markets for goods and for labor tend to be depressed, then expansionary policy is more likely to work itself out primarily in increasing real economic activity, as one would hope. Expansion of the economy will usually be accompanied by some tendency for prices to rise. The real question is by how much, and whether the increase is likely to be cumulative or self-limiting. I think most economists believe that the situation goes gradually from good to bad as the economy becomes more nearly fully employed, over a fair range of situations. There is an alternative view that regards the economy to be more nearly balanced on a tightrope. In any case, the possible effect of expectations about inflation adds an unmeasurable and possibly erratic joker to the deck.

Actually this last question is not fundamentally about economic **policy**. Expansionary policy generates an increase in the net demand for goods. An increase in spending on home-produced goods could happen spontaneously, originating in exports, say, or in some sudden hunger of the natives to consume more or invest more. One would still have to ask how the economy's response would be divided up between higher prices and higher production, and the answer would appear to be the same: some of both, but the more prosperous the economy is to start with, the more prices are likely to absorb the increase in spending. This is important. There is no evidence that any special poison is attached to government spending or to private spending induced by expansionary fiscal or monetary policy that makes it more inflationary than other spending. It is always in order to ask if public spending is well directed, whether socially useful purposes are served, whether there is waste or corruption above and beyond the call of duty. A moralistic observer might even want to ask the same questions about private spending, whether or not it has been induced by fiscal or monetary policy. But that is an entirely different question from the one that concerns us here about the management of the economy as a whole, and the tendency of expansion to degenerate into inflation.

Now, having established a vocabulary and some ground rules, we can come to the central point. First of all, why is it desirable that fiscal and monetary policy should be coordinated? Why should decisions about fiscal and monetary policy moves be made together? Well, there is an obvious reason, and then some subtler ones. The more obvious point is, of course, that fiscal policy and monetary policy can offset or reinforce one another, depending on whether they are pushing in the same direction or opposite directions. Even if it is apparent to everyone that the economy needs restraint, independent contractionary decisions on the part of the fiscal and monetary authorities, each ignoring the other, are likely to lead to too much restraint. It surely does not seem like the most promising way to achieve the right amount of restraint. Fine-tuning is beyond our capacity; but we could hope to do better than mere discord. Of course the fiscal and monetary authorities need not ignore each other. In the absence of coordination, however, each must guess what the other will do. (There is an asymmetry here, because the Federal Reserve can act quicker and more often than the Congress and the President, but I will ignore that for now and come back to it later.) If one or both guesses are wrong, we are back to haphazard policy. If they both guess right, we are still not out of the woods: the two centers may well have different views about the way the economy works, and different evaluations of the possible outcomes, and then the non-cooperative way of playing the game can lead to an end result that is unsatisfactory from everyone's point of view. In any case, non-cooperation is foolish. If analysis and goals have to be compromised, that should be done explicitly in the interest of coordinated stimulus or coordinated constraint, not by some unpredictable accidental process.

Of course, if analyses and evaluations differ, it is possible that fiscal and monetary policy can pull in opposite directions and then worse things can happen. But now we need to take account of a subtlety. To speak of fiscal and monetary policy as being merely expansionary or contractionary is a gross simplification. On a more detailed level, they act in different ways. I have already mentioned in passing that monetary policy operates with greater intensity on those goods that one would expect to be especially sensitive to interest rates and credit conditions—housing, capital investment and consumer durables, for instance. Congress can enact a wide variety of tax and expenditure programs; simple across-the-board tax changes are most likely to stimulate or restrain across-the-board consumer spending in the first instance.

That complication can be read as good news or as bad news. The good news is that coordinated fiscal and monetary policy can aim to hit more than one target. Today, for instance, there appears to be some consensus that it would be a good thing for the economy to continue to expand, and it would be an especially good thing if the expansion included a healthy increase in capital investment to renew our industrial plant, improve fading productivity, and strengthen our competitiveness in international trade. But then a coordinated policy would aim to achieve much of its stimulus from monetary policy, or from targeting fiscal policy. Policy can aim not merely at continued expansion but at investment-biased expansion. Uncoordinated policy will miss on at least one target and maybe both. In short, monetary and fiscal policy are additive but not merely additive. To achieve not only recovery but the right kind of recovery requires that they work together.

