

Economic Growth: Is the Fed Irrelevant?

St. Louis Regional Commerce and Growth Association Leadership Circle

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It is a treat to be with you today—aside from a few occasions when I’ve offered informal remarks, this is my first real speech since I arrived in St. Louis. Beginning my Fed speaking career before an organization dedicated to economic development sends just the right message.

Coming here to this job at the St. Louis Fed is a rare thing for a monetary economist who has been sitting on the sidelines writing journal articles and newspaper op-ed pieces and talking to people about what the Fed ought to be doing. Now I have to say what the Fed ought to be doing, decide what that really is and put my money on the table. The issues are the same as those I dealt with as an academic, but it’s a different matter to deal with them from inside the Fed.

SOME INITIAL OBSERVATIONS...

Well, I have never been through a St. Louis summer. It is HOT here in the summertime! No question about that. Even though I grew up in Delaware and have lived in Baltimore and Washington, all of which are also hot in the summer, I guess I had forgotten what this climate is like. I have lived in New England for a long time. But I will get used to the weather here. It really is an exciting metropolitan area.

We have been here, Gerie and I, just four months now. We have enjoyed driving around, exploring, looking out the car windows and seeing what we see. St. Louis has these great rivers, and we actually looked to see if we could find a place to live on one. We came from a waterfront home on Narragansett Bay and we liked to look out over

the water. I didn’t find a place on the water within commuting distance, but the rivers are wonderful; there’s no question about that. There are also lots of fun restaurants and wonderful cultural resources here. Last week for the first time we got out into the countryside. We drove to the wine country to the west of the city and had a very pleasant evening.

But as we drive around—and I’m sure you have exactly the same reaction, if you just go poking around without any particular destination—you do see some really serious urban problems in this area. In St. Louis and East St. Louis, there is a lot of what looked to me, driving by, to be abandoned industrial land. I’m not a development expert or an urban economist, but you have to ask what can be done about these problems. St. Louis is not alone in having them, but there is no reason why St. Louis couldn’t be out ahead in fixing them. I’m sure that would be the desire of everyone in this room.

Does the Federal Reserve have a role in this process? Well, my main message is going to be “no,” but I want to talk to you about that and tell you what the Federal Reserve can contribute. It’s very important to understand what the function of the central bank is, what it can contribute and what it cannot, to understand where the responsibility really lies.

I want to divide my comments into four main topics. I’m going to start with a little game-playing to explore the effects of much more expansionary monetary policy or much more restrictive monetary policy. We’ll spin out this scenario to help understand what would happen if the Federal Reserve were to attempt, let’s say, to push interest rates down to promote development in urban

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areas or anywhere else for that matter. What would be the result of that process?

Secondly, what can monetary policy really do? Third, what is the Fed's role in the growth process? Lastly, I'll make some general comments on where growth really comes from.

Let's imagine that the Federal Reserve were to follow a much more expansionary monetary policy. For some time now, the Fed has been holding short-term interest rates at about 5.5 percent, and, just for fun, let's suppose that the Fed put interest rates down to 3 percent and kept them there. What would happen?

Well, with the whole structure of interest rates down by a couple of percentage points, there would be an increased demand for borrowing. More people would want to build houses or add to their houses. More people would want to buy cars. More companies would want to build office buildings and factories and so forth, and, with the increased demand for credit, firms and households bidding for resources in an economy that is already fully employed would start to bid up prices.

So we would begin to see increases in wages and prices and—if the Fed really stuck with a 3 percent interest rate—the higher the rate of inflation, the cheaper 3 percent money looks. If the inflation rate is running at 5 percent and you can borrow at 3, well, obviously the lender is then giving you a gift of 2 percent, and the process would continue and eventually we would have an inflationary explosion. In the meantime, there might be some small—and I would emphasize in today's economy for sure—*small* boost to output, because our economy is fully employed. We have lots of job vacancies. Those of you who are recruiting labor know that it is difficult these days to fill your empty positions, and our factories—although not flat out—by and large are pretty fully occupied.

