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The Monetary/Fiscal Policy Debate: A Controlled Experiment

In the 1960s and early 1970s, Keynesian economics was the dominant macroeconomic policy paradigm. Monetary policy was widely thought to have only a minor impact on the real economy or inflation. Fiscal policy—which many thought to be important both for stabilizing the real economy and for controlling inflation—reigned supreme. The objective of macroeconomic policy was to choose a preferred combination of inflation and unemployment rates along a stable long-run Phillips curve.

Several empirical studies in the 1960s challenged this reigning orthodoxy. One of these, published in 1968 by Leonall C. Andersen and Jerry L. Jordan in this Bank's *Review*, showed that changes in money have larger and more predictable effects on nominal gross national product than do changes in government spending. Evidence suggesting that monetary policy was relatively more effective than fiscal policy gave birth to a long-running debate about the relative importance of monetary versus fiscal policy that has never been settled. The debate was preempted when the U.S. government began running large and persistent fiscal deficits in the early 1970s. Advocacy of counter-cyclical fiscal policy largely died, not because Keynesians conceded that fiscal policy was relatively ineffective, but because counter-cyclical fiscal policy was not viewed as an option in an environment of large and persistent deficits.

The experience of Japan during the last decade provides more recent evidence about the importance of fiscal policy. After decades of strong economic growth and only one relatively mild recession (in 1974), the Japanese economy has been in a period of sluggish growth since the early 1990s. From 1991 to 2000, Japan's GDP grew at a compound average annual rate of 1.2 percent—3.0 percentage points below the rate of the previous decade.

The Japanese government shunned monetary policy, as the growth of M2+CDs (a broad monetary aggregate) declined from an average rate of 9.9 percent in 1975-1990 to just 2.6 percent in 1991-2000. Instead, to stimulate the economy, the Japanese government followed a Keynesian fiscal-policy prescription and in 1992 began implementing a series of unprecedented tax cuts and expenditure increases. General government outlays rose from 30.9 percent of GDP in 1991 to 38.1 percent of GDP in 1999, while general government tax and non-tax receipts declined from 33.8 percent of GDP to 31.1 percent. Not surprisingly, the government budget went from a surplus of 2.9 percent of GDP in 1991 to a deficit of 7 percent of GDP in 1999. (In contrast, the largest general [federal, state, and local] government deficit in the U.S. in the deficit-ridden 1980s was 5.3 percent of GDP in 1986). Because of its repeated efforts to stimulate the economy through fiscal policy, Japan now faces a serious debt problem (Japan's debt-to-GDP ratio has nearly doubled in the last decade, rising from 0.58 in 1991 to 1.1 in 2000).[1]

Many of the reasons advanced for the apparent failure of the fiscal policy measures to stimulate the Japanese economy sound familiar: some of the measures were viewed as temporary and, consequently, had little impact on aggregate demand; the actual fiscal policy measures were not large enough—more aggressive action would have been successful; the actions were smaller than originally announced; the wrong set of expenditure programs were introduced—other programs would have been successful. Any or all of these criticisms may be valid, but they imply that implementing a successful fiscal policy is difficult. Hence, either the implication is true—fiscal policy is relatively ineffective—or implementing a successful fiscal policy is difficult. Either way, the Japanese fiscal policy experiment suggests that the practical usefulness of fiscal policy may be limited.

—Robert H. Rasche and Daniel L. Thornton

[1]See Christopher J. Neely, "How Big is Japan's Debt?" *International Economic Trends*, February 1999.

Views expressed do not necessarily reflect official positions of the Federal Reserve System.