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THE FUTURE ROLE OF INTEREST RATES IN OPEN MARKET POLICY

BY

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## THE FUTURE ROLE OF INTEREST RATES IN OPEN MARKET POLICY

There must be some significance in the wide disparity between the way economists and politicians view interest rates these days. Economists, as they move increasingly to the monetarist view, have become inclined to assign a diminishing role to interest rates in monetary policy. Politicians, reflecting, I believe, the man-in-the-street view, attribute considerable importance to interest rates and tend to distrust a monetary policy that promotes high rates.

Like most generalizations, this one is subject to many exceptions. Yet it helps to explain why the future role of interest rates in open market policy is a matter of some significance. Even though some economists are inclined to write off that future as a dim one, policy makers cannot do this so readily.

The role of interest rates in our society has had a long and checkered history. Many social and political conflicts have revolved around interest rates as a symbol dividing the haves and the have-nots. The establishment of the Federal Reserve System, and particularly its form of organization, was influenced by attitudes toward interest rates and the control over them. To a considerable extent, the history of the Fed can be told in its changing attitudes toward interest rates.

In approaching the question of the future role of interest rates, therefore, I want to take a moment to sketch these shifting views in the Federal Open Market Committee since World War II. Although it might appear that the process has been one of fashionable surges and declines in the role of

interest rates, this is not the case. The FOMC has changed its thinking in a logical progression of steps set in motion by an historical event-- World War II--and two intellectual upheavals--the Keynesian and the monetarist revolutions.

### Changing Views of Rate Control in Postwar America

During World War II and for several years afterward, the FOMC abandoned a countercyclical monetary policy for stability of Government bond prices. This era marked the peak of the Committee's concern for interest rates and still stands as an object lesson of the dangers of placing complete emphasis on stable interest rates.

So strong was this lesson, in fact, that not long after the 1951 Accord between the Treasury and the Fed, the FOMC moved to a "bills only" policy which, in its extreme form, denied that monetary policy should attempt to influence the level or pattern of interest rates.

At about the same time, forces within the Fed spearheaded an early counterattack on the Keynesian view that monetary policy could be relatively ineffective in countering cyclical swings in economic activity. The argument went this way. Even if it were true, as the Keynesians said, that aggregate demand is insulated from the effects of rising and falling interest rates, aggregate expenditures can be influenced by changing credit availability.

As time moved on, not only were there opportunities to observe some of the shortcomings of fiscal policy as a countercyclical tool, but there were opportunities to study the extreme Keynesian view that monetary

policy was ineffective. Econometric evidence began to accumulate that aggregate demand is not impervious to credit market conditions in general and interest rates in particular.

Through the early 1960's, a modified Keynesian view began to emerge in the FOMC that monetary policy could work to reduce business cycles and that this goal could best be achieved by influencing interest rates and other money market conditions. Moreover, during the period some of the early bad taste of pegging interest rates began to fade. By about the mid-sixties, a concern for interest rates and money market conditions was again dominating the Committee's thought process.

Just at this time, however, the monetarist response to Keynesian economics was gaining respectability and monetarism was beginning to have an impact on FOMC policy. The monetarist view, of course, represented a challenge both to Keynesian economics and to interest rate policies. In the monetarist counterattack lay the seeds for the second postwar decline in the prestige of interest-rate control. This time, however, the decline has been neither as rapid nor as complete as the one we saw in the fifties.

Views in the FOMC have gradually shifted away from a countercyclical policy based on interest rates toward one based on control of the aggregates. The rapid growth in credit and monetary aggregates of early 1966 precipitated the so-called proviso clause in the Committee's directive to the Open Market Desk. By this device, the Committee, for the first time, instructed the Manager of the System Open Market Account to keep an eye on monetary aggregates as well as money market conditions.

In March of 1970, the Maisel committee on ways to improve the operations of the Open Market Committee completed its report. This report leaned to a further move in favor of an aggregate policy. Although it has not been adopted, the FOMC, earlier this year, agreed on a reserve target designed to help achieve greater control over the monetary aggregates. The precise measure selected was reserves available to support private deposits. The experiment with RPD's calls for the Manager of the Desk to seek tighter control over that aggregate and by implication allows for somewhat more fluctuation in interest rates.

But it still leaves considerable scope for concern with interest rates. To a large extent the current dilemma of the FOMC is to determine the precise role of interest rates in a world which recognizes the importance of monetary aggregates.

#### Present and Future Roles of Interest Rate Policies

As the Committee gropes for an answer to this dilemma, it may find a variety of reasons for giving interest rates a prominent place in its deliberations, including:

1. Interest rates can potentially be used to help control the monetary aggregates.
2. Interest rates can be used as a stepping stone to countercyclical goals.
3. Interest-rate control can be used to stabilize credit markets.
4. Interest rates can, from time to time, enter directly as a goal of economic policy.

How the FOMC comes out on these issues will determine the role and direction of interest-rate policy in the future.

Interest Rates and Control of the Aggregates.

Control of monetary aggregates such as  $M_1$  and  $M_2$  is not a trivial problem. As a practical matter, the Open Market Committee has direct short-term control only over its own portfolio (or some closely related aggregate such as reserves) and interest rates. Its influence on the money stock must therefore proceed indirectly through the size and mix of the System open market portfolio, through interest rates, or through some combination of the two.

From a purely theoretical standpoint, therefore, interest rates might be a useful bridge to the money supply. The Open Market Committee has discussed this possibility, but I think most members believe that they can influence the broad monetary aggregates most successfully by targeting narrow aggregates such as reserves or RPD's and not interest rates.

