

## HAS THE FED LOST ITS INFLUENCE?

Remarks by Thomas C. Melzer  
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There seems to be a growing concern, in financial circles and elsewhere, that the Federal Reserve is losing its ability to influence interest rates and the economy. In January, for example, an Investor's Daily article asked "Is the Fed's Grip On The Economy Slipping?" In March, a front-page article in The Wall Street Journal was captioned: "[The] Fed Has Lost Much Of Its Power to Sway U.S. Interest Rates." And more recently, the lead article in the April issue of the Institutional Investor was headlined: "Frustrating the Fed: How America is losing control over interest rates."

If these articles accurately reflect public opinion, there has been a dramatic--perhaps even historic--turnabout in the public's view of the Federal Reserve's role in the economy. Why, it might even be safe for a Fed official to address a group like this one and feel no pressure at all from the audience for lower interest rates. Now, of course, I do not really believe that public opinion, at least your opinion, has changed quite that much yet. Nor do I believe that public pressure on monetary policymakers is necessarily undesirable, even if it has led, at times, to policy mistakes in the past. I do believe, however, that the

present concern reflects a flawed, but unfortunately widespread, view of how monetary policy actually works. It is this general subject that I would like to discuss with you this afternoon.

Basically, there are two ways to view how the Federal Reserve influences the economy; for convenience, we can label them as the "credit" view and the "money" view. The "credit" view is the more popular one, at least in terms of its broad acceptance by financial market participants, the financial press and the general public. According to this view, the Fed influences the economy by controlling interest rates directly.

Thus, when it wants tighter economic conditions, perhaps to choke off inflationary pressures, the Fed simply drives interest rates up. The higher interest rates reduce demand for housing, autos and other things, thereby slowing down the economy. When it wants easier economic conditions, perhaps to head off the threat of recession, the Fed simply drives interest rates down. This credit view of the Federal Reserve's influence on the economy is promulgated daily in the financial press and, as a result, many people believe that it must be correct.

Those who believe this credit view also believe that the Fed's grip on interest rates, and hence on the economy, is slipping. While the specifics of this story may differ slightly from one version to the next, there are two main reasons given for the Fed's loss of control. The first

centers on a decline in the effectiveness of the "nuts and bolts" of Federal Reserve actions--its open market operations. The second reason has to do with the globalization of credit markets and the magnitude and importance of foreign investments in the United States. Let's consider each of these reasons in turn.

As I am sure you know, the day-in and day-out method by which the Fed conducts its monetary policy is through "open market operations"; these operations simply represent purchases or sales of government securities in sufficient amounts to achieve the desired changes in bank reserves and the federal funds rate. The presumption underlying the effectiveness of open market operations is that banks respond to them by commensurate changes in their lending activities. The changes in bank loans then spill over, via changes in the supply of bank credit, into general changes in credit conditions and interest rates.

The problem that has arisen, at least in the opinion of those who hold this credit view, is that banks have become less and less important as sources of credit in the economy. For example, in 1974, banks provided about 70 percent of the funds raised by non-financial corporations in U.S. credit markets; by 1989, this figure had fallen to around 50 percent, and it continues to spiral downward. A host of financial innovations, ranging from the rise of the commercial paper market to securitized loans, has enabled growing numbers of primary borrowers to bypass U.S. banks

entirely. Consequently, so the story goes, because credit markets have become less and less dependent on the intermediary activities of U.S. banks, the Federal Reserve has become less and less influential in controlling interest rates.

The second reason given for the declining influence of the Fed is essentially a corollary of the first one. Instead of blaming financial innovations, however, it focuses primarily on the growth of international credit markets and the importance of foreign sources of credit in the U.S. According to this argument, worldwide credit market conditions, not U.S. domestic conditions, are the primary source of influence on U.S. interest rates.

