

monetary
Money Policy Today

by

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Must the Fed Fight Growth?

If you get all your information about the economy from the nightly news and daily press, you probably would think the following:

“A funny thing happened on the way to this economic boom: The economy gave a party and the Fed declined to participate. With U.S. business activity poised to finally burst from under the lingering shadows of the 1990-91 recession, monetary policy in 1994 has taken a decidedly restrictive turn, revealing a willingness to sacrifice economic expansion to tilt at inflation windmills existing only in the hyperactive imaginations of central bankers. Refusing to join the parade to prosperity, the Federal Reserve has become the troll under the bridge from stagnation to recovery.”

Sound familiar? Sympathetic sentiment is not hard to find, but if inclined to seek evidence that this interpretation of policy has widespread cachet, one need look no further than this headline reporting the Federal Open Market Committee’s latest policy move: “Federal Reserve Raises Key Rates to Curb Growth.” So said the *New York Times*. So says the Conventional Wisdom.

But is the Conventional Wisdom in fact wisdom? I think not. In my remarks today I wish to emphasize what I believe to be **some fundamental misconceptions** about current monetary policy. They are:

- (1) That interest rates paid by households and businesses would have remained low if monetary policy had remained stimulative-- I disagree.
- (2) That rising federal funds rates -- or, more specifically, overnight interbank loan rates -- will shorten or retard the current expansion -- They won't.
- (3) That the monetary authority controls inflation by controlling the real growth of the economy -- That's not my view.

Allow me to elaborate. These beliefs, **the tenets of modern monetary mythology**, did not, of course, arbitrarily insinuate themselves into the public consciousness. They arise as **false corollaries to general observations** about modern industrial economies, to wit:

- (1) The level of interest rates affects private spending.
- (2) Periods in which growth of spending on current output accelerated have been followed by periods of higher inflation.

Though empirical in nature, these statements reflect more than just statistical regularities. They are familiar assertions that are a standard part of macroeconomic analysis. As such, they have particular rhetorical force, and I would not enjoy the task of trying to undermine their acceptance. I certainly do not intend to argue with them here today.

What I do intend to do is confront the current mythology about monetary policy actions by combining these propositions with two others:

- (3) Inflation results from too much money chasing too few goods.
- (4) The Federal Reserve is held responsible for multiple economic objectives, as opposed to being accountable for price stability alone.

I should probably strengthen this last point. Not only is the U.S. central bank lacking clear statutory responsibility for price stability, and that alone, the very meaning of price stability is subject to a great deal of ambiguity. The consequent lack of a fully credible commitment to stable purchasing power of money results in overinterpretation of every twitch, sneeze, or cough by monetary policymakers.

The step from these four observations to the three monetary myths is a large one, and a large one in the wrong direction. I hope to convince you that this is so, and that my arguments cause you to think twice before you blindly accept the Conventional Wisdom about the motives behind policy actions.

Why Do Interest Rates Rise?

By way of analogy, let me start with a different question. Why does the price of apples rise? The answer to this question is, of course, simple. The price of apples rises for either of two reasons. One is that the price of apples rises along with everything else when the purchasing power of money falls -- the phenomenon we refer to as inflation. Two, even when there is no inflation, the price of apples will change in response to fundamental changes in demand and supply. If the demand increases or supply falls, prices rise.

This example is directly relevant because an interest rate, after all, is really just a price. In particular, it is the price paid to savers and paid by borrowers. Like apple prices, then, interest rates rise either because the rate of inflation increases -- more precisely because the *expected* rate of inflation increases -- or because there is an excess demand for the funds that are provided by national saving.

The critical distinction, of course, is between two related concepts, "changes in demand" and "changes in quantity demanded." For instance, a blight on orchards would raise apple prices and reduce the quantity of apples demanded at the new higher price. In this case we would be inclined to believe that the price increase is not happy news for apple lovers. However, suppose a credible scientific report indicates that apples prevent a variety of diseases. Then prices rise because of a boom in apple demand -- and a corresponding decline in the demand for something else, such as oranges -- and you would be perfectly willing to see the hikes for what they are: The natural consequence of market forces in response to buyers' increasing desire to consume apples.

The failure to think carefully about the difference between demand and quantity demanded leads some people to ignore the possibility that rising interest rates are merely a by-product of better times. In periods of expanding output, economic prospects brighten, and households and firms respond with a heightened desire to consume as well

but the following example distinguishes between change in demand and change in supply.

