

CAN THE YIELD CURVE BE USED TO INDICATE  
THE STANCE OF MONETARY POLICY?

Good morning. I am happy to be here today, even if it is at a time when the beginning of the recovery and its strength seem to be in doubt. An opportunity like this always is welcome because it gives me one more chance to challenge some of the conventional wisdom and make a few more converts to a different point of view.

Indeed, I am especially happy to be here as a former government bond dealer. As some of you may know, I once managed the government bond desk at Morgan Stanley and, in that capacity, spent my time trying to decipher whether an FOMC directive that said "may" was different from one that said "might." And early in my Fed career, I would sometimes think, after attending an FOMC meeting, "If I only knew then what I know now."

The answer, I've discovered, is "Doing time along with other inside traders."

At this important crossroads for monetary policy, I'd like to discuss a problem that has plagued our decisionmaking for a decade. Since the nationwide introduction of NOW accounts in 1981, the monetary aggregates often have behaved erratically. In fact, the behavior of M1 has been so problematic that the Fed no longer sets a target range for its growth. M2, which the Fed now emphasizes, is no winner either as we have seen factors wholly unrelated to money creation--a panic about the safety of large CDs in thrifts in 1989 and a flight to bond funds this year--cause large swings in the growth of M2. These portfolio shifts, I would argue, raise serious questions about the usefulness of M2 either as an indicator of the stance of monetary policy or a guide to the future course of nominal spending and inflation.

Amidst this uncertainty about the best indicator of the thrust of monetary policy, the yield curve has become, to some, the new Holy Grail. Even though a cynic might dismiss it as just another indicator/flavor of the month, I think its potential is worth discussing. Unlike some other proposals, which have had little merit, research evidence from several prominent academics has supported the arguments of some past and current policymakers in favor of this market-based measure. But, as president of the St. Louis Fed, you will not be surprised to hear that I have some doubts. Let me explain why.

Although a variety of specific yield curve measures has been suggested by interest rate aficionados, most rely on changes in the spread between some long rate and short rate to indicate easing or tightening of monetary policy. Despite disagreements on other matters, these analysts and I agree that movements in long-term interest rates are driven by

changes in inflationary expectations. Moreover, because inflation tends to unwind slowly, large and sustained changes in long rates tend to occur only when the Fed has stuck with a relatively easy or tight policy for some time. Certainly long rates move day-to-day but, for our purposes, we are talking about their gradual movement to a new level and staying there in response to a fundamental revision in the public's perceptions of inflation's future course.

Most of the action in a yield curve -- or interest rate spread -- indicator, as you might expect, comes at the short end of the market. Here, a Fed easing occurs through an increase in the supply of credit and is presumed to reveal itself in a decline in short rates; a tightening, caused by a reduced supply of credit, would be expected to raise short rates. Therefore, even without any response in long rates, the spread measures are expected to widen when the Fed eases and narrow when it tightens. And, if you get reinforcing

actions from the long end -- for example, a Fed easing also pushing up inflationary expectations and long rates -- the spread measures should only widen or narrow by greater amounts.

Changes in the yield curve spread between long and short rates, following the story to its next step, then are supposed to affect both business and consumer spending by encouraging credit creation. With lower short-term interest rates, financial institutions will be able to issue liabilities more cheaply and, presumably, will be inclined to make more loans. And, from the other side of the market, borrowers presumably will be more inclined to borrow and spend on such things as consumer durables. Thus, a widening spread is interpreted as an easing of monetary policy because its predicted effect is a more rapid rate of spending in the economy. It also is easy to see how a narrowing spread, which would be expected to slow credit growth and spending, often is linked to a tighter monetary

stance. On the face of it, a spread--or yield curve--measure seems to have a simple logic in its favor.

The attention being paid to market-based indicators of this sort, of course, may never have come about unless we had experienced the financial innovations of the 1980s and ten years of debate on how relationships between the monetary aggregates and both spending and inflation had been affected by them. And, in fairness, there is good reason to be confused on this front. The academic research has shown -- take your pick -- that M1 has or has not been distorted by innovations, M2 is or never was a useful guide to policy and the monetary base has or has not lost its usefulness in the wake of erratic shifts in the growth rate of currency.

How does the evidence shake out? Well, as we've always insisted here in St. Louis, let's look at the data. In fact, let me walk you through a specific case

study of what alternative indicators of monetary actions suggested at a recent crucial turning point. Exactly one year ago, I attended an FOMC meeting that was one of the first, of many, to be leaked almost verbatim to the Wall Street Journal. Although FOMC meetings have since taken on the air of prize fights--"the third fight of the decade this month"--this was a critical meeting. The effects of higher oil prices on economic activity were unknown, money growth (as measured by M2) appeared to be consistent with both price stability and sustained real growth and, at least at that time, neither the Board's staff nor the Blue Chip consensus forecast had yet indicated that a recession was likely.

