



"MONETARY POLICY AND THE CAPITAL MARKETS"

Address by
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It's a great pleasure to be back in Chicago where I spent thirty of my working years. This city will always be "home town" to me--even if you can't produce a world champion sports team!

I especially appreciate this opportunity to speak to the Bond Club. Many of my good friends are included in your membership. Over the years, I have had occasion to do business with a number of you. It's good to see you again.

Your club is truly a venerable institution. I see that you were organized in 1911. Any organization that survives for seventy-two years must be doing something right. In fact, as I think about it, you started a couple of years before the Federal Reserve System was created. That period spans wars, financial panics, the great depression, and the institutionalization of savings in this country. Throughout these years, your members have been active participants in the development of the world's most effective system of underwriting, distributing, and trading fixed income securities--public and private, taxable and tax-exempt.

Today, as you know, the capital markets are increasingly integrated on a world-wide basis, due principally to technological developments which have made possible almost instantaneous communications. As a financial officer of a bank holding company with a shelf registration for fixed-income securities, it was not unusual last year for me to hear from several investment banking firms in a single day. Often, firms from London would call direct with firm proposals. One of the more interesting submissions which I recall involved the issuance in the Euro-currency markets of a floating rate note denominated in guilders, the interest rate on which was to be swapped via a British public sector borrower into a fixed-rate in sterling, and then

to be converted to dollars via a forward transaction in the foreign exchange market. I also heard from you about zero coupons, optional maturities, warrants, and multi-currency issues. That's pretty heady stuff. Clearly, the bond market is continuing to evolve and remains a classic example of free enterprise in action.

In my new role as a central banker, I appreciate the value of your services even more than when I "labored in the vineyards" with you. The bond market is the principal transmission mechanism for intermediating savings flows through the economy. Our capital markets are the envy of the world for their efficiency and scope. Your market also happens to be a crucial point where monetary policy reaches the real world. Because of this integral relationship with the basic functioning of the economy and monetary policy, I am keenly interested in seeing its vitality preserved.

In 1981, I observed institutional investors in this country moving rapidly up the quality scale and down the maturity spectrum in their fixed-income investment preferences. This shift reflected increasing concern over the effects of a declining economy with its adverse consequences for an already short-term/debt-heavy/corporate sector, and apprehension over the then-prevailing high rate of inflation. Perhaps heightened market volatility also should be added to the factors causing bond market investors to "run for cover." Despite these problems, our capital markets continued to perform better than most. In the Euro-currency markets, for example, the longest available maturities for high-grade issuers were most often in the seven to ten year areas, reflecting the experience and inflation fears of investors in that market.

Much, if not all, of the increased market volatility in recent years may be attributable to increased attempts to forecast interest rate move-

ments. Since bond interest rates are perceived to be largely a function of inflationary expectations, and since, as we all know, inflation is closely linked to money growth, this brings us back to monetary policy. It might be useful to review briefly the timing of the relationship between money growth and the economy.

Our research at the Federal Reserve Bank of St. Louis shows that persistent changes in the stock of money are normally followed in about six months by changes in real output and, within three years, by changes in prices. Since money growth during the past year has approximated 11 percent, we are not sanguine about inflation prospects over the next two years, notwithstanding the arcane arguments in some quarters about shifts in money demand and reduced income velocity. Currently, however, things look good on both the economic and price fronts. The recovery from last year's recession is now a genuine "expansion," and inflation has averaged hardly more than 3 percent for three quarters. I suppose the interplay of these two different scenarios is what makes markets.

When I was in your shoes, we used to blame all unexpected market changes on the Fed, also known as the "damn Fed" when we were taking losses. Now that I am on the other side of the fence, I can appreciate more the recently heard paraphrasing of Galbraith's comments about the stock market predicting recessions. This new version says that "bond markets have predicted nine of the last two changes in monetary policy." Certainly, it seems that too much attention is paid to minor wiggles in the money supply. However, I am not one to quarrel with markets as vast as our domestic money and capital markets, the Euro-dollar market, and the foreign exchange market--all of which appear to move on such a basis. I can only conclude that you share my view of the importance of money to our economic well being

and are trying to secure a market advantage by translating weekly fluctuations into your own forecast of meaningful average changes over time.

