5 The Role of Monetary Policy in Overall Economic Policy*

I INTRODUCTION

Any objective inquiry into improving the economic effects of the monetary policy of a central bank should begin with (1) a statement of objectives of such policy and (2) a discussion of means that can achieve these goals.

The four most often mentioned practical goals of monetary policy are:

1. To prevent inflation;
2. To encourage full employment;
3. To encourage sustained rapid economic growth;
4. To counteract balance-of-payments deficits.

In framing these objectives I have deliberately worded objectives no. 1 and no. 4 in negative or obstructive formats, while no. 2 and no. 3 utilize more positive wording. My rationale for this is to emphasize that active pursuit of objectives no. 1 and/or no. 4 by traditional monetary methods will normally obstruct the achievements of objectives no. 2 and no. 3. Accordingly, it is my view that monetary policy should be oriented solely towards achieving full employment and economic growth. This does not mean, of course, that monetary policy should operate in a vacuum. Nor does it mean that money and monetary policy cannot have some impact on the general price level or the balance of payments.

What I wish to recommend is the coordination of monetary and fiscal policy with incomes and foreign trade price policy so that the four objectives listed above can be approached simultaneously. Mere coordination of monetary and fiscal policy, while a step in the right direction, will not be the administrative panacea for reaching these objectives under present institutions— even if accurate forecasts of future events could be achieved.

Although discretionary control over the money supply is essential if we are to obtain full employment and sustained economic growth, any attempt to utilize changes in the money supply as the primary tool to restrict

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monetary, fiscal, and income policies. Until such coordinated policies are developed, this shell game will continue and as the late President Kennedy lamented, we will continue to content ourselves with pious statements about the wastes of our human resources.

Ever since the 1930s, economists have realized that recessions can be avoided and full employment can be achieved by fiscal policies such as tax cuts or increased governmental spending and/or expansion in the money supply. Moreover, if the economy begins from a position of less than full employment, policies that stimulate increased economic activity simultaneously reduce unemployment, and stimulate investment and growth; for one of the most important messages of the ‘Keynesian’ Revolution in economics was the complementarity of consumption and investment in recession. Thus we learned that it is possible to have more butter, more plant and equipment, and more guns, too, if only we had the courage to pursue certain fiscal and monetary policies.

Although there continues to be a debate among economists as to whether, as the Chicago school succinctly asserts, ‘money matters’, that is, a questioning of the relative efficacy of expansionary fiscal compared to monetary policies, most economists now agree that expansion of market aggregate demand is a requirement for continuous full employment and economic growth in peacetime. What has been often overlooked in this professional controversy over whether ‘money matters’, is that an increase in market demand means not merely an increase in wants but also an increase in the ability to pay for goods and services. An increase in the ability to pay, in a modern market-oriented, monetary economy, must involve an increase in the supply of money before the increased demand can be made operational in the market-place. This fundamental notion that an easy-money policy is a prerequisite to expansion and growth is, as I have tried to demonstrate in a number of articles (Davidson, 1965; 1967; 1968), an essential concept necessary to the understanding of the mechanism underlying the traditional Keynesian policy prescriptions for economic expansion.

As John Maynard Keynes wrote more than 30 years ago:

The banks hold the key in the transition from a lower to higher scale of activity . . . The investment market can become congested through a shortage of cash. It can never become congested through a shortage of savings. This is the most fundamental of my conclusions in this field. (Keynes, 1937b, pp. 668-9)

Or again:

A heavy-demand for investment can exhaust the market and be held up by the lack of financial facilities on reasonable terms. It is, to an
important extent, the "financial" facilities which regulate the pace of new investments . . . too great a press of uncompleted investment decisions is quite capable of exhausting the available finance, if the banking system is unwilling to increase the supply of money . . . The control of finance is, indeed, a potent, though sometimes dangerous, method for regulating the rate of investment (though much more potent when used as a curb than as a stimulus). (Keynes, 1937a, p. 248)

Easy-money policies are a necessary but not a sufficient condition for stimulating economic growth. If the desire for new investment goods is weak because of poor profit opportunities, then easily obtainable finance will not, by itself, do the trick. If, on the other hand, the desire for investment is strong among businessmen, the banking system and the monetary authority can play an essential role in providing funds on terms which the investors deem attractive. It is at the level of financing investment projects that the money supply plays an essential role in stimulating economic growth in a monetized market economy, once the investment desire is present in the economy.