? how so?

as invest. In financial markets, these desires translate into reduced desire to save (hence, a lower supply of loanable funds) and more borrowing (hence, a greater demand for loanable funds). The result is higher interest rates.

The converse, of course, is also true. In periods of heightened uncertainty about future economic prospects, enthusiasm for consumption and investment ebbs, implying a somewhat greater willingness by households to save and somewhat lesser demand for loans on the part of borrowers. In these circumstances, interest rates tend to fall.

Developments over the past several years have been unusual. The first two years of the economic recovery that commenced in April of 1991 was anemic by past standards. The dramatic cuts in defense spending, problems in the commercial real estate sector, and a striking weakness in job markets have been a particular hallmark of this business recovery. Because of these extraordinary factors, expectations of better times were slow to materialize. As a result, demand pressures in the aggregate economy did not emerge, and both short and long-term interest rates continued to fall until last October -- 2-1/2 years into the expansion!

Sometime during the second half of 1993, the tide began to turn, and the economy entered a period more like the first year of a typical recovery than the third year. The growth rate of output for the current year is now expected by most forecasters to reach its highest level since 1988. After languishing for more than two years, the long anticipated pickup in employment growth took off in the first five months of this year. Market expectations of nominal GDP growth last autumn had been converging toward something like 6 percent. Sentiment then began to shift in the direction of faster real growth -- and somewhat greater price increases -- so expectations about total spending in the economy started to rise.

Redundant

In such an environment, rising market interest rates were inevitable. Apart from ^{taking} engineering steps to reduce market expectations of inflation, there was nothing the monetary authority could do about it. And, with the exception of adopting such a policy stance, nothing it should do about it.

Tacking Toward Neutrality

Rising market rates are indeed important to understanding recent monetary policy actions, but not for the reasons that are generally believed. The central bank does not control interest rates such as mortgage rates, car loan rates, or corporate bond yields. It does control the supply of money, more specifically the monetary base -- which consists of outstanding currency and bank reserves. Unfortunately though, monetary authorities not only do not control, but have considerable difficulty in estimating the amount of money balances people want to hold. This is critical because in the words of Milton Friedman, inflation *is* everywhere and always a monetary phenomenon.

The crucial point is often muddled because central bank actions employ interbank lending rates to control the quantity of money. If the job is done correctly, the result will be a stable purchasing power of money. However, as general economic conditions change, the interbank interest rate policy consistent with this result will also change.

Sailing provides a good analogy. The helmsman of a boat leaving New England bound for the Bahamas must choose to set the tiller based on wind direction, tides, currents, and surface chop. Those of you familiar with sailing in the Atlantic will know that it wouldn't be long before the sailor may be confronted with different wind and water conditions than those that prevailed near the coast. Experience, of course, will lead the helmsman to adjust the tiller in response to evolving conditions. Such an adjustment certainly does not imply a change in destination. Quite the opposite. The adjustment is *required* if the boat is to having any hope of reaching the Bahamas is planned.

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This is how I would like you to think of recent monetary policy moves. In response to the changing economic weather, it has been imperative that the central bank adjust the monetary tiller, lest we drift further and further away from the goal of price stability.

Recent Policy Moves: A Pro-Growth Policy?

The rationale for focusing on the purchasing power of money is rooted in the overriding goal of maximizing social welfare. By any rational calculation, this requires that policy be devoted to promoting the conditions that yield the highest rate of sustainable economic growth in the long-run. For monetary policy, this means pursuing policies that promote price stability.

Drift in the price level, even if fully expected, induces expenditures aimed at insulating the fruits of labor and investment from inflation-created increases in tax burdens. And even so-called stable and moderate inflation require an excessive churning of financial assets, as ever more sophisticated cash management strategies are needed to avoid ongoing erosion of the purchasing power of money. All of these activities absorb resources, which increase the cost of production, ultimately reducing the economy's long-run growth.

Furthermore, when the price level is uncertain, market participants face the prospects of capricious and unanticipated redistributions of wealth. Because of this, uncertainty about the future purchasing power of money channels resources away from the direct production of consumption and investment goods and toward activities that serve only to protect decision-makers from the ^{being on the losing side of the} ~~negative-sum~~ _{zero} reallocative consequences of inflation.

