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**Should The Fed “Go For Growth?”**

**Remarks by**  
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Last June, a major paper in our region ran an editorial urging the Fed to stop worrying about inflation and to “go for growth.” The editorial argued that—at an annual rate of approximately 3 percent—inflation is simply too low to be a significant concern. The Fed should cut interest rates now to encourage the economy to grow more rapidly, the writer urged.

We often hear such arguments—that the Fed is worried about the economy “overheating,” or growing “too fast.” Let me begin by saying for the record that the Fed is *not* against economic growth or low interest rates. It is my view—and I believe it is the view of other Fed officials—that monetary policy should seek to promote the maximum sustainable rate of economic growth. My message today will focus on the currently popular fallacy that monetary policy must shift its focus away from controlling inflation in order to promote economic growth. Nothing could be further from the truth. In fact, I will argue that when the central bank protects the value of our nation’s money, it is, indeed, pursuing a pro-growth policy.

### **What Determines Growth**

Let me begin by discussing what generates economic growth and how monetary policy fits in. Economic growth has just two determinants: resources and productivity. Put more resources to work, or work a given stock of resources more productively, and output rises. Because government policy can affect resource supplies and productivity, it can affect the growth of national output. Child labor laws, for example, limit the size of the labor force. Emission regulations, in some cases, make power plants less productive. While there may be good reasons to have such policies, they illustrate how government policies can affect economic growth.

What about monetary policy? Monetary policy comes into play through the working of markets. Economic growth involves the allocation of resources to productive outlets--coal and iron ore to steel plants, labor to automobile factories, lumber and other materials to construction of homes and businesses--and this allocation of resources takes place in markets. Without a medium of exchange--in other words, money--markets would virtually cease to operate. Money allows markets to allocate economic resources over space and time.

In a market economy, exchange value is expressed in terms of prices--which, in turn, are determined by the forces of supply and demand. For example, gasoline prices usually rise around Memorial Day because that is the start of the summer driving season, when the public demands more gasoline from suppliers. Recognizing the increased demand, suppliers tend to refine more gasoline--increasing supply--and prices may fall back, as they did this past summer. Suppliers shift resources in response to changes in relative prices, and productive allocation of resources requires clear signals from the price system.

That's where monetary policy comes into the equation. Monetary policy can enhance the clarity of price signals--or it can muddy the waters. If it clouds the signals from the price system, it creates a drag on economic performance. If it causes sharp fluctuations in the value of money, it makes resource allocation more difficult. Let's look at one example: Petroleum refiners who are uncertain about whether a price increase is caused by increased demand for *their product*--as opposed to a general increase in consumer prices--won't know whether they should devote more resources to refining or leave production at the existing level. On the other hand, if they are

confident that the consumer price level will remain stable, they can be more certain that individual price changes reflect true shifts in demand. Throughout the economy, farmers, home builders, retailers, even bankers must make these kinds of calculations. Obviously, then, a monetary policy that maintains stability of the price level can help markets work efficiently. This, in turn, promotes the full employment of resources at their most productive uses.

Let me give some other examples that may strike closer to home for most of us. If monetary policy allows people to expect that a dollar will hold its value over time, they will be much more willing to save and invest. Interest rates will be lower, thereby reducing the cost of financing an inventory of automobiles, of building a home, or of borrowing to meet a college tuition bill. If the public can count on the Fed to defend the value of the dollar, they can make better informed decisions about where to invest or how to spend their money. This is a monetary policy that promotes productive employment of resources and thus promotes maximum economic growth.

The macroeconomic evidence also suggests that stable money promotes financial and economic development, maximum growth, and prosperity. Which economies have been the perennial strong performers in recent decades? Those coming to mind most often--Japan, Germany, the US--have some of the lowest inflation rates among economically developed nations. It is true that some countries have experienced rapid growth, even with high inflation, but their prosperity has tended to be short-lived. Over the long haul, history has shown that sustainable economic growth simply isn't possible in countries with persistently high inflation.

To sum up, monetary stimulus cannot boost the rate at which real output or employment can grow over the long-term. Inflation, however, can certainly impede growth. Economists have found that inflation is higher in countries with more rapidly growing money supplies. In other words, overly expansionary monetary policy does not generate real economic growth, only inflation.

### **Why the Role of Monetary Policy is Confused**

If maintaining a stable price level promotes economic growth, why do we hear that monetary policy is today “too tight”—that it is holding down real growth? I believe the answer is that we sometimes expect more from monetary policy than it can deliver. We tend to confuse short-term fluctuations in output with long-term growth. There is evidence that monetary policy can affect the level of output or employment for short periods—say a few quarters or even a year or two. Extremely contractionary monetary policy was an important contributor to the Great Depression, for example. Similarly, by giving a boost to spending, expansionary monetary policy might temporarily raise the level of economic activity at a time when resources are not being fully exploited.

The confusion comes about because monetary policy affects aggregate spending, and, under the right conditions, a boost in spending can temporarily increase output. If there is substantial slack in the economy—if resources are under-employed—then increased spending can raise the level of output. However, both the level and the growth rate of output are limited by the supply of resources and the level of productivity. If resources are fully employed, then output cannot increase without a corresponding increase in productivity. At full employment, increased spending will generate higher prices but no increase in output.

