

IS THE FED LOSING ITS INFLUENCE?

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There is increasing public interest in the Federal Reserve's role in this nation's economy. Some of this represents the usual "cheerleading" that the Fed hears from financial and political circles--often around periods of elections or slow economic growth as we have now. Generally, these cheers are intended to lead the Fed to deliver some specific economic outcome quickly.

However, there also seems to be growing concern, in financial circles and elsewhere, that the Federal Reserve is losing its ability to influence interest rates and the economy. Last 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." In April, the lead article in the Institutional Investor was headlined: "Frustrating the Fed: How America is losing control over interest rates." And, just last month, Alfred Malabre and Lindley Clark, two of the most well-known and respected economic reporters in this nation, entitled their Wall Street Journal article "[The] Fed May Find It Hard to Reverse [the] Slump: Strict Bank Rules, Rise in Nonbank Debt are Factors."

If these articles accurately reflect the cutting edge of public opinion, then a dramatic--perhaps even historic--turnabout is taking place in the public's view of the Fed's role in the economy. While I don't really believe that the broad sway of public opinion has changed quite this much, at least not yet, it is interesting to consider why this perception might exist. In my judgment, fears of the Fed's waning influence reflect a flawed, but unfortunately widespread, view of how monetary policy actually works. Oddly enough, this same flawed view is the one that, until recently, led many people to attribute far greater influence to the Fed than it ever really had. This is the 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. According to this view, the Fed influences the economy by controlling interest rates directly and completely.

Thus, when it wants tighter economic conditions, perhaps to choke off inflationary pressures, the Fed simply drives up interest rates. The higher interest rates reduce demand for housing, autos and other things, thereby slowing the economy down. Alternatively, when it wants easier

economic conditions, perhaps to spur the economy out of recession, the Fed simply drives interest rates down. I am certain that you are familiar with this particular view of how the Fed influences the economy. It is proclaimed daily in the financial press and, as a result, many people believe it to be correct.

Those who believe the credit view are also the ones who are concerned 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 essentially two main reasons given for the Fed's loss of control. The first reason 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 called "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.

These changes in bank loans then spill over, via changes in the supply of bank credit, into general changes in credit conditions and interest rates.

Unfortunately, at least in the opinion of those who believe the credit view, something has happened that threatens to weaken, perhaps even break entirely, the link between open market operations and the economy at large. The problem is that banks have become less and less important as sources of credit in the economy. To really appreciate just how much the role of banks in credit markets has declined, consider the following numbers: Banks provided about 35 percent of the funds raised by U.S. nonfinancial corporations during the 1960s; however, they provided only 23 percent of these funds during the 1980s. Indeed, by 1989, bank loans accounted for only 14 percent of the funds raised by these corporations.

The same pattern emerges when you consider total debt outstanding instead of just nonfinancial corporate debt. Malabre and Clark, for example, point out that nonbank financial institutions, such as finance companies and insurance firms, now hold 48 percent of all debt, up from 35 percent back in 1981. What has happened to the banking industry? Simply that 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, as credit markets become less and less dependent on the intermediary activities of U.S. banks, the Federal Reserve must inevitably 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. conditions alone, are the primary source of influence on U.S. interest rates.

To cite one recent example of this story, suppose that profitable investment opportunities should open up in Eastern Europe as these countries rush toward capitalism. Because the flow of foreign savings into the U.S. will now be diverted, at least in part, to investment projects in Eastern Europe, the presumption is that U.S. interest rates must inevitably rise. Moreover, they must continue to rise until foreign savers can get the same rate of return on their savings whether they invest in Eastern Europe or the United States. Thus, this view concludes, the Federal Reserve is powerless to prevent U.S. interest rates from rising; the interest rate increase is being driven by changes in flows of foreign savings that the Federal Reserve can neither control nor offset.

Faced with such stories and statistics, it is not surprising that allegations of the Federal Reserve's diminished capacity to influence U.S. interest rates and, thereby, the U.S. economy, have become hot topics 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 comes from its effect 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 is reflected solely in higher inflation. The exact opposite pattern occurs when monetary growth slows down. Thus, changes in the Federal Reserve's monetary policy stance have two separate effects on the economy. The initial effect is the Fed's ephemeral influence on the real side of the economy; the subsequent, but longer-lasting, impact is on the rate of inflation alone.

