HOW THE FED PROMOTES ECONOMIC GROWTH

Remarks by
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Rotary Club of Springfield
Springfield, Missouri

February 22, 1994
I am pleased to be in Springfield today and to have this opportunity to speak with you about the Federal Reserve’s role in promoting steady, non-inflationary economic growth.

For an organization that has traditionally received little notice, the Fed has been in the news quite a lot lately. Over the past year, a few members of Congress have charged that Fed policymakers are not accountable, and have therefore proposed major changes in the structure of the Federal Reserve System. More recently, others have warned the Fed not to raise interest rates, claiming that we have been too pre-occupied with controlling inflation at the expense of promoting economic growth. I would like to take a few minutes this afternoon to discuss how limiting inflation and promoting economic growth are not incompatible objectives, and why, in my view, the proposed restructuring of the Fed would reduce our ability to foster economic growth.

To understand how the Fed can best promote growth, one must understand the behavior of interest rates, particularly long-term interest rates. As we have all observed, long-term interest rates have fallen substantially over the past few years, which has helped stimulate the economy. Because of falling rates, firms can raise funds less expensively to finance new investment. Falling mortgage rates have encouraged new housing demand and construction. Lower consumer rates have enabled households to finance the purchase of a new car. The lower cost of borrowing has even helped to reduce government outlays and hence the deficit.
What accounts for the decline in interest rates? Like anything that is bought and sold in a free market, the price of securities is determined by market forces -- supply and demand. In recent years, investors have been more and more willing to buy securities that offer lower and lower yields. Why is it that investors are now willing to accept a 6-1/2 percent yield on a Treasury bond that in 1990 yielded 9 percent, and that 10 years ago returned as much as 13-1/2 percent? I believe a large part of the answer has to do with inflation and the confidence the public now has in the Federal Reserve’s ability and desire to keep it under control.

If you examine a chart of long-term interest rates and the rate of inflation over time, you will see a close, positive relationship between the two. In the early 1960s, inflation was low, averaging less than 2 percent per year. Interest rates were also low: the yield on 10-year government securities was 4 percent, the prime rate was 4-1/2 percent and home mortgage rates were about 5 percent. Beginning in the late ‘60s, and continuing through the 1970s, inflation rose, and long-term interest rates rose with it. The rate of inflation peaked at 13 percent in 1980, and within a year, the 10-year bond yield was over 15 percent, while the prime rate reached an astounding 20 percent.

The upward spiral of inflation was finally broken in the early ’80s and the stage was set for a long period of sustained growth. But long-term rates remained exceptionally
high. In 1983, for example, the rate of consumer price inflation had fallen to less than 4 percent. Long-term interest rates did not fall nearly as much or as fast, however. In 1983, the 30-year bond yield was still over 10 percent, and in 1984, when there was a whiff of renewed inflation, bond yields jumped back up to over 13 percent.

Why did long-term interest rates not fall with the decline in inflation? One answer, I believe, is that the public was not convinced that the Fed was serious about holding inflation in check. After 15 years of rising rates of inflation, investors had tired of seeing their interest income buy fewer and fewer goods and services and of having their bond holdings decline in value. Inflation had robbed investors of their savings too many times during the '60s and '70s, and the public was understandably wary about the Fed’s willingness to keep inflation down, let alone to reduce it further. Consequently, in the early '80s, investors were unwilling to accept lower returns on their long-term savings, despite low prevailing rates of inflation. It was not until 1986, when the rate of inflation was less than 2 percent, that long-term interest rates fell substantially below 10 percent, and only in the past year that they have fallen below 7 percent. Rates are now at levels not seen since the early 1970s.

My point is that, when investors expect inflation, they demand an extra return on their long-term investments to
compensate for the anticipated decline in their purchasing power over time. The effect of this "inflation premium" on interest rates will be smaller when the public believes that the dollar is likely to remain stable over time, that is, when little or no inflation is expected. Keep inflation down, and long-term interest rates will be low. Of course, interest rates may rise or fall, even if there is no inflation, but rates will be lower in the absence of inflation than they would be if prices are rising.

Another problem with high inflation is that it is often highly variable. When the rate of inflation varies widely from year-to-year, business people and consumers have difficulty planning their investments and expenditures. When inflation is unpredictable, the inflation premium will be higher. Savers will not willingly invest their money without some extra compensation for a possible return of high inflation.