Faced with these stories and statistics, it is not surprising that the Federal Reserve's alleged diminished capacity to influence interest rates has become a hot topic for discussion. And, if there were only one view of the Federal Reserve's role in the economy, we would have to resign ourselves to the conclusion that the Fed has, indeed, lost it. However, there is an alternative view of the Fed's influence, the money view, that yields a far less pessimistic conclusion. In fact, it suggests that the Federal Reserve's influence on the economy remains essentially the same as it has always been.

According to the money view, the basic thrust of the Federal Reserve's influence on the economy comes from its impact on the nation's money supply. When monetary growth

accelerates, total spending accelerates along with it. The immediate effect of this greater spending is to encourage increased output and employment growth. Unfortunately, the long-run effect of this spending is reflected solely in higher inflation. The exact opposite pattern occurs when monetary growth slows down.

In this view, banks play an important role in the Federal Reserve's influence on the economy only because they produce the bulk of the nation's money supply. Changes in the Fed's open market operations immediately affect the growth of bank reserves. Banks, in turn, respond with commensurate changes in the growth of their loans. Through a multiple-expansion process, the new reserves are transformed into changes in the nation's money supply. In the money view, these changes are the source of the Fed's influence on the economy.

It is important to emphasize the vast difference between the two views in terms of how banks are treated as purveyors of Federal Reserve policy actions and how interest rates are influenced by the Federal Reserve. According to the credit view, banks are the key channels of Fed influence only because they are important suppliers of credit in financial markets. Since changes in the supply of credit, relative to the demand for credit, arguably determine interest rates, the Fed's influence over interest rates is closely related to the overall importance of bank credit.

As banks increasingly become supplanted by other sources of credit in financial markets, the Fed's influence obviously diminishes.

According to the money view, however, banks' proportionate share of the total credit market, whether it is 100 percent, 50 percent or even 10 percent, is totally irrelevant. Banks are important only because, through their credit operations, they happen to produce the largest part of the nation's money stock. Since other credit intermediaries, domestic or foreign, do not add to the U.S. money supply as a by-product of their credit operations, they cannot possibly supplant banks as money creators. Thus, the Fed's influence on the economy remains intact and undiminished.

Obviously, these two views yield very different conclusions about the Fed's continuing influence on the economy. And, just as obviously, both views cannot be correct. What is not necessarily obvious, however, is which view is correct and precisely why it is correct. Part of the problem is that we often confuse the concepts of money and credit; the other part is that we frequently do not distinguish between nominal and real interest rates.

To be honest, it is easy to be confused about the difference between money and credit. After all, when we borrow, we borrow money; and, when we lend, we lend money.

There is, however, a crucial difference that we need to understand if we want to determine how the Fed actually influences the economy.

The nation's money stock is represented by--in fact, is defined as--the sum of currency and checkable deposits available to be spent by you, me and others. In contrast, credit markets are simply arrangements set up to determine who gets to spend the existing money supply. Consider what happens when you write a \$1,000 check to your mutual fund. The banking system recycles the money from you to the mutual fund. The mutual fund might then purchase a \$1,000 certificate of deposit from a bank, which, in turn, lends the \$1,000 to a finance company. The banking system has now recycled the money from the mutual fund to the finance company. The finance company, in turn, might lend the \$1,000 to someone who buys lottery tickets with the money. The number of financial intermediaries involved and the total amount of credit generated are certainly impressive. The bottom line, however, is that, after the financial smoke finally clears, the \$1,000 simply changed hands from you to the guy who sold the lottery tickets.

While this process of financial intermediation makes our credit markets considerably more efficient, it should not blind us to the underlying realities involved. In general, neither the credit arrangements or the number of intermediaries in the credit chain have any effect on the size of the money supply or the total level of spending.

Instead, they simply represent more convenient ways to recycle existing money and, thereby, to rechannel spending from some individuals to others. However, an increase in the money stock, whether generated through the usual banking channels or, for that matter, dropped from airplanes, will affect both the total level of spending and the amount of credit extended. New money, as opposed to recycled money, always produces new spending and new lending.