In this view, banks play an important role only because they produce the bulk of the nation's money supply. Changes in the Fed's open market operations immediately change 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 in the nation's money supply 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 Fed. According to the credit view, banks are the key channels of Fed influence only because they are important suppliers of credit. Since changes in the supply of credit, relative to the demand for credit, determine interest rates, the Fed's influence over interest rates is closely related to the overall importance of bank credit. As banks increasingly are 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 completely irrelevant. Banks are important only because, through their credit operations, they happen to produce the largest part

of the nation's money stock. Because no other credit intermediary, domestic or foreign, can add to the U.S. money supply as a by-product of its credit operations, it cannot possibly supplant banks as a money creator. 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. Just as obviously, both views cannot be correct. However, what is not necessarily obvious is which view is correct and precisely why. Part of the problem is that we often confuse the concepts of money and credit; the other part of the problem is that we fail to recognize the crucial difference 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 distinction that we must recognize 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, for example, what happens when you write a \$1000 check to your mutual fund. The banking system recycles the money from you

to the mutual fund. The mutual fund might then purchase a \$1000 certificate of deposit from a bank which, in turn, might lend the \$1000 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, may lend the \$1000 to someone who buys lottery tickets with the money. The number of financial intermediaries involved and the cascading amount of credit generated by them is certainly impressive. The "bottom line," however, is that the \$1000 simply changed hands from you to the guy who sold the lottery tickets; or, in other words, after all the financial smoke clears, you loaned someone \$1000 to buy lottery tickets.

While this process of financial intermediation makes our credit markets considerably more efficient, it shouldn't blind us to the underlying realities involved. In general, neither these credit arrangements nor 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, 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. Only credit transactions involving banks can change our money supply and only those specific bank credit operations resulting from changes in bank reserves actually do so.

But what about interest rates? Is their level not important in determining economic activity? And shouldn't the Fed, as the credit view holds, be able to set interest rates by influencing the supply of bank credit? The answer to these questions is an unambiguous "yes and no." The interest rates we observe in financial markets are nominal interest rates. They are made up of two chief components: the expected inflation rate and the expected real interest rate. Expected inflation enters the nominal interest rate because it represents the expected decline in the value of the dollars loaned over the life of the loan. The expected real interest rate is the return we expect to pay or receive from the credit transaction after inflation is accounted for.

Real rates of interest, not nominal rates, are what influence real economic activity. They 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 and foreign firms, changes in tax legislation, and changes in trade or capital restrictions across countries. Clearly,

despite what people might like to believe, the Federal Reserve has never had any significant short-run or long-run influence on 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. Only through its influence on inflation expectations can the Fed directly influence U.S. nominal interest rates.

This influence is not unique to the United States. Each central bank has the same impact on its own country's nominal interest rates. Countries with higher nominal interest rates, like Brazil, are those whose central banks have followed drastically looser monetary policies. In contrast, countries with lower nominal interest rates typically have central banks that have pursued tighter monetary policies. Finally, there are those countries whose central banks have wavered back and forth between tighter and looser monetary policies; they have generally found that changes in inflation and nominal interest rates have wavered right along as well.

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 credit growth, not from credit growth to money growth or spending growth.

Second, despite a myriad of financial innovations and the increasing globalization of financial markets, neither the Federal Reserve nor any other central bank has lost its influence on the economy, on financial markets, on inflation or on interest rates. Those who believe otherwise have typically overestimated the Federal Reserve'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 discussions of what monetary policy can and should accomplish, I believe that underestimating the Fed is by far the more dangerous error. Whenever the public believes that the Federal Reserve has significant influence on the economy, extensive public attention is focused on the Fed's actions. In part, such public pressure was responsible for the Federal Reserve's successful move, 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 move closer to an economy with truly stable prices, the Fed needs all the support and encouragement that it can get.