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HOW CAN THE FED INFLUENCE INTEREST RATES AND SUSTAIN GROWTH?

**Remarks by
Thomas C. Melzer
President, Federal Reserve Bank of St. Louis**

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I am pleased to be here today and welcome the opportunity to discuss an often widely misunderstood topic--the Federal Reserve's monetary policy. The Fed is often portrayed as Scrooge--raising interest rates, slowing the economy, fighting an imaginary inflation. The Fed at times is even viewed as "anti-growth," and its actions especially harmful to those sectors, like homebuilding, that are interest-sensitive.

This characterization pains me. I can tell you definitively that, as a Fed official, I do not like high interest rates, and I certainly am not "anti-growth." Quite the contrary, I seek a monetary policy that fosters the maximum sustainable rate of growth for our economy. Sustainable growth cannot, however, be achieved by manipulating interest rates in an attempt to rev up the economy. Rather, the Fed can best promote low long-term interest rates and sustainable economic growth by pursuing a credible monetary policy designed to achieve stability in prices over time.

I will focus my remarks today on three key points: First, I will discuss what factors determine economic growth and how the Fed plays a role; next, I'll turn to how inflation can impede growth; finally, I'll discuss the benefits of a credible anti-inflation monetary policy.

Let me get into my first point about determinants of growth by mentioning that I have spoken with homebuilders on a number of occasions, and I understand the crucial sensitivity of your business to interest rates. I was not a

Fed official at the time, but can imagine how harmful the high interest rates of the early '80s must have been for the construction industry. As one who now helps determine the nation's monetary policy, I want to avoid the circumstances that can lead to such extremes in interest rates.

The way I see it, there are two fundamental determinants of output growth in any industry: resources, such as labor and capital, and productivity growth, that is, improvement in the efficiency with which resources are used to produce goods and services. The Fed is often called upon to stimulate the economy, but except for brief and unpredictable periods, monetary policy has little, if any, direct effect on economic growth. Fundamentally, the production of real goods and services is determined by real factors, such as employment and investment in plant and equipment.

Homebuilders often tell me that the region's employment growth is perhaps the most important influence on the demand for new construction over time. But the Fed cannot raise employment, find new resources or devise ways to increase productivity. Indeed, over time, the Fed doesn't even have much control over the level of interest rates.

The Fed can affect growth indirectly, however, through the impact of its policy actions on the price level. If monetary policy causes excessive fluctuations in the price level--inflation or deflation--it can hinder the working of a market economy and interfere with the allocation of resources to their most productive uses. A monetary policy that limits

such fluctuations can contribute to achieving maximum economic growth over the long haul.

Monetary policy actions are often discussed in terms of interest rate movements. The power attributed to the Fed over the level of interest rates, however, reflects a widespread misunderstanding over what the Fed can and cannot do. Monetary policy is carried out through Federal Reserve purchase and sale of government securities, the so-called open market operations. These operations affect the volume of reserves that commercial banks have available to make loans and other investments and, ultimately, that determine the nation's money supply. Now, undoubtedly these operations do affect various interest rates, especially short-term interest rates such as the federal funds rate, which is the interest rate that banks charge one another for overnight loans of reserves. But all interest rates are determined by market forces--supply and demand--and the Fed has relatively little direct influence, especially on long-term interest rates such as those for Treasury bonds or mortgages.

One might think that the Fed could push interest rates as low as it wanted simply by increasing the amount of money it supplies to the economy. The consequence of such a policy, however, would be to generate inflation--excessive money growth causing prices to rise. After a time, the effort to lower interest rates would backfire and end up producing higher interest rates instead. Sooner or later, the public would recognize that the Fed was pursuing an inflationary

policy and demand higher nominal interest rates to compensate for higher inflation. In this way, inflation is like a tax that, among other things, erodes the purchasing power of those who save or invest.

The principal way that monetary policy can hold down long-term interest rates is thus by holding down expectations of future inflation. A policy that is strongly committed to maintaining stability of the price level over time will minimize expected inflation and therefore produce lower long-term interest rates than otherwise. Keep inflation down, and long-term interest rates will be low. Of course, interest rates will always rise and fall to some extent--even when there is no inflation--but rates will be lower in the absence of inflation than they would be if prices are rising.

My second point is that inflation can impede growth. First, inflation can hinder economic performance by causing interest rates to be high. Another problem with high inflation is that it tends to be quite variable from one year to the next. When the rate of inflation varies widely from year-to-year, business people and consumers have difficulty planning their investments and expenditures because inflation camouflages the signals given by changes in relative prices. A construction firm that experiences an increase in the price of lumber, for example, will be unsure how much of the increase reflects factors unique to its own market as opposed to a general inflation. The implications of the two possibilities for the firm may be very different. An

inability to distinguish changes in relative prices from changes in the general price level will likely lead to inefficient resource allocation, and hence to lower growth.