From my experience, I know that markets don't like uncertainty. All of you know that the Fed attempts to smooth out major disturbances to normal supply and demand flows by its daily involvement in the money market through the trading desk at the New York Fed. The magnitude of so-called operating factors can be very large as evidenced recently in a single day's swing of over \$8 billion in the Treasury's balance with the Fed. Fluctuations in float, "as of" adjustments to bank reserve accounts, and other factors may require substantial offsetting open market activity on any given day in order to prevent conditions which could severely diminish liquidity and produce undesired large changes in bank reserves. While it may sometimes seem inconsistent, or even confusing to you when the trading desk opens with a billion dollar reverse RP and follows this later in the day with an announcement of several billion dollars of non-withdrawable term RP's for the following day, these actions are intended to produce the desired effect on the monetary targets established by the FOMC, and do not imply changes in monetary policy. But when markets perceive that some of the desk actions may be indicative of monetary policy changes, and if these changes may augur changes in the rate of inflation, uncertainty arises.

Bond markets don't like inflation. It erodes capital values of outstanding fixed-income securities. It raises the interest rate required to induce investors to commit their savings, particularly for longer maturities. The inflation estimation or anticipation process involves substantial uncertainty and adds to market volatility as these judgments are being made in the context of ever changing economic and monetary information. Therefore, it seems to me that your objectives, those of your customers, and

ours at the Fed are essentially the same--to create sustainable economic expansion without undue inflation.

Now, given our experiences over the past few years, actually over the past two decades, we might well wonder, if nobody likes uncertainty or inflation, just why we have been victimized by so much of both? Although I am new to the ways of monetary policymaking, let me hazard a guess as to how these enemies of the bond market evolved and why they are (potentially at least) still with us. To fully understand how the problem evolved, however, requires looking back to the halcyon period from the end of the Korean War to about the middle 1960s. Whenever we allude to the "good old days," we surely have this period in mind: Aaa corporate bonds yields were about 4 percent, commercial paper was yielding less than 3-1/2 percent, inflation was only about 2 percent and real output growth was almost 4 percent per year.

Since then, we have had, until recently, accelerating inflation, reduced real output growth, rising interest rates, and, even worse for bond markets, measures of bond yield volatility that have risen three- to four-fold.

This volatility has clearly increased market risks. In recent years, a negative yield curve resulted in a negative carry on underwriting or trading positions. And fluctuations in long rates have subjected you to enormous potential capital losses on positions. These risks have bred a whole menu of new market instruments. Consider how many resources you devoted fifteen years ago to financial futures, options, and other exotic instruments of hedging? Compare that to the resources you devote to these now? Fifteen years ago, there didn't seem to be much reason to spend considerable sums on attempting to divine what even long-run governmental

policies might be. Compare that to the attention and resources you now devote to trying to fathom what next Friday's money supply announcement will be. These are symptomatic of the higher costs that now face the bond markets.

Now, you might ask, "Why don't we do something about these adverse interest rate fluctuations?" Indeed, conventional wisdom has it that the Federal Reserve can arbitrarily manipulate interest rates. Thus, if volatility of interest rates is the culprit in increasing bond market risks and costs, surely the Fed can quickly offset these undesirable influences and stabilize interest rates. However, it was precisely this view that created the problems we have observed over the past fifteen years. Around the middle 1960s, fiscal policy decisions were made that entailed greater expenditure for both domestic and international programs. The rise in expenditures, unaccompanied by higher taxes, produced greater deficits and upward pressure on interest rates. From that time, until late 1979, the Federal Reserve attempted to "lean against" these interest rate movements. In retrospect, it was more like spitting in the wind.

In general, monetary policy is implemented mainly through supplying and withdrawing reserves of depository institutions through open market operations. The changes in reserves produce an expansion or contraction of credit by these institutions.

Since interest rates are the price of credit, the net injection of reserves and subsequent increase in the supply of credit, everything else remaining constant, should cause a decline in interest rates. A net withdrawal of reserves, during periods of downward pressure on rates, holding everything else constant, should produce the opposite results. If this line of reasoning is pursued to its logical conclusion, then it appears that the

Fed could set some interest rate and hold it there forever by simply supplying or withdrawing reserves in appropriate amounts.

Unfortunately, as our experience since 1965 has shown, there is a slight flaw in this analysis. The flaw is that everything else does not remain constant. In particular, supplying or withdrawing reserves has predictable effects that produce significant changes in the economy and, not surprisingly, in financial markets as well. When reserves of depository institutions rise, these institutions actively expand their loans and investments. In so doing, they also create additional checkable deposits--that is, they create additional money. And an increase in the money supply impacts the economy in predictable ways. Initially, it induces an increase in real economic activity--in output and employment; ultimately it produces an increase in inflation. A decrease in reserves, of course, produces opposite and symmetrical changes.