Finally, high and unstable inflation also encourages people to divert resources away from productive investment into inflation hedges and speculative ventures. Overbuilding in commercial real estate, and the speculative frenzy that characterized many metals and commodity markets in the late '70s and early '80s, reflected expectations of continued price increases, not fundamental values. By misallocating productive resources, inflation can thus inhibit real economic growth.
Now, let me talk a bit about how the Federal Reserve fits into the discussion. Although politicians often cajole the Fed to keep interest rates low, the Federal Reserve does not control rates. Monetary policy does play a role, however. By establishing a strong commitment to fight inflation and to maintain a stable price level, the Fed can minimize the inflation premium in interest rates and provide a stable price backdrop to promote sustainable real economic growth.

What does it take to achieve a credible commitment to the goal of price level stability? This is where the structure of the Fed -- and Congressional proposals to change it -- become important. Researchers have found that countries that have achieved the best records in controlling inflation are typically those with independent central banks, such as Germany, Switzerland and the United States. Where the central bank is an arm of the Treasury or is otherwise political, as in England, Italy or Brazil, inflation rates are usually higher. In some countries, the central bank pumps out money to fund government budget deficits. In others, it finances the operations of state-owned enterprises. Russia is a prime example. Many Western economists believe that Russia will not emerge from its economic crisis until it brings inflation under control.

In the United States, we have a central bank with the independence necessary to control inflation. Fed policymakers are able to look beyond the next six months or the next
election. This independence derives from the Fed’s structure, which was carefully crafted by Congress to minimize the influence of short-term political agendas, while preserving the accountability that any policymaking institution must have. Over the years, the Fed has been modified in many ways. Yet the balance between political independence and public accountability has wisely been maintained.

The organization of the Federal Reserve System is unique among American institutions. The Board of Governors is a public body fully accountable to Congress and the American people. Board appointments are made by the President and confirmed by the Senate. The seven board members have a two-vote majority on the Federal Open Market Committee, or FOMC, which is the Fed’s chief monetary policymaking body. At the same time, Board members are appointed for 14-year terms, which gives them some insulation from political pressure.

The 12 Federal Reserve Banks, on the other hand, though subject to the general supervision of the Board of Governors, are similar in structure to private corporations. This enables them to efficiently carry out the System’s operations, while maintaining public accountability through the Board. Moreover, the participation of Reserve Bank presidents on the FOMC, with five presidents voting on policy on a rotating basis, provides a voice for policymakers outside of Washington, D.C. The regional system puts these policymakers, who are appointed by their boards of directors with approval
from the Board of Governors, in direct contact with local individuals and groups. As a result, there is a two-way channel for information about monetary policy and economic conditions at the local level.

The FOMC, as a committee, is also fully accountable to Congress and the American people. Detailed minutes of each FOMC meeting are provided promptly after approval by the Committee, and twice each year the Chairman sets out in Congressional testimony the Committee’s future monetary policy objectives. Each member of the Committee, regardless of how appointed, is equally accountable for his or her individual actions on the Committee.

Congress is now considering proposals that would significantly alter the Fed’s structure. One proposal would dismantle the Federal Open Market Committee and eliminate the regional Reserve Bank presidents’ vote on monetary policy decisions. The Board of Governors alone would determine monetary policy. An alternative proposal would retain the FOMC, but make Reserve Bank presidents appointees of the President with Senate confirmation. A third proposal would have the President appoint the Chairman of the Board of Governors during his first year in office, so that the President can have "his person" running the Fed.

If enacted, any of these proposals would subject monetary policy decisions to greater political pressure, upsetting the delicate balance between accountability and independence. Put
bluntly, those who spend the public's money would have greater control over those who determine the nation's money supply. Each proposal would also lessen regional input in policymaking, either by eliminating it altogether or by making Reserve Bank presidents political appointees.

In my opinion, the Fed should be judged on the performance of monetary policy, which over the last decade has been reasonably good. In the early '80s, it was the Fed that led the attack on inflation, reversing an escalating trend and setting the stage for lower interest rates and economic expansion later in the decade. Since then, monetary policy has gradually reduced inflation over a long period of moderate economic growth and established the credibility that helped bring long-term interest rates down to their lowest levels in 20 years. Today, while Japan and most of Europe are mired in recession, our economy is growing at a good clip and inflation has thus far remained subdued.

Our experience over the past three decades, as well as the experiences of many other countries, has shown that sustainable economic growth cannot be purchased with higher inflation. Indeed, the evidence shows just the reverse -- that over time, higher rates of inflation are associated with higher interest rates and, often, slower economic growth. We have also seen that central banks are best able to control inflation when they are somewhat insulated from politics.
It is because of its independent structure that the Fed is able to control inflation and provide the stable price backdrop necessary to promote economic growth. We should thus be wary of proposals that, in the name of accountability, increase the political pressures on the Fed. The result, by hampering the Fed’s ability to achieve the best monetary policy for the nation’s economy, could well be higher inflation, higher interest rates and reduced economic growth.