Some Perspectives on Interest Rates

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Presented to the

Southern Minnesota Farm Forum
Lake Crystal, Minnesota

January 24, 1981

I welcome this opportunity to address the Southern Minnesota Farm Forum, but I will confess to a certain trepidation about appearing here with you this afternoon. The apprehension arises in part because I suspect that many of you look upon the Federal Reserve as the cause of the current high level of interest rates. In that light, I hope to use this occasion to put the current interest rate situation in its proper perspective and, in the process, shed some light on the causes and cures for high interest rates.

But in the spirit of the frankness that I know will be a hallmark of our dialogue, I have to own up: the real reason for my sense of trepidation in meeting with you this afternoon is that I know full well that as an Eastern "city-boy," my limited knowledge of your business and, in some cases, your problems will be all too transparent.

I am, however, beginning to learn about your business and from what I have already seen and learned, I can tell you that from the vantage point of Wall Street in New York or Constitution Avenue in Washington, it is virtually impossible to appreciate and understand the contribution that you in the agricultural sector make to our economy and our well-being as a nation. The magnitude of agricultural production just can't be captured by reading in The Wall Street Journal that corn production in 1980 totaled 6.65 billion bushels. The high and growing productivity of our agricultural sector can't be captured by looking at comparative statistics. The extent to which agricultural exports have, particularly in recent years, contributed to our strengthened balance of payments--OPEC notwithstanding--can't really be appreciated by looking at the numbers, impressive as they are.

However, it is not my purpose to speak to you today about the agricultural economy as such, but rather to use this occasion to discuss with you some of the more general economic problems, the economic challenges and the economic opportunities that are facing all of us today. I say all of us because I strongly believe that the core issues and the core problems facing this nation truly do face all of us--farmers and bankers, consumers and producers.

Some of the symptoms of those problems are seemingly conflicting and certainly confusing: the simultaneous occurrence of high inflation and high unemployment; the simultaneous occurrence of low and, in some instances, declining real incomes in virtually every sector of the economy; the simultaneous and self-defeating effort of all groups to escape the dilemma by striving to increase their real income--their "share of the pie"--at the expense of others.

Other symptoms are less ambiguous. The "buy now" attitude that we see so plainly is, in one sense, an understandable response to the fact of inflation and to the expectations of still more inflation. But that same attitude produces low savings and therefore low investment, low capital formation and sluggish productivity. Similarly, our markets, whether the market for precious metals, for corn, or for Treasury bills, are buffeted by short-run price variability that, in my view, illustrates forcefully the heightened sensitivity of market participants to changes in inflation and expected inflation.

Surely some part of this churning we see in our markets is a reflection of the inflationary process as both buyers and sellers try to outwit each other in the drive for that one extra basis point--that one-hundredth of a percent that looms so large when margins of profits are so thin. Again, in this case, we lose sight of the fact that unless we can achieve again sustained real economic growth, the market churning we see is a "zero sum game"--a game in which today's winners could be tomorrow's losers. What we need, not just in our markets, but in our economy at large, is to recreate the conditions in which we can all be winners!

At the risk of a gross oversimplification, I think it is fair to say that the symptoms of which I speak--those that are ambiguous and those that are clear--can all find their roots in a decade and a half of essentially accelerating inflation. And, I would submit to you that the experience of 15 years of progressively higher inflation was not altogether an accident or an outgrowth of OPEC. In part, it was a reflection of the fact that many, if not most of us, convinced ourselves that we could somehow live with a "little" more inflation. We could somehow isolate or insulate, we could somehow index or subsidize, we could somehow muddle through. We accepted that thinking because we also believed that the "little more" inflation seemed to buy so much more in terms of lower unemployment and increased availability of goods and services.

Unfortunately, we, like many before us, were wrong. Indeed, in retrospect it is now clear that had we been willing to look hard enough and had we been willing not to delude ourselves, we would have recognized that accelerating inflation is not something that can be lived with. There is no such thing as a "little more" inflation. Inflation is inherently debilitating, and as it grows, the resulting distortions and inequities grow with it. There is no escape--there is no haven. In short, inflation must be attacked and it must be rooted out. Avoiding that reality only intensifies the problem and increases the pain and discomfort associated with the process. That is why I believe it is so important that we, as a nation, come to grips with inflation now--now before both the problem and its ultimate solutions reach proportions that could make our current difficulties look mild by comparison.

I do not mean to suggest for one minute that this implies that our national priorities and our national policies need be or should be designed to the exclusion of other pressing and legitimate concerns. Certainly there is a long agenda of other priorities--energy independence to name one--which must be addressed. However, I do mean to suggest that as we approach these other problems we should keep one steady eye on the manner in which our efforts to solve those problems will either contribute to or detract from the ongoing effort to control inflation.

Nor do I mean to suggest that the task of rooting out inflation will be easy. It will not be. But I do very much believe that we have the knowledge, the tools, and above all, we now have the opportunity to get on with the job. Indeed, the only issue is whether we have the will.

All of which brings me to the role of monetary policy. I know full well that monetary policy and the Federal Reserve are not easily understood. Monetary policy--particularly in a day-to-day operational sense--is highly complex and is subject to many kinds of misunderstandings. I'm sure you appreciate that just from reading the financial press. It's also subject to many technical problems and--I would freely acknowledge--it may even be subject to some short-run miscalculations on our part now and then. These issues can and should be matters of concern, but they should not stand in the way of an appreciation of the core and essence of our policy.