High and unstable inflation also encourages people to divert resources away from productive investment into inflation hedges and speculative ventures. The overbuilding in commercial real estate and the speculative frenzy that characterized many metals and commodity markets in the late '70s and early '80s, for example, 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. Though more limited now, for many years consumer interest payments were deductible from taxable income, which made borrowing more attractive when inflation was high. Meanwhile, savers were taxed on their nominal income, not their inflation-adjusted income. It was not uncommon in the '70s for savers to lose wealth on their financial investments in real terms, despite having a nominal gain and an income tax liability. Not surprisingly, people expend considerable resources trying to forecast inflation and find inflation hedges. In the absence of inflation, these resources could be allocated to more productive uses.

This brings me to my third main point. We have seen how inflation can hinder economic performance. A credible commitment by monetary policymakers to low inflation, on the

other hand, can reap many benefits. If the public believes that the Fed will maintain price stability, the inflation premium in interest rates and the allocation of resources toward inflation hedges will be minimized, and the meaning of individual price and wage signals will be clearer.

Let me give you a few examples of the value of a credible anti-inflation policy. Last year the United States and Argentina had similar rates of inflation--about 3 percent in the U.S. and 3.5 percent in Argentina. Why was it then that investors were willing to buy U.S. government securities yielding 8 percent, but required a return of 16 percent on Argentinean government securities? Some of the difference in yields might be explained by political risk, or simply the difficulty of obtaining information about securities in Argentina, but surely one reason has to do with inflation. Even though inflation is now roughly the same in both countries, our histories with inflation are very different. For many years, Argentina had high inflation, which penalized those who saved. Compared to Argentina, inflation has been relatively low over time in the U.S., and hence the public has more confidence in the future value of the dollar than it has in the Argentinean peso. Simply put, interest rates are lower in the United States in part because our central bank has more credibility at controlling inflation.

Let's look at a few more countries. Among the industrial countries, the differences in government bond yields are less stark. Still, during 1994 long-term government bond yields in

G-10 countries ranged from a bit over 3 percent in Japan to nearly 9 percent in Italy. More often than not, countries that have had a history of relatively high inflation, such as Italy, have higher long-term interest rates than historically low inflation countries, like Japan. This relationship holds true even for countries with similar current rates of inflation. I interpret these numbers as saying that the more successful a country has been at controlling inflation in the past, the lower long-term interest rates will be today, irrespective of the current year's inflation. Credibility takes time to build, but we see that it does produce real benefits in terms of lower long-term interest rates.

Now, let me turn to the recent behavior of long-term interest rates in this country. Remember that the Federal Reserve affects the volume of bank reserves and the money supply. Fed actions have little direct influence on interest rates, which are determined by supply and demand. Long-term interest rates rose over the past year, especially during the first half. Several factors may have contributed to this increase, but I believe that one reason was the expectation of rising inflation.

From 1991 to 1993, the Fed pursued an aggressively stimulative monetary policy. Bank reserves and M1 grew very rapidly. At the same time, proposals were floating in Congress to limit the Fed's independence from politics. Because inflation results primarily from excessive money supply growth, and because it tends to be higher in countries

where the central bank is more directly under the control of politicians, I believe that doubts were raised in the public's mind about the Fed's commitment to controlling inflation. Although interest rates tended to fall during this period, much of the decline was in short-term rates.

As the Fed began to tighten policy in early 1994, long-term interest rates increased by about as much as short rates. By mid-year this pattern had largely ended, however, and further increases in short-term interest rates were not matched by increases in long rates. In fact, when short-term rates increased by 75 basis points in November, long-term rates actually fell.

The experience of 1994 demonstrates how fragile credibility can be. It also shows, however, that increasing public confidence in the willingness of monetary policymakers to hold the line on inflation can help reduce long-term interest rates. That is, by establishing a credible anti-inflation policy, policymakers can lessen the inflation premium and encourage long-term investment. Such a policy also limits confusion over the meaning of individual price changes and minimizes the unproductive use of resources in the search for inflation hedges.

To conclude, let me restate the question posed in the title of my talk: "How can the Fed influence interest rates and sustain economic growth?"

Some would have us adopt highly stimulative monetary policies to push interest rates lower and speed up the

economy. Inflation is not a problem right now, these people say, so let's lower interest rates to propel growth. We can always reverse our policy later if inflation accelerates.

We have seen, however, that such a prescription for monetary policy is short-sighted and would risk worsening economic performance. I think that none of us wants a monetary policy that reacts excessively to the latest economic news, or one that pushes down hard on the gas to rev up the economy one year, then slams on the brakes the next. Such a policy puts too great a burden on the marketplace and causes the public to waste time and resources trying to figure out how policy will affect them and their businesses.

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 production or employment. Our own experience, as well as that of other countries, has taught us that monetary policy can best promote low long-term interest rates and sustainable economic growth only when it is oriented toward controlling inflation.

Price stability and sustainable growth are thus not incompatible. In fact, one requires the other. A monetary policy that is strongly committed to price stability is a pro-growth policy. The answer to the question of how the Fed can influence interest rates and sustain growth, therefore, is by

adopting a policy of price stability. That's what the historical record supports and what I believe is the appropriate goal of a pro-growth monetary policy.