Fiscal policy, on the other hand, may develop latent investment demand either by increasing profit opportunities by augmenting consumer or government demands in the market-place or by increasing after-tax profits on existing market demands by use of subsidies, tax credits, or profit-tax cuts. Nevertheless, unless investors can obtain funds, they cannot place orders for additional investment goods no matter what level of profits are expected to be earned on the potential investments. Since in modern, money economies with a developed banking system, the money market may not "clear"; that is, there may be an unsatisfied fringe of borrowers (particularly when business is active), aggregate demand may be deficient merely because there is a shortage of money. Accordingly, fiscal policy may be a necessary, but it is not by itself a sufficient condition for full employment and economic growth. In a monetary economy, it is finance (i.e. increases in the money supply) which provides the energy fuel that permits the investment tail to wag the gross national product dog.

It is obvious, therefore, that the necessary and sufficient conditions for full employment require the coordination of fiscal and monetary policy. To the extent that H.R. 11 has as one of its major objectives "to improve the coordination of monetary, fiscal, and economic policy", it must be warmly supported.

Nevertheless, coordination of monetary and fiscal policy is not the panacea for our economic problems. In the absence of a coordinated "incomes policy" to prevent inflation and a foreign trade policy to correct balance-of-payments deficits, a coordinated fiscal and monetary policy may be required to deal with these latter issues - a task which they are not equipped to efficiently handle.

Accordingly, before providing my conclusions on H.R. 11's detailed recommendations for coordination, I should like to discuss the inflation and balance-of-payments questions.

3 INFLATION

The 1964 tax cut was the first major measure taken by Congress for the expressed purpose of expanding aggregate market demand in order to move towards full employment. This action plus the subsequent military expenditure expansion as hostilities in Vietnam increased brought the United States close to full employment and rapid economic growth for the first time in more than a decade. But with this achievement came the usual corollary of a free market economy - rising prices.

No one is against full employment per se. Moreover, if one begins in a recessionary period, full employment and rapid economic growth are complementary objectives which simultaneously can be achieved by a judicious mix of proper monetary and fiscal policy. It is the increasing inflationary effects as unemployment declines which constitute a basic conflict and which induce policy-makers to adopt measures designed to restrain aggregate demand, and hence hopefully restrict price increases by creating slackness in labour and product markets.

This fear of inflation is not new; however, the fear of massive unemployment which was generated in the Great Depression, as well as the hot and cold wars which followed, overrode the objections to inflation and made possible the expansionist policies in the 1940s and early 1950s. But almost a third of a century has passed since the Great Depression and for many citizens these terrible years are as remote as the ravages of the Civil War. Continuing inflation in the 1940s and the early 1950s increased our fear of rising prices, while the continuing prosperity has dulled, for most white urban workers at least, the fear of unemployment. At the present time, inflation and not unemployment appears to be the most likely source of economic dislocation, although it is my firm belief that much of the riots of the urban ghetto community and the problems of the rural poor reflect the continuing unemployment and underemployment problems in those sectors of the economy. A truly fully employed economy would not only raise the level of real income for the entire community, but it would open up job opportunities for members of many minority groups, so that, in general, the average level of real income of these minorities would rise more rapidly than the national average.

Under present institutional arrangements, however, the rate of inflation that would accompany sustained full employment would severely damage (1) the real income of those citizens on relatively fixed money incomes, the so-called rentier groups - the retired, the disabled, unemployed, widows,
It is neither rising prices of non-reproducible goods such as rare paintings or sculptures, nor the prices of securities listed on the New York Stock Exchange, nor even the prices of reproducible non-consumer goods like aircraft carriers, which are the main focus of public concern in discussions of inflation. Inflation becomes a major cause of public interest only when it is the market prices of reproducible goods that bulk significantly large in consumers' budgets that are continuously increasing. Keeping this pragmatic view of the public concern about inflation in mind, the problem can be readily analysed by concentrating on what economists call the 'low supply price of goods', where the latter is defined as that price 'which is sufficient and just sufficient to make it worthwhile for people to set themselves to produce the aggregate amount' (Marshall, 1950, p. 373) of output. Our emphasis on supply prices should not be interpreted as supporting the myopic view that demand factors cannot affect price; nevertheless, if the supply price for any given quantity of reproducible goods does not alter, then no matter how far the market price may be momentarily displaced from that supply price, the price of future output will subsequently return.¹

¹ Supply prices can increase for three main reasons: (1) diminishing returns, (2) increasing profit margins, and (3) increasing money wages (relative to productivity increments).²

² For more than a century, economists have taught that every expansion of output and employment will normally involve increasing costs and increasing supply prices because of the law of diminishing returns. Diminishing returns, it is held, is inevitable - even if all labour and capital inputs in the production process were equally efficient - because of the scarcity of some input such as raw materials or managerial talent. Actually, however, economic expansion will lead to increasing costs (and prices) not only because of the classical law of diminishing returns but also because labour and capital inputs are really not equally efficient. Expansion of output in our economy often involves the hiring of less-skilled workers, and the utilization of older, less efficient standby equipment and therefore adds to diminishing returns. Thus, as long as unemployment is declining, diminishing returns inflation will be an inevitable and unavoidable consequence of further expansion.