There is a third level of sophistication that I would like to sketch, if only superficially, because it is directly relevant to the current predicament of the U.S. economy. There is, as I have said, wide-spread agreement that the U.S. needs a long upswing because it has a long way to go to achieve a state of prosperity worthy of the name. A wave of capital investment would help fuel such an upswing and have other benefits besides. We start from a situation in which real interest rates are very high, so high by historical standards that it is uncertain that any substantial recovery can occur and it is fairly certain that no investment biased recovery will occur unless they come down. We start also with a budget deficit in the current fiscal year amounting to some 6 percent of GNP. Over half of that is due to the depressed state of the economy; standardized to 6 percent unemployment, the deficit would be less than 3 percent of GNP. Moreover, half of the total deficit and all of the standard-employment deficit consists of interest payments on the federal debt. If interest rates were substantially lower, the deficit itself would be much lower. The final piece of bad news is that the best projections suggest that the standard-employment deficit is not shrinking. A lot depends on how seriously you take Congressional resolutions in a political year. Since the Congressional Budget Office expects that unemployment will still be higher than 6 percent of the labor force after five more years, a cynic might think that the actual deficit in 1988 might be near 5 percent of GNP.

It is possible that private spending will prove to be very strong in the near future, without any help from policy. But suppose, for the sake of the argument that something will need to be done to keep the economy moving. If it is done by fiscal expansion, i.e. by actions that will raise the standard-employment deficit, then by the time full prosperity has been regained, the standard deficit will be bigger yet; it will be absorbing a very large part of the country's saving, and there will not be much left over to finance that badly-needed wave of investment. Of course the Fed could monetize a lot of that 1988-or-whenever deficit, but if the economy were already prosperous by then, the combination of expansionary fiscal and monetary policy might well tip us over into revived inflation. Alternatively the continued expansionary push we need right now might come from the monetary policy side, especially since real interest rates are high to begin with. But then another obstacle appears. The bond markets have been so indoctrinated with the notion that easy money (or just easier money?) means inflation, that nominal interest rates could begin to incorporate the offsetting premium right away. Since the inflation has not yet happened, the immediate result would be a perverse rise in real interest rates. The same anticipation of future inflation will lead to anticipations of an early return to tight money, and therefore to high interest rates, especially with that overhanging budget deficit congesting the capital market. If bond rates are expected to be higher soon, no one will buy bonds bearing the lower interest rates now. Monetary-policy expansion is self-destructive too, according to this scenario. Can we not get there from here?

The Reagan administration at one time proposed a way out of this box that is reasonable in broad outline, though a decent person could quarrel intensely with its particulars and its numbers. The idea was that the Congress would commit itself **now** to a policy of fiscal austerity in the **future**, when the recovery will have matured. Thus the danger of inflationary over-expansion later on will be avoided, and the perverse effects of current expectations of future inflation will also disappear. This proposal went rapidly nowhere and has now been abandoned, partly because the Congress does not like to—and knows that it cannot—commit future Congresses, and partly because the details of the administration's proposal were unacceptable to very many members. But I want to take the idea seriously for a moment, because it is reasonable, and because it points to the importance of intelligent coordination of fiscal and monetary policy.

Suppose an appropriate combination of fiscal and monetary stimulation were achieved now. No one knows when the economy will reach an agreeably prosperous state, so one could not hope to legislate now the future path of fiscal policy. Moreover, when the great day arrives and it is time to reduce the standard deficit, that will be contractionary. Since the object is not to abandon prosperity the instant it is achieved, the right thing may be to provide a mixture of fiscal contraction and monetary expansion that will be neutral in the aggregate, and to do so at a future date not currently knowable. And since part of the goal is to influence expectations today, what is needed is current assurance that this combined operation will take place when it is needed in the future. That is the third level of sophistication that I spoke of a moment ago. To succeed, we must not only coordinate monetary and fiscal policy but know that we can coordinate monetary and fiscal policy.

If Professor Pangloss is in the audience, he is presumably already thinking to himself: if coordination is so important, surely it has already been achieved, for is not all for the best in this best of all possible worlds? Candide is forced to reply that if it were so, we would not now find ourselves saddled with excessively high interest rates and an excessively large series of standard deficits, when nearly everyone agrees that we need just the reverse. Moreover, it is generally accepted that the turn to very tight money in 1979 is what brought us four years of economic stagnation, only partially relieved by the massive tax cuts, which in turn have turned the whole package against the capital investment everybody claims to want. You have seen the spokesmen of the administration alternatively—and sometimes simultaneously—praise and blame the Fed. The Congress is full of bills proposing to limit or eliminate the Fed's freedom of action over monetary policy and replace it by one or another rule, or perhaps by two contradictory rules. The game Mr. Volcker appears to be playing with Congress looks suspiciously like Chicken. If this is coordination, then conflict would look like the beginning of World War Three.

