Federal Reserve Bank of Minneapolis

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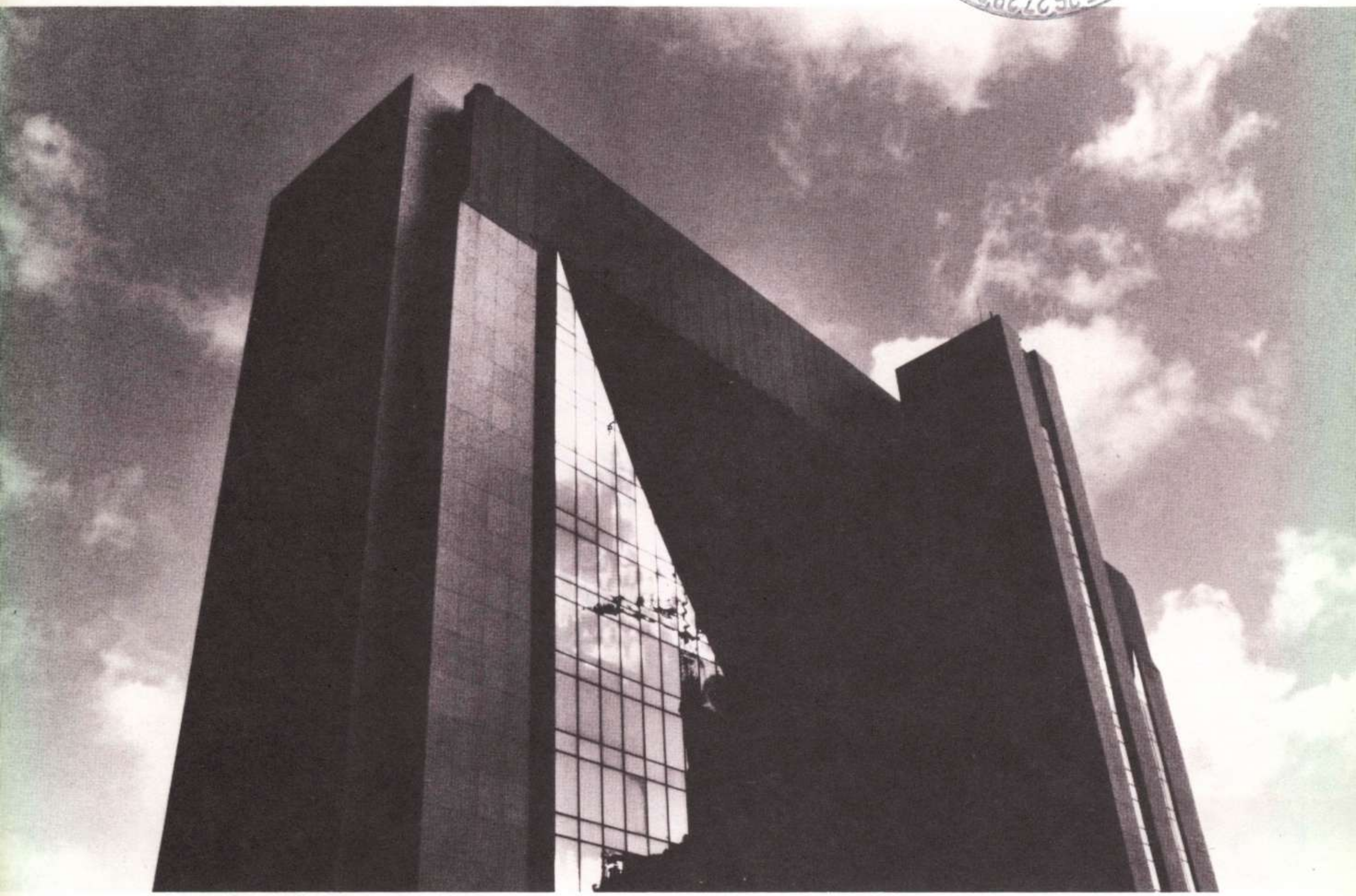

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Produced in the Research Department. Edited by Preston J. Miller, Richard M. Todd, Kathleen S. Rolfe, and Inga Velde.
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Address requests for additional copies to the Research Department,
Federal Reserve Bank, Minneapolis, Minnesota 55480.

# *In This Issue . . .*

**Testing Legal Restrictions**

In "A Shred of Evidence on Public Acceptance of Privately Issued Currency" (p. 2), Martin S. Eichenbaum and Neil Wallace report two recent cases where privately issued coupons began circulating in Canada as currency. Because these were store coupons, they were not initially subject to Canada's prohibition against the issue of private currency. These cases support a key tenet of the legal restrictions theory of money: namely, that without restrictions, private arbitragers would issue liabilities, backed by interest-bearing securities, which the public would accept as currency. This theory (described in Wallace's winter 1983 *Quarterly Review* article) holds that high interest rates are possible because of government restrictions against such arbitrage, and it suggests that doing away with these restrictions would make monetary policy ineffective.

**Adding to Arithmetic**

In "Deficits, Interest Rates, and the Tax Distribution" (p. 5), S. Rao Aiyagari demonstrates the importance of the tax distribution in determining the relationship between budget deficits and interest rates. Aiyagari's point received little attention in previous *Quarterly Review* articles on budget deficits and monetarist arithmetic (see below). Aiyagari constructs a simple model to show that higher deficits need not imply higher interest rates. By manipulating the way taxes are distributed among agents, he demonstrates that it is possible to have an unchanged real interest rate when government consumption is raised and total taxes are unchanged. He also shows that when total taxes are lowered without changing government consumption, taxes can be redistributed so that interest rates are unaffected. The key to these results is that the tax distribution is changed to keep the relative distribution of wealth unchanged.

**Collecting Terms**

For readers' convenience, this issue includes the previous *Quarterly Review* articles on monetarist arithmetic to which Aiyagari refers (see above): Thomas J. Sargent and Neil Wallace's "Some Unpleasant Monetarist Arithmetic" (p. 15), Michael R. Darby's "Some Pleasant Monetarist Arithmetic" (p. 32), and Preston J. Miller and Thomas J. Sargent's "A Reply to Darby" (p. 38). Because of an unforeseen high demand, the issues in which these articles first appeared are now out of stock.