The severity of diminishing returns inflation will vary with the level of unemployment. When the rate of unemployment is high (say about 5 per cent), idle capacity will exist in most firms, so that diminishing returns are likely to be relatively unimportant. As full employment is approached, however, an increasing number of firms will experience increasing costs, and diminishing returns inflation will become more important. Although in the short run diminishing returns inflation is an inevitable consequence of every expansion in employment, in the long run, improvements in technology, government-sponsored training and educational programmes, and increases in capital equipment per worker can offset this price rise.
fiscal policy aimed at preventing all price increases before full employment is reached, can be successful only if they perpetuate sufficient unemployment. All expansions in economic activity, whether they are initiated by increasing government’s demands for goods and services or by an increase in demand by the private sector tend to bring about some price increases.

It should be obvious, however, that any increase in aggregate demand would induce changes in the supply price of reproducible goods, if there is no change in the money wage rate (relative to productivity) or gross profit margins, only to the extent that diminishing returns are present. Moreover, this diminishing returns associated price rise would be a one-and-for-all rise associated with increasing real costs of expansion due to lower productivity. Installation of new equipment and training programmes would help offset any price rise due to this aspect.

If, on the other hand, there is an increase in money wages in excess of productivity, whether demand is unchanged or not, the resulting supply price will be higher except if gross profit margins decreased proportionally. Similarly, increases in gross profit margins can induce price increases. Consequently, in the real world of changing levels of aggregate demand (usually at less than full employment) an income policy which controls both the money wage and profit margins will provide more stability in the purchasing power of money than a policy which permits ‘free’ collective bargaining and unrestricted pricing practices.

Although some economists have attacked such a policy as undesirable because it would not permit markets to allocate resources optimally, I believe that such a criticism is for all practical purposes irrelevant. First of all, these critics implicitly assume that present resource markets are efficient allocators. There is, however, evidence that indicates that existing labour markets are not very good allocators under existing free collective bargaining arrangements (Weintraub, 1963, ch. 5). More importantly, resource allocation merely requires changes in relative prices and not in the general price level. Different variants of income policy have been suggested which would permit these relative price changes while restricting a general price increase (Lerner, 1967; Weintraub, 1963, ch. 6).

Secondly, any possible loss in social welfare due to possible resource misallocation, in our economy, will be small relative to the welfare loss resulting from our continuing failure to maintain full employment and growth. As long as there are several million unemployed who are willing and able to work, I think that an economy that continuously utilizes these resources is less wasteful than a system which requires millions to be perpetually ‘on the dole’ (a system which ultimately must foster social antagonisms) in order to maintain reasonable price stability via monetary and fiscal policies alone.

In sum, there is no monetary or fiscal policy which can provide sufficient...
conditions to insure price stability, without wrecking any chance of sustaining full employment and economic growth. Hence there is an urgent need to develop a viable incomes policy.

An incomes policy obviously requires that the public interest be taken into account at the wage bargaining table and when management is making its pricing decisions. This policy must be considered a necessary supplement to monetary and fiscal policies which would guarantee continuous full employment. In return for this guarantee of full employment and optimum production levels, labour would be required to restrict its wage demands to, at most, rises in productivity, while business must hold profit margins constant.

The administrative details of implementing such a policy could take a variety of forms. The British, for example, have established restrictions on wage, salaries, and dividend increases. A National Board for Prices and Incomes was established which can require notifications of increases in prices and pay and can legally delay implementation of these increases if the board finds them unjustifiable and if voluntary compliance to holding the price–pay levels cannot be obtained. In a larger economy, such as ours, we may prefer a somewhat different arrangement than that adopted by the British. In any event, collective bargaining or pricing decisions which do not take the public interest into account should no longer be tolerated.

If, in fact, we could go even further and keep both money wages and gross margins constant, then with technological progress, price levels would decline. This would allow all consumers, including renters, to share in the gains of technology. This ideal variant of an income policy (which is less likely to be politically acceptable) would provide the greatest degree of fairness; for as long as some groups in society have their income fixed in money terms, then equity should require that all remuneration be somewhat fixed in money terms.