So we can't get that much more output out of the U.S. economy in the short run. We would just get more inflation. The bottom line is that if the Federal Reserve steps on the accelerator, we are going to get more inflation. At best, we might get a very short temporary increase in output from persuading people to work overtime, or whatever.

Consider the opposite possibility. Again, interest rates have been around a 5.5 percent short-term rate. Suppose the Fed were to say, "Let's put rates up at 10." We might as well. Academics like to play such games. Let's have a really nice experiment here. Let's put the rate up to 10 percent. What's going to happen? The reverse of the process just described would get under way. A lot of firms and households that had been borrowing money to finance new projects would back off. There would be a reduced demand for goods. Factories would slow down with pressure coming off the product markets and the labor markets. You would start to see some softness in prices and wages, and, if the Federal Reserve hung on to interest rates that were much too high, this process would continue.

In fact, we got into something sort of like this deflationary spiral at the very beginning of the Great Depression in 1930, '31, and '32. The Federal Reserve held interest rates too high for too long, and the economy started a downward spiral. We ended up with a complete collapse of the banking system and a terrible mess.

So if the Fed tries to put interest rates very far off of the equilibrium for the economy, we are going to end up with a big problem, and that is going to be an economy-wide problem. The Fed's responsibility is to try to find that sweet spot where interest rates lead to balanced growth with low inflation.

So what *can* monetary policy do? As you are well aware, the U.S. economy is today in very, very good shape. My career as a professional economist really began in 1963 when I became a newly minted assistant professor at The Johns Hopkins University in Baltimore. Since 1963, the economy has never been in better shape than it is today. We have a very low unemployment rate. We have the highest percentage of the population employed that we have had since World War II. We have a very low inflation rate. We have good—although not by historic standards sparkling—growth in real output.

The Fed's contribution to this process has been to keep inflation low, to keep the economy balanced, and that's what yielded this happy

state of affairs. The economy seems to be pretty stable. We are not going through cyclical fluctuations. That's what the Fed can do. If we do our job well, we have an outcome such as we have today. I can brag a little because I have nothing to do with the success. I've just arrived. I hope I can indeed brag a couple of years from now when I have been here for a while. We shall see.

Think again about some of these urban problems that we talked about a few minutes ago. Why is it that we have such vigorous development to the west of the city? Again, just from my wandering around trying to find stores and furniture and places to explore, why is it that the development is taking place in outlying areas and we see all of this apparently abandoned land in the urban areas? In East St. Louis, across the river, there's a glorious view of the St. Louis skyline and the Arch, and yet it's a wasteland—or so it seemed from my driving over there. I hope that is not too strong a way to characterize that area along the river.

Why this wasteland? Why are people locating one place rather than another? It has to do, obviously, with the rate of return on investment and the relative advantages of where you put your capital. The Federal Reserve is not going to affect those relative rates of return in one place over another place. That is not within the Fed's area of responsibility.

To use an analogy, today in some parts of Texas and Arkansas, there is drought. Some regions have too much rain, but Arkansas and Texas have drought. The crops are shriveling up. The Fed can print money, but the Fed can't print rain and what those areas need is not more money—they need rain. It is the same sort of thing with development here. What we need is not more money, not easier credit or anything like that. What we need is to improve the attractiveness of these areas that are not doing so well.

The Fed's role in the growth process—my topic three—is significant, but not overwhelming. Maintaining stable and low inflation is a contribution to efficiency of the economy. Maintaining an efficient payments mechanism is important. We take for granted—as we should—that checks clear, wire transfers work, and that the currency

is sound. A sound payments system is a necessary basis for much economic activity. You don't really realize that until you go to an economy where the banking system or the monetary system does not work, such as in Russia today, where there are big problems with the banking system.

