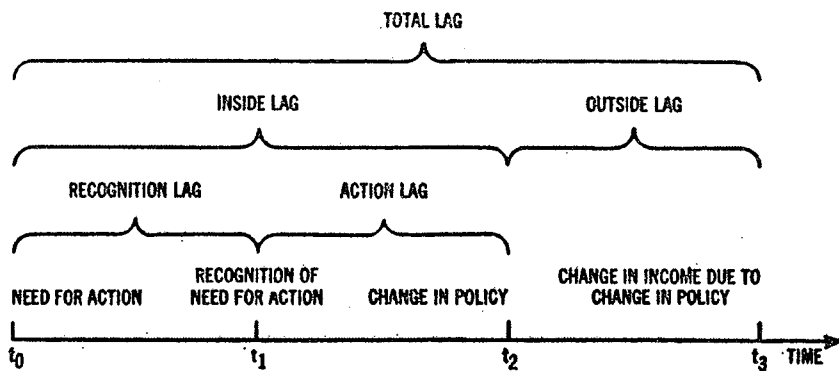


Figure 1**SCHEMATIC OF THE LAGS OF MONETARY AND FISCAL POLICY**

Causes of outside lags are difficult to analyze because they involve complex aspects of the way the economy works. Economists have incomplete knowledge of all the relationships involved. Some of the main factors can be discussed in a general way, however. The outside lag associated with income tax changes, for example, depends on the time required to alter the disposable income of individuals and corporations and their spending. Adjustments by corporations probably tend to be more sluggish than those by individuals. Corporate cash positions generally are not affected so quickly as are those of individuals, corporate planning and spending tend to be longer, and so on. These differences between individuals and corporations likely diminish as corporate tax payment schedules are accelerated.

Changes in Government expenditure policies may influence the pace of economic activity quickly. In some cases, placement or cancellation of orders for goods can cause changes in production and income before any actual alteration in Government spending takes place. Even without this, release of additional funds to an ongoing project often will stimulate spending immediately, while a cutback in actual expenditures generally will have immediate depressing effects on national income. Similarly, changes in transfer payments (like unemployment benefits) or purchase of services usually will cause an almost immediate alteration in disposable income and spending. On the other hand, newly appropriated funds for projects involving considerable planning or organization may begin to find their way into the spending stream only after some months. Similarly, reduced appropriations may not produce an immediate cut in spending if unused previous appropriations exist.

The link between changes in monetary policy and spending is not so direct as in the case of fiscal policy. Economists are still debating exactly what the channels are. Some think monetary policy is linked to the real sectors of the economy primarily through interest rates. An increase in rates inhibits investment and perhaps consumption and thereby causes a reduction in the rate of growth of income. Other economists view the monetary mechanism as involving primarily the quantity rather than the cost of money. As individuals and corporations adjust to changes in their actual and desired holdings of money, they change their expenditures on goods and services, thus altering the level of national income. Still other economists focus on availability of credit, arguing that a change in monetary conditions alters banks' willingness to lend. Bank lending behavior, in turn, influences the amount of investment and consumption expenditures that can be financed and therefore the level of income.

The first step in each of these theories is the response of banks to changes in monetary policy. Banks may or may not adjust quickly to changes in monetary policy depending on their current reserve position, loan demand, interest rate