But what about interest rates? Do they not reflect the interaction of the supply and demand for credit? And is their level not important in determining economic activity? The answer to these questions is, "yes and no." The interest rates we observe in financial markets are nominal interest rates. They are comprised of two chief components: the expected inflation rate and the expected real (or inflation-adjusted) interest rate. The expected inflation rate enters the nominal interest rate because it represents the expected decline in the value of the dollars involved in the credit transaction over the loan period. The expected (or ex ante) real interest rate is the return we expect to pay or expect to receive from the credit transaction after inflation is accounted for.

Expected real rates of interest reflect the real forces that underlie supply and demand conditions in credit markets. These conditions include things like the public's willingness to save, investment opportunities for domestic as well as foreign firms, changes in tax legislation, and

changes in trade and capital restrictions across countries. Clearly, despite what people might like to believe, the Federal Reserve has never had any significant short- or long-run influence on expected real interest rates. Yet, this is precisely what adherents of the credit view implicitly hold when they argue that interest rates are the primary channel of the Fed's influence.

On the other hand, monetary policy--or, more precisely, monetary growth--is the prime determinant of the inflation rate. Consequently, the Federal Reserve plays a key role in influencing both U.S. inflation expectations and the actual course of inflation. Through its influence on inflation expectations, the Fed directly influences U.S. nominal interest rates. And, through its influence on actual inflation outcomes, the Fed also influences actual (or ex post) real interest rates.

These influences are not unique to the United States. Each central bank has the same impact on nominal and ex post real interest rates in its own country. Countries with high nominal interest rates, like Brazil, are those whose central banks have traditionally followed looser monetary policies. In contrast, countries with low nominal interest rates, like Switzerland, typically have central banks that consistently pursue tighter monetary policies.

Indeed, once we examine both the domestic and the foreign evidence concerning the impact of monetary policy on the economy, two things become rather obvious. First, the

money view, not the credit view, seems to best explain how any central bank, including the Federal Reserve, can influence its domestic interest rates and its economy. The causal link runs primarily from money growth to spending growth and to credit growth, not from credit growth to money growth or to spending growth.

Second, despite a myriad of financial innovations and the increasing globalization of financial markets, neither the Federal Reserve nor other central banks have lost their influence. The short-run impact of monetary policy actions, while temporary, is still on the real economy; and, the longer-run, permanent effect still shows up in price movements. For example, U.S. money growth slowed abruptly from late 1988 through June of last year; anyone who held the money view would have been concerned about the prospect of slower U.S. economic growth by the end of 1989 or early 1990. And, as expected, real growth in the U.S. weakened, almost right on schedule, and has remained weak.

Likewise, when money growth in Japan and West Germany accelerated sharply in the last few years of the 1980s, anyone who held the money view would have suggested that higher inflation and higher interest rates would follow. And they did! Back in March, 1989, for example, U.S. long-term interest rates were 250 basis points higher than German interest rates and 500 basis points higher than Japanese interest rates. Now, however, German interest rates are actually above ours and Japanese interest rates

are only 150 basis points below ours. Moreover, while German and Japanese rates were rising, our long-term rates declined about 50 basis points below what they were in March of last year.

In summary, despite recent claims to the contrary, the Federal Reserve is not in danger of losing its influence on the economy, on financial markets, on inflation or on interest rates. Those who believe otherwise, that is, those who subscribe to the credit view, have typically overestimated the Fed's influence in the past. Now, they are making the opposite error; they are giving the Federal Reserve far too little credit for its influence on the economy.

While either error is potentially hazardous, especially in public discussion of what monetary policy can and should accomplish, I believe that underestimating the Fed is by far the more dangerous error. When the public believed that the Federal Reserve had significant influence, extensive public opinion was focused on the Fed's actions. In part, this public pressure was responsible for the Fed's successful move, beginning back in the early 1980s, to reduce inflation by the end of the decade. If the pendulum now swings too far in the opposite direction, an important source of public pressure or guidance, on both current monetary policy actions and the future course of U.S. inflation, will be

lost. I, for one, would hate to see that happen; in order to achieve price stability in this country, we will need all the support and encouragement we can get.