

**EMBARGOED UNTIL 9 a.m. EDT
Saturday, April 9, 1994**

HOW THE FED PROMOTES ECONOMIC GROWTH

**Remarks by
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**International Association of Financial Planners Annual Meeting
Kentucky and Southern Indiana Chapter
Louisville, Kentucky**

April 9, 1994

I am pleased to be in Louisville 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, members of Congress have charged that Fed policymakers are not accountable and have followed up this criticism with some major proposed 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 preoccupied with controlling inflation at the expense of promoting economic growth. I would like to take a few minutes this morning 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 sustainable economic growth.

To understand how the Fed can best promote growth, one must understand the relationship between interest rates, particularly long-term interest rates, and inflation. Interest rates have risen in recent weeks, after a long period of steady decline. Rising rates are a normal part of the business cycle: as the economy grows, credit demand increases and interest rates are bid up. Interest rates are also very sensitive to news about inflation or, for that matter, any other threat to economic stability. One should not read too much into day-to-day volatility of interest rates, but

interest rate trends do tell us a lot about how savers and investors view the economy's prospects.

Stepping back from events of recent weeks, we see that the trend over the past few years has been for interest rates to fall. This decline has helped to stimulate the economy. Because of falling rates, firms have been able to 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 declining trend in interest rates in the late '80s and early '90s? Supply and demand. Like anything that is bought and sold in a free market, securities are sold at a price that is determined by market forces. 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 7-1/4 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 has in the Federal Reserve's desire and ability 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 '70s, 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, however, did not fall nearly as much or as fast. 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 inflation, savers had tired of seeing their interest income buy fewer and fewer goods and services and of having their holdings decline in value. Anyone with a savings account or other investments knows how inflation eats away at their savings. To illustrate, consider an investor who had purchased corporate shares for \$10,000 in 1970. Inflation

caused the U.S. price level to more than double during the '70s. Consequently, if this investor had sold his shares for \$21,000 in 1980, he would have just broken even with inflation, despite having a nominal profit of \$11,000. If we account for the fact that income tax is paid on capital gains, then this investor would actually have experienced a negative real return over the life of his investment.

By the '80s, the public was understandably wary of the Fed's willingness to keep inflation down, let alone to reduce it further, because rising inflation had robbed investors of their savings too many times during the '60s and '70s. 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 finally fell substantially below 10 percent, and only in 1993 that they fell below 7 percent.

In 1993 the rate of inflation was approximately 3 percent. Even at this seemingly low rate, an alarming amount of the value of a long-term investment is eaten away over time. If the annual inflation rate remains at 3 percent, for example, 10 years from now you will need over \$13,400 to purchase what \$10,000 does today. Clearly someone with a fixed income, like many retirees, can be greatly harmed by even a low rate of inflation. And unless your investments return an annual after-tax yield of at least the inflation rate, your savings will buy less in time than they do today,

even if all of the income is reinvested. Little wonder that long-term investors pay close attention to news about inflation.

My point is that, when investors expect even a low rate of 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 will remain stable over time, that is, when little or no inflation is expected.

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. In these circumstances, the inflation premium will be higher. Savers will not willingly invest their money without some extra compensation for a possible return of high inflation. Keep inflation down, and long-term interest rates will be low. Of course, interest rates may rise or fall even when there is no inflation, but rates will be lower in the absence of inflation than they would be if prices are rising.

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, high land values, 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.

Inflation also promotes borrowing and consumption, because a rising price level means that debts will be repaid with dollars that buy less in the future than they do today. For many years, consumer interest payments were deductible from your taxable income, which made borrowing more attractive when inflation was high. Interest payments remain deductible today for businesses, as does mortgage interest for homeowners. Inflation contributes to a bias toward debt finance, and high leverage has left many U.S. firms and households excessively vulnerable to bankruptcy. By misallocating productive resources and encouraging excessive debt, inflation can thus inhibit real economic growth.

Now, let me talk a bit about how the Federal Reserve fits into the discussion. Politicians often cajole the Fed to keep interest rates low or claim that the Fed is too worried about inflation and not worried enough about growth and employment. Such statements reflect two fundamental misunderstandings: First, that the Fed controls interest rates; and second, that the Fed can set its policy dials so as to buy faster growth and higher employment at the expense of higher inflation. Neither is accurate.

Federal Reserve actions do influence interest rates, but the Fed cannot control interest rates for very long periods of time. One might think that the Fed could push interest rates down as low as it wanted simply by increasing the amount of

money it supplies to the economy. However, the consequence of such a policy would be to generate inflation--more and more money chasing a fixed amount of goods and services, thereby causing prices to rise. After a time, the effort to lower interest rates would backfire and actually produce higher interest rates. The public would recognize that the Fed was pursuing an inflationary policy and demand higher nominal interest rates to compensate for higher inflation. The role monetary policy can best play is to establish a strong commitment to fight inflation and to maintain a stable price level, because in doing so the Fed can minimize the inflation premium in interest rates.

This leads me to my second point--that attempts to exploit a tradeoff between economic growth or employment and inflation will inevitably be futile. The gains in production or employment that may come from adopting a highly stimulative monetary policy tend to be short-lived, while the increased inflation it generates lasts much longer and ultimately requires painful measures to restrain it. Eventually, excessive monetary stimulus generates only inflation, not gains in employment or production, even in the short run. Thus, from a policymaker's point of view, the perceived inflation-employment tradeoff is a mirage. Only when monetary policy is oriented toward controlling inflation will it provide a stable price backdrop and 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 succeed in restructuring itself until it brings inflation under control.

In the United States, we currently 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, staggered 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 sector enterprises. 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 conduit 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. In addition, twice each year the Chairman sets out in Congressional testimony the Committee's future monetary policy objectives, as well as information on the recent conduct of policy. Each member of the FOMC, 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 he 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, increasing the potential for higher inflation. 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 short-term 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.