One might suspect that this disarray in macroeconomics is special to the current administration; perhaps someone has confused the Fed with the EPA or the Legal Services Administration or some other pinko plot. It is worth looking back over a somewhat longer past. I don't have the time to produce a potted history of fiscal and monetary policy since 1960. But I can report that two of the most fair-minded and reasonable people I know—Professor Alan Blinder of Princeton University and myself—have independently thought to compare annual changes in the standard deficit and in the money supply (in his case) or monetary base (in mine) to see if they appear to have been working in tandem since 1960, which is about as long as this question has attracted attention. This is a superficial test, and could mislead; but the impression it gives is that monetary and fiscal policy seem to have operated essentially independently, as if they were ignoring one another. There is certainly nothing in the data to suggest a well thought out combined approach.

Why do we fail in this respect? There is some conventional wisdom on this subject. As with most conventional wisdom, there is some truth in it, but it does not appear to be the whole story. The conventional wisdom says that expansion is almost always politically popular and restriction is not. It is the idea of bread and circuses all over again, only now it is entitlement programs, low taxes and the pork barrel. The consequence is that governments tend to over-expand, to run the economy too close to the edge where real expansion tips over into inflation. Thus fiscal policy, which is a legislative matter and responsive to the popular will, has an expansionary, even an inflationary, bias. Central banks, on the other hand, have a deflationary bias, and can afford to have it because they tend to be more remote from the political process and because central banking is a recondite mystery, in the sense given by my dictionary of a "cult or secret rite to which only initiates were admitted". But why are central banks—and central bankers—natural-born deflationists? Perhaps because they see themselves as guardians of the integrity of the currency against the instinctive inflationism of democracies and kings. Perhaps because banking is a conservative profession which, with its conservative allies in business at large, just naturally opposes the populist activism of legislatures. Perhaps because central banking attracts anal types for reasons I do not wish to know. It all rings a little true, but I do not think it can be the whole story. For one thing, this account would imply a greater concentration of fiscal expansion than of monetary expansion in election years; but the data collected by Blinder and by me do not really give that impression. Nor is tight money always so great for profits.

I think there is some additional insight to be gained by thinking about the institutional set-up within which monetary and fiscal policy are made in the U.S.; that may tell us **how** failure of coordination arises, even if it will not tell us why.

Monetary policy, as you all know, is in the hands of the Federal Reserve System, which means, in effect, the seven members of the Board of Governors. (Five of the presidents of the twelve regional Federal Reserve Banks rotate on and off the Federal Open Market Committee, in which monetary policy is actually made; but unless one or two of them have very strong personalities, the Governors tend to dominate.) The Federal Reserve was created by act of Congress, and so it is responsible to Congress. The Federal Reserve Act could, after all, be amended like any other piece of legislation, though not easily, I suspect. Nevertheless, the Fed is protected by a mystique of "independence" which it, in turn, protects and cultivates. It is clear that some degree of independence was intended by the Federal Reserve Act: the Governors are appointed by the President and confirmed by the Senate for terms of 14 years, and this was undoubtedly meant to protect them against political pressure. (The right to appoint one of the Members as Chairman for a four-year term gives the President some extra influence. The Chairman has more and more come to be the dominating personality on the Board of Governors; this fact, combined with the mystique of independence, makes the President's right something of a hot potato, as Mr. Reagan has recently discovered.)

In any conflict between fiscal and monetary policy, intended or accidental, the Fed has certain natural tactical advantages, in speed and flexibility. The Board of Governors spends full time on monetary policy; the Open Market Committee meets monthly in private, and more often if necessary; monetary-policy directives can be changed overnight. Moreover, the Board has a tradition of unity; differences of opinion can and do emerge, about analysis, objectives and policy, but they almost never erupt into open debate. The Fed has a large and excellent staff; it is one of the major centers of economic research in the U.S. Nor is the Fed isolated politically. On most monetary matters, and especially when its independence is threatened, it can mobilize a formidable domestic lobby of bankers. Every small town has a banker, and every Congressman will pay attention to so solid a citizen in his district. The international fraternity of central bankers is another source of solemn symbolic support, especially impressive given the arcane character of the whole enterprise of monetary policy.