These predictable results are not missed by market participants. If lenders expect inflation to accelerate, they will try to protect their purchasing power by demanding higher nominal interest rates. And borrowers, under the same circumstances, will pay the higher rates.

Thus, prolonged and repeated attempts to keep short-term interest rates from rising actually produces, over the longer run, interest rates that are even higher and more volatile than would have otherwise occurred. For example, in a recovery, when credit demands are rising, an attempt to hold interest rates constant by accelerating reserve and money growth simply fuels the recovery even further. It generates increased inflationary expectations and causes prices and interest rates to rise even higher than otherwise. In an economic contraction, attempts to keep interest rates from falling will produce an even deeper contraction and eventually a drop in

interest rates. In other words, attempts to stabilize short-run interest rates produce, in the long run, unstable prices, unstable employment, and unstable long-run interest rates--precisely the pattern we observed until recently.

Why is this past history relevant today? Because we face virtually the same pressures now that we faced fifteen years ago. Today we have large government deficits, both current and projected. Today, although interest rates have currently retreated from the recent peaks, we face projections of higher rates for next year. And, each time interest rates tick upwards, we see increased political and market pressure on the Fed to control these rates, to keep them from rising by accelerating credit and money growth.

Virtually everyone wants stable interest rates: you and I, the financial markets, politicians and monetary authorities all do. It is precisely this desire for stability that underlies the demands that the Fed should stabilize rates. But, attempting to stabilize the fed funds rate has a cost: it produces increased fluctuations in long-term rates.

Should monetary policy attempt to stabilize short-term or long-term interest rates? Where do the greater costs lie? I hope that you will agree with me that daily fluctuations in short-term rates are inconsequential compared to the risks facing bond markets produced by volatile and uncertain rates of inflation and the associated effect on long-term rates. Thus, I would like to see a monetary policy that does not try to prevent every market-induced wiggle in interest rates, but which tries to reduce both the level and volatility of inflation.

Of course, pursuing such anti-inflationary policy actions is easier to advocate than to actually accomplish. That is evident in the experience of the last three years. And, clearly, there are difficulties in engineering a

smooth reduction of inflation. One of the major problems would be maintaining such a policy long enough to wring out inflationary expectations. But we know that there is very little we can do about inflation in the short run.

A decline in reserve growth will under most circumstances raise short-term interest rates. This invariably produces widespread concerns over the fate of interest-sensitive sectors of the economy and recession. Yet we know that short-term interest rates have little lasting impact on the economy. It is the long-term rates that produce appreciable changes. We can predict with reasonable accuracy what a reduction in reserves will do to the money supply. We can predict how total spending will react. And we have reliable estimates of what can happen to output and what eventually will happen to inflation. The longer run problem is one of political will; in the past, long-run policy actions to reduce inflation have been repeatedly thrown off course by immediate political and financial market concerns about changes in short-run interest rates.

What options do we have? We can continue to demand stabilization of short-term interest rates. But then we ought to remember that chances for reacceleration of inflation or appearance of recession increase substantially. And if the inflation rate becomes variable, so do bond yields. And, as we have seen, highly variable bond yields do not bode well for the bond markets.

I, for one, prefer long-term interest rate stability, and that can be achieved only through stable money growth and a stable rate of inflation. We may debate endlessly the definition of money and what happens to velocity, but even an elusive monetary target is preferable to stabilization of short-term interest rates.

In summary, if we want to have bond markets that generate minimal risk, that efficiently perform their function of channeling savings into long-term investments, we must have a stable and predictable rate of inflation. That cannot be achieved by a monetary policy that reacts to every wiggle of the federal funds rate! Yet, to my dismay, financial market participants are often the ones who clamor the loudest for this unsound course. And that to me is the biggest puzzle of all.

Our present situation appears to be an opportunity to accomplish everyone's desired objective--sustained economic expansion without undue inflation. The economy is doing well, inflation is subdued, and the monetary aggregates are squarely within the long-term policy bands set by the Federal Open Market Committee. In my opinion, the best way to keep them there is to concentrate on management of reserve growth--not the level of short-term interest rates--since, over time, this will determine money supply growth. This is a two-way street. If money growth lags for too long, we could precipitate a recession.

As I review the changes in the principal monetary aggregates, I note that their rate of growth has slackened in each successive month since May. However, I also note that growth of the monetary base has picked up considerably since its low point in July. This leads me to conclude that growth of the monetary aggregates will increase at a more appropriate rate in coming months.

I leave it to you to decide what this means for interest rates. One of the offsets to what is euphemistically termed the "public sector discount" to Federal Reserve Bank Presidents salaries is the fact that we don't have to predict interest rates.