I remember a few years ago traveling to Romania. My youngest son married a Romanian woman, and we went there for the wedding. As all good U.S. travelers do, I took a bunch of traveler's checks. I found that it was almost impossible to cash them in Bucharest at that time. We had to go through an enormous rigmarole to cash our traveler's checks in order to cover some of the wedding expenses that we had agreed to pay for. So when you can't make transactions on a routine basis, it really does interfere with the efficiency of the economy.

One of the Fed's responsibilities, then, is to make it a matter of course that the payments system works well, and we do a pretty good job of that. We also have responsibilities for supervising and regulating banks as part of that same process of making the financial system work well.

Where *does* economic growth come from? The most important thing, of course, is productivity—the increase in output per hour of labor input. That is where our wealth comes from.

A LITTLE PERSPECTIVE...

In the United States over the last 150 years or so, productivity growth—growth of output per hour of labor input—has been about 2 percent per year. That means that output per hour doubles in 35 years. Since 1973 or thereabouts, productivity growth has been more like 1 percent per year. Now, the difference between 2 and 1 doesn't sound like very much, but 1 percent productivity growth means that output doubles in 70 years. There is a big difference in a society where output doubles in 70 years versus 35 years.

From the end of World War II to the early 1970s, we had output growth per hour of labor input of about 3 percent. Instead of 35 years, out-

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put doubles in more like 23 or 24 years. So, if we need wealth to solve a lot of our problems and to enjoy the benefits of a wealthy society—and I don't just mean material goods per se, but a lot of the cultural things that we enjoy—productivity growth is very important. We have been lagging behind on this front, without any question.

Where does productivity growth come from? We often focus on big things, like assembly lines or the invention of the steam engine or the microchip, and obviously those are important. But I always like to emphasize that of much larger importance is the accumulation of an enormous number of little things. You can see this in your own businesses—the returns you get from the accumulation of lots of little things.

For example, some years ago, the airlines installed lighter carpeting in their aircraft to reduce weight so there would be less fuel usage and larger payloads. Little things like that. It doesn't sound like very much just to install lighter carpeting.

I remember at the time of the first energy crisis in 1973 when the fuel prices went up so much, some of the airlines were taking out some of the airline magazines and putting them in every other seat pocket instead of every seat pocket to save weight. Attention to detail like that is what I'm talking about.

At our Reserve Bank, we have high-speed sorting machines for our check operations. We were having problems with checks jamming and not feeding through properly. Before putting the checks on the machine, the machine operator now puts each box of checks on a vibrator table that shakes all the checks down so that the edges are lined up and then they feed through the sorter properly. This extra step is a simple thing, but it adds to productivity. The accumulation of ideas like that, bit by bit, is where productivity comes from in the long run.

The engine of growth, then, is not what somebody else does. It's what each of us does in our own business. In the context of regional development and government policies, it's not what the Federal Reserve does, it's not what the federal government does, but it's what our communities do to make it attractive for people to build here rather than someplace else. To start to use some of the idle land in our urban areas is our responsibility and no one else's.

A COUPLE OF CLOSING OBSERVATIONS...

The Fed's monetary policy gets a lot of press. Fed policy is obviously a big issue. Everybody is interested in where interest rates are going to go and their impact on the economy. But the most important contribution is still for the Fed to keep inflation low. That's what has produced an economy that is far more stable and has opportunities for growth without the confusion of changing currency values. Low inflation has made a major contribution to the U.S. economy. That's what the Fed can deliver, that's what the Fed's responsibility is. If we at the Fed can continue to be successful on the inflation front, then we have done our job well.

Secondly, the Fed's roles in the payments process and the supervision of banks are important in helping consumers and businesses function effectively. We have a responsibility to do our jobs efficiently there, too.

So that's the bottom line. Our job at the Fed is to print the right amount of money and if you walk out of here remembering only one thing, just remember the Fed can't print rain.