Good morning. Having heard Abby Cohen's international view of the economic and financial markets outlook, I would like to focus on something closer to home—not just in the sense of an important topic for U.S. monetary policy, but "home" in terms of a 35-year tradition at the Federal Reserve Bank here in St. Louis. The topic is inflation and the policy question is the Fed's attention to it. The Fed is approaching an important crossroads, and the direction we take will have consequences not only for domestic inflation, interest rates and real growth, but for foreign economic performance as well.

Chairman Greenspan's diligence in containing inflationary pressures and a Congressional proposal to target zero inflation seem to support the view that the central bank's most important and, I would argue, only achievable long-run objective is price stability. But to some people in St. Louis, the mystery is why it has taken so long to air this debate and perhaps, finally, come to a consensus on it.

Some history may help. Homer Jones, who had been a teacher of Milton Friedman's at Rutgers University, came to the Federal Reserve Bank of St. Louis as Director of
Research in 1957. It took him exactly one Board meeting to begin lecturing on the universal links between the growth rate of the money supply and inflation, on one hand, and expected future inflation and interest rates, on the other. Reading from the Review, our bi-monthly research journal, one comes across statements like the following:

--from a 1969 speech by Darryl Francis, one of my predecessors,

"...there is substantial empirical evidence indicating that marked and sustained changes in the rate of growth of the money supply have always been followed by changes in the growth of total spending in the same direction. ...[S]ince there are close causal links between changes in Federal Reserve actions and in the money supply and between changes in the money supply and changes in spending, I submit that the money supply gives us the best overall measure of the influence of policy actions."

--and from Larry Roos, another St. Louis Fed President, speaking in the early days of Paul Volcker's fight against the double-digit inflation of the late 1970s,

"By gradually reducing the growth of the money supply, the Fed can bring down inflation over a predictable and reasonably short period of time."
... Continued restraint will mean a period of softness in the economy, and individuals who are adversely affected can be expected to call vociferously for a return to more stimulative monetary policy.... Finally, 1980 is an election year, and the bitter medicine of monetary restraint has never been welcomed by candidates for public office."

I could go on citing from speeches and research papers, but, to the Federal Reserve Bank of St. Louis, money growth consistent with price stability always has been the appropriate focus of policy. And whether it was the Keynesian thought of the 1960s or the velocity breakdown of the 1980s that seemingly made the monetary aggregates objects unworthy of the public's attention, statements from the St. Louis Fed have never wavered in laying the blame for inflation where it belonged: at the doorstep of the central bank, which bears the responsibility for excessive money creation.

And the data have been all too willing to confirm this view. In the late 1950s, with M1 growth averaging 1.7 percent, the inflation rate hovered near 1.5 percent. By the late 1960s, with trend M1 growth accelerating to 5.9 percent, inflation obliged by following along and rising to
6.2 percent. By the late 1970s, M1 growth had risen still further to 8.3 percent and, as one should have expected, inflation jumped as well to 11.7 percent.

According to the skeptics, the financial innovations of the 1980s--nationwide introduction of NOW accounts, MMDAs and the like--broke the long-standing link between money and prices. But surely this relationship was robust enough to survive some regulatory changes. After all, if primitive island economies that used seashells for currency experienced inflation whenever storms deposited more shells on the sand, wouldn't the modern U.S. still see an increased inflation rate after an increased rate of money growth?

Once again, the data complies. After staying in the 3 to 4 percent range for much of the middle 1980s, the U.S. inflation rate jumped to something above 5 percent in 1987. The reason? A sharply expansive monetary policy in 1985-86 as the Fed arguably lost sight of its main objective amidst pressures to cheapen the dollar's value in foreign exchange markets. Only when this expansionary monetary policy was reversed early in 1987 did the inflation rate begin to fall. And it has been contained since then only because money growth has been restrained as well.

For people who live and die by movements in interest rates, I need not spend much time emphasizing that low and stable interest rates of all maturities depend critically on people's expectations about the future course of inflation.
Because inflation erodes the purchasing power of money, investors will insist on being compensated for such expected losses when lending money over time. This premium, which is reflected in nominal interest rates, obviously will be lower if people expect inflation to be low. Moreover, the premium will decline as the risk of a higher inflation rate declines.

Thus, if we want permanently lower interest rates, it is not enough to have a monetary policy consistent with reducing inflation to some acceptably low rate. Instead, it is also imperative that the Fed establish an unquestioned credibility that it will maintain the slow, stable money growth necessary to keep prices stable. Unfortunately, as the stop-and-go monetary policies of the last three decades have shown us, temporarily restrictive monetary policy can be achieved to reduce inflation for a while. But the permanent changes necessary to establish central bank credibility and permanently lower inflation and interest rates still elude us.

This is precisely why 1991 will be such an important crossroads for policy. Since 1987 we have progressively laid the groundwork for something very close to long-run price stability. The trend rate of M1 growth now is at a level—3 percent—not seen since the late 1950s, the last era of essentially no inflation. When we get past the first quarter's 5.5 percent inflation rate—badly distorted by
last fall's oil-price gyrations—I believe we could see, over the next year or so, inflation numbers below 4 percent and falling.

That is, if we do not abandon the policy course of the last four years that has made so much progress. But, the temptation to ease monetary policy during an economic downturn has always proved irresistible. The sad truth is that the inflation rate after a recession has tended to be higher than the inflation rate before the downturn. Why? Because the Fed has eased money so much during each recession that average money growth ends up rising above its pre-recession rate.

A famous cynic once said that "the only thing we learn from history is that we don't learn anything from history." So, at this turning point for monetary policy, what will the Fed do? And what has it learned from history?

Based on some recent press reports, the consensus is that the Fed will, perhaps can, do nothing. According to these reports, the Fed has become paralyzed by internal strife, with Reserve Bank presidents locked in combat with the Chairman over the soul of policy. Stories like this, however, misrepresent the truth.

Federal Reserve policy discussions have always embraced different points of view, but in the end have had the character of a family argument. What is said within the privacy of the home is family business; outside the home,
everyone is united in the family's decision. This has been true throughout the history of the modern Federal Reserve. From quiet chairmen, like William McChesney Martin, to Arthur Burns and Paul Volcker, who were perceived as more autocratic, the Fed has always had a tradition of strong internal debate and a generally united public stance.

The trouble with these recent reports is that a difference of opinion about style has created the impression of a serious split over substance. Some participants in FOMC discussions have apparently spoken with outsiders about the details of meetings which have been reported in the press. Understandably, the public, being used to the Fed speaking with one voice, is confused by this abrupt change in the Fed's public posture.

The public's concern is genuine and, also, unfortunate. As I mentioned a moment ago, one factor influencing the level of long-term interest rates is a premium associated with the trust that investors place in the stability of policy. Public airing of private disagreements, of course, only adds to that premium as people wait for the argument to shift from one policy stance to another. And it undermines the Fed's own agenda of trying to produce permanently lower and more stable inflation and interest rates. To sum up, then, the Fed is not paralyzed, but it has lost some of its dignity.
So, where do we go from here? To me, the answer seems clear. We have invested four years in reducing a dangerously high growth rate of money that, left unchecked, was sure to ignite a significant upturn in inflation. The real economy is in a recession that, as past episodes have shown us, will not, in the long run, be aided by an overly aggressive monetary easing; indeed, such a response has worsened the seemingly permanent inflation that has characterized postwar America.

If we have learned anything from history, we must pursue the path of price stability and continue to build on the progressively slower monetary growth of the past four years. This path will offer the greatest prospect for lower inflation and interest rates, both now and in the future. Thank you.