The desirability of instituting a full employment policy in coordination with an incomes policy is clear. The problem is to find a political leader who will advocate these policies which will be, at least initially, unpopular. (Many people might find themselves liking the results of such a policy, once they got over the shock of it.) Who will come forth to demand a simultaneous full employment and an incomes policy? Is there anyone in our society who will provide the political impetus that will convince most of us to pay this required tariff to sustain full employment?

Obviously no one has yet appeared on the political scene. No one will speak against the status quo and for the LIFO workers (who are usually the young, the uneducated, the migrants, and the members of minority groups, who are often disenfranchised by race, age, education, and residential requirements). Many 'liberal' groups are not ready to admit that unions ought to be restrained in the public interest, while 'conservatives' do not desire to see managerial pricing decisions limited by the public interest.

4 BALANCE-OF-PAYMENTS DEFICITS

I have held the payments problem for last for two reasons: (1) the magnitude of the payments problem for the United States is small in comparison to the previously discussed subjects; and (2) it is my personal belief that the United States should not allow foreigners to control its domestic economic policies; accordingly, methods for dealing with payments deficit should have a relatively lower priority.

The traditional monetary policy approach for eliminating a payments deficit is tight money -- a policy specifically aimed at (1) staunching short-term capital outflows, and simultaneously (2) inducing slack demand at home, thus encouraging industries with exportable products to search for new markets abroad, while domestic demand for imports declines. If such a policy is successful, although our balance-of-payments position will improve, the recessionary effects make it socially undesirable.

An increase in exports relative to imports is the obvious cure for a payments deficit. This can be accomplished without creating unemployment (or even devaluation) via an alteration in the domestic price level relative to the foreign price level. A prominent English economist, Sir Roy Harrod (1963), has recently shown that an incomes policy could not only be used to control the price level at home, but it could be used simultaneously to alter the export price level relative to import prices in order to improve the balance of payments. Hence, it would appear that an incomes policy could be designed concomitantly to prevent inflation and eliminate payments deficits, thus freeing monetary and fiscal policy to concentrate on achieving full employment and growth. Moreover, the utilization of an incomes policy, which allows export prices to alter slowly relative to import prices, would tend to eliminate the need to alter exchange rates and thus reduce the possible capital gains incentive for speculation against so-called 'key currencies'.

5 CONCLUSIONS AND RECOMMENDATIONS

Having developed my position at length, I believe I can now succinctly present my major conclusions and recommendations to the committee.

(1) A coordinated monetary, fiscal, and incomes policy should be a major objective of economic policy-makers. Since fiscal policy and incomes policy are, by their very nature, likely to reside in the executive branch of the government, it seems practical to give responsibility for coordinating monetary policy with these other policies to the administration.

To disperse power over these various policies would be almost to guarantee that economic policies would, at times, be at cross purposes. It is obvious that the brake on an automobile is a check on the accelerator, but
no one seriously suggests that one passenger in the car should work the accelerator and another the brake pedal. By analogy, we cannot afford separate passengers to operate monetary, fiscal, and other economic policies independently.

Nevertheless, it is of limited value to coordinate control of the brake and accelerator pedals only, while the steering wheel of money wages and profit margins are left to be driven by an ‘invisible hand’. As long as unbridled wage and price decisions are permitted, disastrous crashes can be avoided only by utilizing the brake pedal almost continuously and for constraining the accelerator pedal to permit very slow forward movements.

(2) The major instrument of monetary policy should be the money supply and its prime target should be to provide sufficient finance to bring the unemployment rate down, say to 3 per cent or less.

As long as money markets do not automatically ‘clear’, the expected rate of return (adjusted for risk) on new investment projects can be significantly greater than the rate of interest. Consequently, a reduction in the rate of interest may not stimulate additional investment purchases as credit rationing limits the number of entrepreneurs who can obtain finance in order to make operational their demand for capital goods. Furthermore, when there is an unsatisfied fringe of borrowers there is no way of knowing whether those investments projects which are being financed are more productive than those projects which cannot obtain funds. Consequently, control over interest rates rather than over the supply of money may result in misallocating resources in the investment goods industries. The monetary authority must, therefore, exercise its role via primarily the money supply and not rely on interest rate changes alone to do the job.

(3) Although monetary, fiscal, and incomes policies should be coordinated, it must be recognized that the first two should be oriented primarily to achieving full employment and growth and should not be concerned with price level problems per se. An incomes policy, on the other hand, should have primary responsibility for controlling our domestic price level and its relationship to import prices.

