CHINTAMAN DESHMUKH MEMORIAL LECTURE

CENTRAL BANKS AND GOVERNMENT BUDGETS

by

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Requisites of independence of monetary from fiscal policy.

As my title suggests, I propose to discuss with you the mix of fiscal and monetary policies, national and international. The very concept of a policy mix presupposes that governments and central banks jointly enjoy some freedom of choice, that they can set fiscal and monetary instruments independently one from the other. This condition is not met to any significant degree in most national economies, for reasons I shall mention briefly below. But it is met in the large developed countries whose policies and performances decisively shape the course of the world economy-- the "locomotives" of North America, Western Europe and Japan.

Of course, the policy choice of each of these nations is in some degree constrained by international conditions, and thus by the policies of the other major economic powers. But the United States can certainly choose among a menu of differing combinations of fiscal and monetary instruments. And so can West Germany, the key country of the European Economic Community, and Japan. The choices of these three locomotives, or more broadly those of the seven governments of the annual economic summit meetings, or still more broadly those of the members of the Organization for Economic Cooperation and Development (OECD), determine the fiscal-monetary policy mix of the advanced capitalist democracies as a group.

The capacity to choose a policy mix obviously requires that government budget deficits need not be financed wholly by printing money, whether base money created by central bank lending to the government or "low-powered" money created by other banks. There must be instruments of public debt that are neither monetary nor automatically monetizable. Those instruments must not be perfect substitutes for base money as bank reserves or for currency and bank deposits as means of payment. Their prices and interest rates must be variable, not pegged by open-ended commitments of the central bank or the banking system to buy and sell them. By maturity, denomination, and risk of capital loss, these instruments must be differentiated from base money and its close substitutes. Where these instruments and associated financial institutions, markets, and technologies are absent, budget deficits determine the growth of money supplies, and fiscal policy is indistinguishable from monetary policy.

Even when an independent monetary policy is technically feasible, the political means and will to use monetary policy instruments independently of public borrowing requirements may not exist. Quasi-constitutional provisions to insulate central banks from governments frequently provide the means and will to break the fiscal-monetary link. The cost of arrangements which assign fiscal and monetary decisions to separate policy-makers is that no conscious coordinated choice of the policy mix is made.

I propose to discuss the macroeconomic consequences of different mixtures of monetary and fiscal policies in the major developed economies, particularly the United States. I apologize