“Monetary Policy Dominates”
by Milton Friedman
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“The economy has remained in the doldrums despite about 80 trillion yen [$678 billion] in economic stimulus measures since 1992.” So wrote the *Nikkei Weekly* on Nov. 9. But is it “despite,” or perhaps “because of” or “unconnected with”?

The Keynesian view is that government deficit spending is cyclically stimulative whether it is financed by borrowing or by newly created money. The monetarist view is that spending financed by newly created money is cyclically stimulative whether the spending is by the government or the private sector. Government spending financed by borrowing may or may not be stimulative depending on how much private spending is crowded out by government spending. Either outcome is possible, depending on conditions.

It is not easy to distinguish between these views on the basis of empirical evidence, because fiscal stimulus generally is accompanied by monetary stimulus. The relevant evidence is provided by those rare occasions when fiscal and monetary policy go in different directions.

The quote at the top of this column refers to such an occasion. Repeated fiscal stimuli since 1992 have been accompanied by restrictive monetary policy ever since the Bank of Japan stepped sharply on the brake in 1990 to burst the bubble in the stock and property markets. During the past six years, growth in the monetary total (M2 plus CDs) has averaged 2.8% a year at a time when the economy was in the doldrums, inflation was declining and turning into actual deflation. All of which would raise the demand for money. So this is a clear case where monetary, not fiscal, policy determined the course of the economy.

The U.S. is currently another such case. Fiscal policy has been highly restrictive for some years, with a shift from large deficits to surpluses in a few years. Monetary policy has been expansive, with M2 rising at the annual rate of 15.4% during the past three months, 8.7% over the past year and 4.7% over the preceding five years (1992–97). The economy has been in an expansion. As in Japan, monetary policy has clearly determined the course of the economy.

Some years back, I tried to collect all the episodes I could find in which monetary policy and fiscal policy went in opposite direction. As in these two episodes, monetary policy uniformly dominated fiscal policies.

These examples all refer to fiscal policy judged in Keynesian demand-side terms. Government spending financed by borrowing not only is not stimulative, it is positively harmful. It replaces private spending by government spending, which is almost surely less productive. Japan offers a striking example. Government fiscal stimulus has largely taken the form of infrastructure building, stimulated in part by the construction industry’s generous contributions to the ruling Liberal Democratic Party – a story that clearly has its counterpart in the U.S.

Supply-side fiscal policy is very different. It consists of cutting high marginal tax rates in order to stimulate innovation and entrepreneurship. It may lead to a deficit by reducing tax revenue, though even that is not certain. However, it may also encourage a decline in government spending. Experience suggests that it is very effective in stimulating economic growth. It is a policy for the long run, not for the cycle.

The implications of this experience for policy in Japan and the U.S. are in some respects the same, in some different. For fiscal policy, both countries would benefit from cutting high marginal tax rates and government spending. For monetary policy, Japan needs to be decidedly more expansive; the U.S., decidedly less expansive.

These are broad generalizations. There are many other government policies than the kind of broad-brush fiscal and monetary policies that I have referred to that affect the cyclical and long-run fate of any economy. As usual, the devil is in the details.

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