Essentially, that policy is one that says that we in the Federal Reserve intend to restrain the growth in money and credit and bring the growth in money and credit into line with that compatible with a sustained and continuing reduction in the rate of inflation. That policy and that realization over time, I submit to you, is a necessary prerequisite to rooting out inflation. It is plain from history--both here and abroad--that inflation cannot be turned around in an environment of rapid and undisciplined growth in money and credit. This is not to suggest that the appropriate monetary policy can or should do the job by itself, but it is meant to say that without that policy other efforts will surely fail. Specifically, we must have a compatible and credible fiscal policy as well as a disciplined monetary policy. An appropriate monetary policy is a necessary but not a sufficient condition for controlling inflation.

What then about interest rates? What then about the claim that the Federal Reserve is the cause of the current high level of interest rates that I know is such a concern to all of you?

There is, I must confess, an element--and I emphasize, only an element--of truth to that supposition. It is true, for example, that our policy of restraining the growth in the supply of money does imply that only a certain amount of credit demands can be satisfied at any interest rate level. When credit demands are sizeable--and especially when they are fueled by inflation and inflationary expectations--interest rates will rise, as they did so markedly in the fourth quarter. I wish I could tell you that there was some easy way to avoid that result or to somehow get around that result.

In fact, in the short run and given some set of overall economic and financial conditions, I can see only three alternatives. First, the Federal Reserve could back off. It could speed up the printing press and push enough new money out into circulation to validate all of the credit demands. That could be done. But I think you recognize as readily as I that such a response would only fuel more inflation, higher inflationary expectations and, in very short order, higher, not lower, interest rates would result. In short, I don't think much of that alternative.

A second approach might be to try to somehow structure a program of credit controls or interest rate ceilings. On the surface, at least, that idea may seem to have appeal. However, on reflection, it too, I believe, is fraught with problems and doomed to failure. Experience has shown all too vividly that controls entail massive governmental bureaucracies and arbitrary and sometimes counterproductive allocations, and they are fundamentally in conflict with our system of markets and free enterprise--a system that you farmers may well more fully appreciate than do many. But there is another and perhaps even more fatal practical flaw with credit controls and interest rate ceilings. That is, with the advent of high technology in the money transfer business, trying to impose artificially low lending rates by law or regulation would only ensure that money--which is highly fungible--would flee to other markets, even to foreign markets. From where I stand, those are not the results we want either.

There is a way, however, that can help to lessen the pressures on interest rates, even in the short run. For example, it is clear that pressures on interest rates would be relieved if the demands for money and credit were more moderate. Unfortunately, such a softening in credit demands is often associated with a fall-off in economic activity--a process that we saw very clearly in the second quarter of 1980. However, achieving a moderation in credit demand need not entail that kind of circumstance particularly when we recognize that the government itself, and its sponsored agencies, are by far the largest single source of credit demand. Obviously, large and persistent patterns of government borrowing work to place upward pressures on interest rates and in the process work to limit the amount of credit that is available to private borrowers--small and large. Stated differently, we simply cannot tolerate successive and large federal deficits--with all they imply for the borrowing needs of the Treasury--and at the same time expect to meet the legitimate credit demands of businesses, households and farmers in a climate of moderate interest rates.

Achieving improved performance in our fiscal affairs will not be easy, but I have the clear sense that we are now at the point where we have both the recognition and the opportunity to achieve that objective. In my judgment, the first and most necessary step in that process is to achieve meaningful and credible reductions in federal spending. I do not claim to know how large such cuts can be; nor do I claim to know how and where they should fall. But I do sense that Congress and the American public will more readily accept spending cuts if the associated burden of short-run adjustment is shared across industry and interest groups. No group should be singled out, but no group should escape scrutiny. In that light, I think we must be frank and recognize that farm programs--either the direct spending programs or the off-budget lending programs--should, in the interest of a balanced program of federal spending restraint, be subject to the same scrutiny. My point, of course, is that unless our nation's producer and consumer groups, including farmers, can compromise their narrow interests and unite behind a broad program of fair and equitable reductions in federal spending, then I fear we will all be losers.

Achieving that broad-based discipline in federal spending is necessary and desirable in its own right, but it also has a bearing on the related question of tax policy and tax reductions. There is, for example, no questioning the proposition that the tax burden on households and businesses has become stifling. Thus, the case for tax reduction is strong. But I believe that we must earn our tax reductions by spending restraint. As importantly, I believe that, in tandem, spending restraint and tax reduction can, if properly balanced and structured, play a positive role in recreating the conditions needed for sustained economic growth and a sustained reduction in inflation.

I said earlier that none of this will be easy. Even if we are successful in these efforts, it will take time and effort to get the appropriate legislation through the Congress and it will take more time for the resulting programs to work their way through a large and complex economy. That period of transition will be difficult and it will test the strength of our conviction. However, I must confess that I have a sense of optimism that we now are prepared to get on with the job. That sense of optimism grows in part out of my belief that we have learned from our past mistakes and it grows out of my strong conviction that there is a widespread recognition that prosperity--true prosperity--can only be achieved in a noninflationary environment. Our efforts now can pave the way to that true prosperity. That is the only sure road to lower interest rates.

Thank you.