Achieving price stability would be like a positive technological advance. It ^{redundant} ~~release~~ resources from inflation hedging/risk avoidance activities and hence ~~increase~~ ^{would} the amount of real goods and services that can be produced with the economy's existing resources. In this way, price stability is pro-growth.

Does Price Stability Require the Fed to Fight Growth?

The position that price stability is pro-growth would seem strange to the proverbial visitor from Mars. Taking cues from bond-market participants, the financial press, and so-called "Fed watchers," our visitor would be propelled into a state of high anxiety about the adverse inflationary consequences of an economy in which output is expanding too rapidly. This Conventional Wisdom is misleading because of failure to distinguish between the short-run and the long-run.

There will indeed be times over the course of the cyclical ups and downs of the modern business cycle when the pace of economic activity exceeds its maximum sustainable rate. Experience also tells us that, during such periods, a shift in demand toward current output causes asset prices to ^{fall} rise -- that is interest rates to ^{rise} fall -- reducing the public's demand for the existing stock of money. The excess money balances will, in turn, cause current output prices to rise faster than the rate we desire in the long run.

Redundant.
Also, it is the expansion phase under consideration here, not both expansion and contraction phases.

This implies we desire some positive rate of inflation.

Sometimes, of course, the economic weather will shift in the opposite direction. Then, demand will shift away from current output, interest rates will fall, and prices will rise slower than we expect in the long run.

Over time, we expect that such output price fluctuations will be, at least approximately, offsetting. With appropriate adjustments of the tiller of monetary policy, these cyclical zigs and zags of output and asset prices can be accommodated without undermining our pursuit of a stable purchasing power of money.

That we have in the past lost our bearings in this pursuit is a consequence of the absence of a credible commitment to price stability. Announcement of clear and verifiable multiyear targets for the price level would be one way to build credibility. With such a credible commitment, short-run deviations from these targets could be accommodated without eroding public confidence in the purchasing power of money. At the least, the lack of such a credible commitment traps public discourse into the unproductive and perverse rhetoric of treating growth as undermining price stability. At

This section confuses credibility with commitment. Both are needed, but they are not the same. If we lose our bearings, it is because of lack of commitment, whether credible or not.

the worst, we are all led to treat the rhetoric as reality, ultimately leading to policies that are destructive of both economic growth and a stable and predictable monetary standard.

The Fed as “Anti-Growth:” What We Have Here is a Failure to Communicate

Many economists, and the news media generally, think that the Fed is more interested in inflation control than economic growth (as if there is a tradeoff), and that monetary authorities must deliberately slow the economy in order to achieve an inflation objective.

The economic view leading to these conclusions is a combination of a “slack model” and a perceived necessity to fine-tune aggregate demand. The central bank is regarded as being continuously responsible for manipulating the level of total spending in the economy to be equal to some estimated level of potential output. Parenthetically, this line of thinking also exposes monetary authorities to all of the political problems that occur when the actual level of output and employment is not “high enough” to suit the needs of the electoral cycle.

*define, or
don't use this
term*

If households and businesses throughout the nation -- as well as our elected political leaders -- knew and agreed that all central bank actions were, and should be, focused on achieving the highest sustainable rate of real economic growth, the timing of particular actions would not generate much news. If it were generally believed that monetary policy would be steered to achieving this end by a single-minded pursuit of price stability, then specific short-run adjustments would have no more meaning than the helmsman's adjustment of the tiller when the wind shifts.

From now on, when you see a story that says “Fed raises interest rates to slow housing starts, or auto sales, or economic growth,” I hope that you think about matters differently. The short-term interest rate policies of the FOMC cannot be simply characterized by references to “tightening” when interbank rates rise, or “easing” when they fall. A 3 percent federal funds rate with inflation expectations of 3 percent and

rising real interest rates would be quite expansive, and inconsistent with the pursuit of price stability. However, that same rate may again be perfectly appropriate at a time when inflation expectations are falling towards 1 percent or so.

Progress in the conduct of monetary policy would be greatly enhanced by a vigorous effort to disabuse the public -- and some public officials -- of the notion that adjustments in monetary policy are intended to manipulate real activity in the economy. Just as a boat cannot sail east and west simultaneously, the tools of monetary policy are not capable of achieving multiple objectives, even in the short-run. An explicit commitment to a multiyear price level objective would increase the flexibility of monetary policy and promote higher standards of living in the future by steering us toward the one destination that the central bank, and the central bank only, can deliver: a stable purchasing power of money.