Fiscal policy, on the other hand, is made by the Congress and the President. The Congress has the advantage of being in ultimate formal control. The Fed is, as I said, a creature of legislation. But that ultimate threat is hardly a tool of everyday policy. Moreover the Congress suffers the disadvantage of being a partisan body with an unwieldy committee structure and sometimes, it seems, an invincible ignorance about economics. It cannot act quickly and flexibly on fiscal-policy matters; and even if it could it probably should not. Taxes and expenditure programs cannot efficiently be altered frequently. That is not altogether to the bad, tactically speaking. Every game-theorist and every game-player knows that it is sometimes a strength to be able to make your move and then assert convincingly that you are powerless to change course; your opponent must adapt to your decision because you are lashed to the mast, like Ulysses, and have no capacity to adapt to his. Nevertheless I share the common impression that, on the whole, the advantage in this game lies with the Federal Reserve. The President has considerable leverage, as always in our system, but must use it very skilfully, with one eye on party politics and the Congress and the other on the opinions of the financial community. If fiscal and monetary policy are conducted in an uncoordinated way, the Fed will usually have the last word.

When fiscal and monetary policy are moving in contradictory ways, there is no doubt about who **should** prevail. The Constitution gives Congress the ultimate authority for monetary policy, but that is not the main point. When push comes to shove, it is our democratically elected representatives and President who have the responsibility to determine macroeconomic objectives and design a policy to pursue them. It would be simply intolerable for their decisions to be frustrated in favor of the conflicting objectives of the central bank.

This line of reasoning may seem to suggest the desirability of Congress asserting more operational control over the conduct of monetary policy. Lack of coordination could be remedied by unifying the control over fiscal and monetary policy. But that is not the conclusion I draw. In fact I am inclined to think that the various pieces of legislation proposed to achieve some such end are misconceived. I have to say why.

In the first place, it is pretty obvious that Congress is too ponderous and too inexpert a body to assume direct operational control over monetary policy. Even the establishment of a monetary-financial analogue to the Congressional Budget Office—which has been a great success in the fiscal-policy field—could not possibly alter that. Decisions must be made too frequently and too tentatively to be done by a legislature. The alternative would be for Congress to prescribe rules or at least to specify operating objectives for monetary policy, and leave the technical problem of carrying out the rules or achieving the operating objectives to the central bank. But that seems to be a losing proposition too. All our experience tells us that rigid rules break down; the behavior of the economy is not so regular that we can devise a rule for all seasons. The sad history of the past four years is in part the record of the failure of the Fed's attempt to play that game. What I have called an "operating objective"—an injunction to achieve this or that state of affairs in the monetary sphere—is likely to be either so rigid as to constitute a rule, or so vague as to be empty of content, or—as in the case of the Humphrey-Hawkins Act—so unrealistic as to evoke a charade.

Secondly, while I am not convinced of the truth of the axiom that governments tend to be overexpansionary and therefore inflationary, I do not know that it is false. From that point of view, a system of dual control might have its uses. The notion of checks and balances is not alien to the American system of government.

Third, I can see positive advantages in having several independent **voices** heard in the formulation and discussion of macroeconomic policy. The establishment of the Congressional Budget Office as a counterweight to the Council of Economic Advisers has made for more intelligent and focussed discussion of fiscal policy. Monetary policy is at least as complicated and as changeable. What is the right thing to do and what is the right way to do it is not so simple a matter that we can dispense with debate. The problem is to raise the intellectual level of the debate, and the existence of the Federal Reserve Board, with its staff, as an important player may be an effective way to accomplish that goal. We have not achieved it so far; but I doubt that stifling the voice of the Fed, or absorbing it into the executive or legislative branch of the Federal Government, would be a step in the right direction.

Instead I want to suggest a simple procedural reform that could be accomplished without much uproar. If taken seriously it would have the effect of alerting the press, the public, and the players themselves whenever fiscal and monetary policy are pursuing incompatible goals. Suppose the Federal Reserve were to adopt as its fundamental target the achievement of a desired path for the country's nominal GNP, aggregate final production in current prices.