At a meeting of this sort, however, you can well expect that some people argued for restraint -- to hold the price-level consequences of higher oil prices in check -- while others argued for ease -- to ameliorate the adverse consequences of higher oil prices on real

activity. With the FOMC having the same three options as Goldilocks, the remainder of the Committee thought the current thrust of policy was "just right."

What did the data show? M2 had grown at a 3.5 percent rate during the second and third quarters of 1990 relative to its three year trend rate of 4.2 percent, a sign -- to St. Louis Fed junkies -- that the stance of policy was about right and, if anything, a little on the tight side. Looking at adjusted reserves would have reinforced this view as they had grown at a 0.8 percent rate over the same two quarters relative to their 1.4 percent trend rate.

A garden-variety yield curve measure, however, would have suggested that an easing of monetary policy had been in place since the previous spring. For example, the spread between fed funds and 10-year Treasuries had widened from 20 basis points in June to 70 basis points by the end of September.



Looking back on that October 2, 1990, FOMC meeting through the fourth quarter and into spring of 1991 we can see how, at a crucial turning point in both monetary policy and the business cycle, a yield curve indicator of monetary policy can be extremely misleading.

As we know now, the economy weakened considerably during the fourth quarter. Simultaneously, both M1 and M2 growth were flat. Growth in adjusted reserves, although picking up slightly in the fourth quarter, was recovering from its anemic third quarter pace. From my perspective, these data tell me that monetary policy--at best--was neutral in the fourth quarter of last year and, by some indicators, got more restrictive. And yet, by early January, all of the spread measures had widened by another 70 basis points.

How can that be? Well, the fly in the ointment is the possibility that short rates tend to fall -- irrespective of Fed actions -- as the economy slows

because of a reduction in the demand for credit. Or, to put it simply, the difference between the standard yield curve story and the reality of what occurred in the market last year is based on a confusion between an increase in the supply of credit and a reduction in the demand for credit. Either change will tend to make short rates fall, but the two sources of change have completely different interpretations and consequences.

Let me explain in greater detail. In retrospect, it seems clear that the decline in short-term interest rates last fall (and the widening spread) were sending a signal. The problem is that a slumping economy and a reduced demand for credit -- not a Fed easing -- was the message. This very real possibility, verified by the data of past recessions, tells me that interest rate spreads, like other market-based measures of the thrust of monetary policy, are not particularly useful because a variety of factors -- mostly beyond the

control of policymakers -- are likely to drive their behavior.

What would the same yield curve measure tell us now? In the first half of this year, the 10-year Treasury - fed funds spread widened by another 75 basis points. Since mid-July, however, it has narrowed slightly. The M1 measure of the money supply, however, has been rising at a 7.5 percent annual rate since the end of last year, a pace nearly double that of last year. Similarly, the growth rate of adjusted reserves also has doubled relative to its rate during the second half of 1990. The adjusted monetary base has been expanding smartly as well. All told, I think the evidence points to a mirror image of the conditions last fall: instead of signaling ease when policy actually was getting more restrictive, the yield curve measure now indicates a neutral policy when, in my view, the Fed has eased quite enough, thank you.

Where does this leave us? Frankly, I believe that, despite all of the debate and confusion, nothing in the world has changed to refute the idea that reserves are the foundation for money creation. Moreover, accelerations or decelerations of money growth above or below its trend rate still tend to be reflected in accelerations or decelerations in the inflation rate. Admittedly, the empirical relations are not as tight as they once were. But they still give clear, leading signals of the direction of change in spending and prices. From my view, as a central banker, all of the sound and fury over the financial changes of the 1980s have done nothing to alter the approach to monetary policy advocated by my St. Louis colleagues for so long.

And in that view, where do we stand now? Perhaps at one of the most important turning points for monetary policy in some time. As I've already noted, the growth rates of adjusted reserves, the monetary

base and M1 all have accelerated sharply from their slumps during the second half of last year. Slow M2 growth is, I believe, a red herring that is related to portfolio reallocations rather than money creation. Still, the current data on real economic activity are mixed and, to some observers, indicate the corner has not yet been turned for real activity. So, as you well know, the drumbeat for more ease goes on.

Frankly, this causes me a great deal of concern because, if we've learned anything from the past, it's that monetary policy has only temporary effects on the real economy but it's effects on inflation are persistent. Why then, with the trend growth rate of money in the neighborhood of 3 to 4 percent, should we give up this hard-won ground for a temporary boost in output? If we can stay the course, experience tells us inflation will continue to fall from its pre-war rate, approaching 6 percent, to something closer to three

percent and that long-term interest rates will come along for the ride.

Experience also tells us that using monetary policy to reverse recessions has left us with inflation rates that have been higher after every recovery than their values prior to those downturns. This is not good long-run policy. And now that I have given up the bond desk and its long-run horizon of an hour or two, I have to avoid the lure of short-run palliatives as we move the country toward low, sustained inflation rates not seen in thirty years. From this foundation I believe it also is possible to re-launch a comparable period of strong and sustained real growth. Thank you.