(4) If rapid economic growth is to be sustained, the money supply must increase in anticipation of the output growth. In an uncertain world, where expectations are volatile and often unpredictable, the relationship between the required increase in the money supply and the increase in the economy’s wealth is much too complex to be handled by any simple rule. Money clearly matters in the process of economic growth in a monetary economy, but a simple rule can be no substitute for wise management of the money supply.

Accordingly, the money managers cannot fix their gaze to any one statistical index – although they should always keep global statistics such as the unemployment rate and the rate of growth of gross national product in view. Nevertheless, disaggregative statistics on unemployment rates for particular groups and regional gross product growth must also be utilized in suggesting a desirable coordinated fiscal, monetary and incomes policy. Price indexes, for reasons I have already elaborated on, should be of secondary importance for the money managers.

(5) Although it would be possible to achieve monetary policy solely via open market operations (as long as the public owned a significant amount of government bonds), I see little reason for restricting the Fed solely to this tool. If the objectives are clearly recognized, then the Fed ought to be given as much flexibility as possible in choosing the method of achieving these objectives, since no two particular cases will be identical in all respects.

(6) Reducing the number of members of the Federal Reserve Board should not necessarily be an objective. What is desired is better educated members who understand the interrelationships of monetary, fiscal, and incomes policies, not fewer members. I do not believe it is essential that members need know the intricacies and mechanics of the banking system any more than members of the Council of Economic Advisors need know the labyrinthine relationships among governmental bureaux.

(7) If monetary policy is coordinated with other economic policies of the administration then I see no merit in having the Fed make separate reports – separate from The Economic Report of the President – to Congress. If monetary policy is left uncoordinated, then a requirement for separate quarterly reports by the Fed not only has little merit, but such a requirement might be detrimental if it opened the Federal Reserve Board to more political pressure to pursue, what I have labelled above, ‘political trade cycle’ policies.

(8) Coordination would necessarily involve representatives of the Treasury and CEA at open market committee meetings, and, I would hope, these representatives would be participants and not merely interested onlookers.

(9) As far as appraisal of the structure of the Federal Reserve is concerned, I believe that it follows from my strong advocacy of coordination that (a) the Chairman of the Board’s term be coterminous with the President of the United States, and (b) since the Federal Reserve is an instrument of the public and not of the member banks, there is no necessity to maintain the fiction of private ownership. Accordingly, the Federal Reserve bank stock should be retired.

(10) Since a central bank is by its very nature as the monetary authority does not need a cushion of ‘undistributed profits’, I see no reason why the Federal Reserve should not pay all its earnings over to the Treasury, while funds to operate the System would be appropriated by normal legislative means. Certainly, if the Chairman of the Federal Reserve had to submit a budget request to the President – as does the Secretary of the Treasury and the Chairman of the CEA – coordination of policy would be facilitated.

(11) The term of members of the Federal Reserve Board depends, in
part, on what individuals are likely to be appointed as members. If members are to be selected primarily from the banking community and are expected to return to this sector after a single term, then I believe the longer the term the better, for a long term frees the members from having their own future economic self-interest affect their decisions. If, on the other hand, one anticipates selecting them from the academic field—such as is now done for CEA members—then a term similar to Cabinet members seems desirable if coordination is going to be efficiently accomplished. In any case the choice of five years rather than, say, four years, as H.R. 11 provides, strikes me as strangely incongruous with political realities.

(12) It follows from my analysis in section 3 above, that the Federal Reserve’s policies of the last three years have been socially undesirable. The continued rise in the consumer price level during the past few years is indicative of the failure of monetary policy to contain the inflationary pressures, while the continued high unemployment rate in the ghettos must, at least in part, be associated with these policies. Ultimately, policy-makers must recognize that labour and management in our system share responsibility with the monetary and fiscal authorities for the maintenance of price level stability, full employment, and economic growth. An incomes policy is an essential consort to a sound monetary policy. Until this notion is accepted, modern market-oriented systems such as ours will continue to follow erratic paths of economic growth.

Notes

1. If only non-reproducible goods such as works of arts by dead artists were rising, no major public policy problem would arise. This latter case would be an example of a pure demand-price inflation and could readily be analyzed primarily by concentrating on changes in demand factors.

2. If imports are an important component of the output of most reproducible goods, then rising import prices can affect the flow supply price. For the United States, I do not believe this is a significant problem and hence I have omitted it from the discussion.

References

Davidson, P. (1968), ‘Money, Portfolio Balance, Capital Accumulation, and..."