Remember that the President already produces and, in effect, endorses a nominal GNP projection every year in the January Budget message. It is indispensable; without a projected GNP path it would be impossible to estimate Federal revenues. Now of course that GNP projection is sometimes a political number, a ploy, and not an honest estimate or a genuine target. But one of the achievements of the Congressional Budget Office has been to keep the Executive Branch honest. It does an Administration little good to insert a phony GNP projection in the Budget calculations, only to have it shown up as embarrassingly unrealistic by the highly competent staff of the CBO at the House and Senate Budget hearings. I notice that at this very moment the Administration's projected GNP path is almost identical with that proposed by the CBO. It was not always so.

Now suppose that the Federal Reserve Board were required to state officially to Congress and the country the path of nominal GNP that it regarded as compatible with its projected monetary policy. That too would have to be understood as a target. The Fed would no doubt prefer not to be so explicit; the guardians of a mystery always prefer smoke and dim light. But of course the Board has such GNP projections. It needs them for its own deliberations and its excellent staff can do as good a job as anybody in making them. We would then, once or twice every year, have three sets of GNP projections before us: one from the President, one from the Congressional Budget Office, and one from the Federal Reserve. Benighted as we are, even we would know, even Tom Brokaw would know, that something was peculiar if the three agencies were to report that they were aiming at, and expected, incompatible paths for the national economy.

It goes without saying that the art of passing from policy choices to their implications in the national economy is imperfect. The expected path for GNP might turn out to be off the mark, as even honest forecasts often are. Moreover one cannot legislate candor; the projections might still be phony. There is no way to insure good economic policy. But I think even so simple a device as this would be a strong force favoring coordination of fiscal and monetary policy. If congressional hearing and public opinion required the fiscal and monetary authorities to be aiming at the same GNP path, we would be well on the way to the mutual adaptation of fiscal and monetary policy to be compatible with the agreed path for the economy.

I better make two slightly technical qualifications. The Fed seems to be in the process of abandoning, as a failed strategy, the targeting of monetary policy on the path of a single monetary aggregate. It appears to be moving toward the use of multiple targets, including something as broad as aggregate non-financial debt. It should be realized that these are intermediate targets, useful for the day-to-day conduct of monetary policy, and there is no need to interfere with them. The specification of the corresponding path of nominal GNP in addition is merely coming clean about the ultimate target. The true goal of monetary policy is not to achieve some financial or monetary result, but to achieve some national-economic outcome. Only good can come from making that clear.

Secondly, one might justly remark that nominal GNP is itself a peculiar goal around which to coordinate macroeconomic policy, neither fish nor fowl. Why not go all the way and require separate targets for real output and the price level instead of just their product? My answer is that the intellectual underpinnings for that refinement are lacking. If there is no common analytical foundation on which to base a policy, there is no point in looking for agreement and coordination.

The Chairman of the Fed already produces a consensus "projection" of nominal (and real) GNP for the next 18 months or so when he makes the report to Congress mandated by the Humphrey-Hawkins Act. This projection is officially attributed to the Open Market Committee, but it does not serve the purpose I have in mind. It is presented as some sort of objective forecast by the committee members, not as a target they feel committed to achieve. Their target is still stated in terms of M2 and M3, with some attention to M1 and total debt. The implication is clearly the monetary aggregates are what matters, and the GNP number is just another guess. Paul Volcker has argued against the adoption of a GNP target, but I think his reasons are unconvincing. He has suggested that he could not hope to get his fractious fellow members of the Open Market Committee to agree on a GNP target. But he now gets them to agree on a money-supply target. If they make sense to themselves at all they must be agreeing implicitly on some economic magnitude that really matters. Otherwise they are just playing a meaningless game, which ought not to be encouraged. Mr. Volcker has also argued that monetary policy is intrinsically incapable by itself of achieving a GNP target, so it ought not to be saddled with one. But of course that misses the point completely. The function of an explicit GNP target is to provide a focus for a coordinated fiscal and monetary policy, precisely so that monetary policy does not have to attempt an impossible task alone. If as my plane took off from Boston this afternoon I had heard the pilot assure us that we were bound for Memphis while simultaneously the co-pilot announced that we were heading for Chicago, I feel certain that Delta Airlines would have heard from the passengers. That's all I am hoping for here.

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