This view rests to some extent on tentative evidence accumulated by staff economists in the System, but mostly it is based on the Committee's experience in recent years. On several occasions, members of the Committee have felt in retrospect that they lost control of the aggregates because of excessive concentration on interest rates. Looking into the future, therefore, my guess is that the Committee will continue to try to influence the aggregates through reserves rather than through interest rates.

## Interest Rate Control and Countercyclical Monetary Policy

The future role of interest rates will depend, secondly, on where the Federal Open Market Committee comes out on the question of rates vs. aggregates in achieving its countercyclical goal. As I have said, the FOMC has switched from a strategy that relied almost exclusively on money market conditions to a strategy that recognizes value in both the aggregates and money market conditions.

The Committee has adopted an essentially eclectic position for two reasons. First, as a group it does not believe that the state of the economic arts allows a clear choice between the two. Some members tend to lean in one direction, some in the other, but few are entirely convinced of either view. Second, there is a general belief among Committee members that the economy and the policy problem are too complex to yield to simple either/or choices made once and for all. The Committee would rather keep its options open.

As I look ahead, I see that the inroads made by the monetary aggregates into countercyclical policy will be permanent. In fact, the Committee probably is prepared to push control of the aggregates further if the current experiment with RPD's turns out to be successful. But I have difficulty seeing the FOMC going all the way to make the aggregates the sole guide to countercyclical policy.

## Interest Rates and Credit Market Stability

The role of interest rates in the future will depend, thirdly, on the importance of a long-standing goal of policy: stability of the credit market.

This is one of the most controversial goals of the central bank. On the one hand, it has been attacked as an unnecessary subsidy to dealers in the credit market at best, and a cause of economic instability at worst. On the other, it has been supported as the first line of defense against financial panics, essential for the maintenance of efficient credit markets, and a crucial contributor to smooth Government debt operations.

The validity of each of these points has been debated widely, and time does not allow a review of them in detail here. I believe the FOMC would agree that it has an important obligation to preserve some degree of stability in the credit market. Certainly, it sees as one of its responsibilities the avoidance of cumulative financial distress such as that threatened at the time of the Penn Central bankruptcy. Whether it would see stabilization of the credit market as always consistent with its other goals is more difficult to say.

On a day-in-day-out basis, fostering stability in credit markets generally means providing smooth and orderly movements in interest rates. It is possible, of course, to minimize very rapid day-to-day swings in interest rates while providing sufficient month-to-month movement to achieve other goals, especially those involving the monetary aggregates. A trade-off between interest rates and aggregates develops only when interest-rate stabilization extends over long periods of time. The danger is that a policy aimed essentially at smoothing day-to-day rate movements will tend to drag on into weeks and perhaps even months at the expense of other objectives. This danger is



compounded by the fact that policy is ordinarily made by a series of fairly short-run decisions. Unless longer-run goals are constantly in mind, stabilization of interest rates can get in the way of other countercyclical objectives.

#### Interest Rates as an Ultimate Goal of Policy

A fourth determinant of the role of interest rates in monetary policy will be how they enter directly into society's or the Government's utility function. A special case today is the relationship between interest rates and direct controls. A legitimate case can be made on equity grounds that when some income receivers are restricted, earners of interest income should not be allowed off the "control hook." This argument, taken by itself, leads many to believe that increases in interest rates--as well as wages, prices, and dividends--should somehow be limited.

The problem, of course, is twofold. If the attempt is to restrict increases in interest rates in general by an expansive monetary policy, the result can not only be inflationary but also self-defeating as inflation premiums themselves push up interest rates. If the attempt is to limit increases in specific kinds of interest rates, the result can be a misallocation of resources among various uses of credit.

The Committee on Interest and Dividends has recognized both of these dangers. In an early statement of policy, its Chairman stressed the need for flexibility of interest rates for countercyclical purposes.

Arbitrary attempts to control interest rates, either in selected areas or for the economy as a whole, must be rejected as inefficient, inequitable and, in the end, unworkable for all concerned.\*

The Committee also has made clear that its efforts to hold down specific kinds of rates are directed toward making the credit market more flexible and effective as an allocator of funds and resources.

Nevertheless, the strong political and social overtones implicit in the public's attitude toward interest rates place the FOMC in a potentially difficult position in a period of direct controls. The FOMC must clearly take into account these political and social considerations in deciding on the most appropriate policy to follow with respect to interest rates. The Federal Reserve does have an obligation to be as responsive and sensitive as possible to national economic goals as reflected in Government policy.

The danger comes in the temptation to see every period as somehow special and somehow worthy of abandoning long-run goals of economic policy. To adopt such an attitude uncritically could lead to abandonment of the responsibilities of a central bank as one "special" period blends into the rest.

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\* Arthur F. Burns' testimony before Committee on Banking and Currency, House of Representatives, November 1, 1971, p. 19.

Conclusion

So, in conclusion, what is the likely future role of interest rates in monetary policy?

In recent years the FOMC has tended to concentrate its actions more heavily on the monetary aggregates. It has not, however, been willing to move to the extreme of abandoning interest-rate policies entirely, nor is it likely to do so.

The aggregates seem to be firmly entrenched as a tool of countercyclical policy and may make further inroads. Countercyclical policy, however, is not the Fed's only goal. Two other important ones are credit market stability and, from time to time, interest rates themselves.

Speaking for myself, I continue to see countercyclical goals as the Fed's primary responsibility over the long haul. I would not, however, be willing to reject other important goals of policy. The problem will be in choosing when and for how long to yield temporarily on countercyclical targets in favor of other legitimate goals.

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