Consider a simple example. Suppose a retailer suddenly experiences more traffic in her store—more customers are buying whatever she has to sell. The retailer may call her supplier and request an increased shipment of goods. If the supplier has been operating at substantially less than capacity, he may be glad for the extra business and willingly supply the additional goods at the usual price. Thus, increased demand stimulates increased output. If, on the other hand, he is already operating close to capacity, the supplier may demand a higher price from the retailer, or he may simply refuse to ship any more goods. The retailer, in turn, may determine that her best course of action is to raise her own prices, and expect to sell about the same quantity as before. In this case, increased demand leads to higher prices.

If we extend this example to the economy as a whole, we can readily see that, under some circumstances, increased demand can generate increased output and sales, with little change in prices. Under other conditions, however, increased demand causes inflation, with little or no boost in output.

What does all of this imply about how to conduct monetary policy? Because monetary policy has the potential to boost output in the short run, some may be tempted to push for faster and faster growth by stepping on the monetary accelerator. Output may indeed go up for a time, but eventually inflation will be the only outcome of our experiment. Because economic growth is limited by the supply of real resources and the level of productivity, printing money simply can't boost the rate at which the economy will grow on a sustained basis.

I'm afraid the Fed—and many other central banks around the world—got into this trap in the 1960s and 1970s. Beginning in the early '60s, the Fed sought to encourage

a higher level of economic activity by keeping interest rates artificially low. For a time, output rose, while inflation stayed low. The money supply, however, began to grow at an accelerating rate, and by 1965 inflation had begun to rise. In response, the Fed tapped on the brake, causing the money supply growth rate to drop sharply and the inflation rate to dip. But, tight money also reduced the flow of credit to the housing market, so the Fed responded by releasing the brake and pushing down on the accelerator once more. As a result, the money supply expanded sharply and inflation accelerated.

This stop-and-go cycle was repeated once again toward the end of the '60s and became a well-entrenched pattern in the '70s. The economy lurched from recession to recession, and each recession was followed by an expansion with a higher rate of inflation than the previous one. For the 1970s as a whole, average inflation was significantly higher than in any previous decade this century, except for the periods surrounding the two world wars. Meanwhile, the average growth of real output was lower in the '70s than in either the 1950s or 1960s, when inflation was much lower.

My point is *not* that high inflation necessarily caused the real growth rate to fall. I simply want to point out that there is *no evidence* that the Fed's efforts to stimulate real growth in the 1960s and '70s did anything but raise the rate of inflation. Simply put, printing money does not increase the rate at which the economy can grow.

### **The Consequences of an Uncertain Monetary Policy**

The policy failures of the 1970s came from a mistaken notion that if monetary policy can boost the level of economic activity in the short run, it can be used to generate sustainable output growth over time. Unfortunately, the view that monetary policy could "fine-tune" economic activity turned out to be a mirage. Moreover, an erratic monetary

policy—one that steps on the gas today only to brake tomorrow—can put a permanent drag on the economy by interfering with the signals coming from price changes.

Let me now pursue the idea that an erratic, or uncertain, monetary policy can be an economic drag. As we know, monetary policymaking attracts a lot of attention. Each time the Fed's Open Market Committee meets in Washington speculation abounds about whether the Fed will adjust its policy to "raise rates," "lower rates," or leave them unchanged. Similarly, when Chairman Greenspan, or any other Fed official, testifies before Congress or makes a speech, the financial press hangs on every word in the hope of receiving a signal about the future course of policy. This behavior reflects uncertainty about the course of monetary policy, and this uncertainty has real economic costs.

Uncertainty about the course of monetary policy clearly increases the volatility of financial markets: witness the gyrations in the stock and bond markets last July when guesses about near term monetary policy moves abruptly changed. The FOMC met on July 2nd and 3rd, and made no explicit change in its policy. As a result, the so-called Fed watchers in the press claimed that the Fed was unlikely to move any time soon. Two days later, on July 5, a report of unexpectedly strong employment growth during June prompted a number of market watchers to forecast an imminent tightening of monetary policy. The bond and stock markets tumbled, with the Dow Jones Industrial Average falling nearly 115 points and the yield on 30-year government bonds rising one-quarter point in just one day. If we believe the news accounts, this market skid was caused by speculation about monetary policy--indeed by speculation that turned out to be wrong.



I don't know how much of this decline could have been avoided if the Fed had a clear policy mandate. Perhaps none of it. But I am convinced that uncertainty about the Fed's monetary policy goals and methods produces greater volatility in markets than would otherwise occur.

Uncertainty about monetary policy also leads to increased use of economic resources to forecast policy, or to hedge against its effects. Some of the increased activity in options and futures markets over the last 20 years, for example, can be attributed to people's desire to hedge against unexpected monetary policy and inflation. Finally, as I have already stressed, an unfocused or uncertain monetary policy causes uncertainty about the nature of price changes in all markets, and such confusion interferes with their efficient operation. If we make monetary policy transparent, our market economy can operate more efficiently.

### **Reducing Uncertainty about Monetary Policy**

Let me finally turn to how we might work to minimize the sources of uncertainty. Currently, the Fed does not have a clear, achievable policy mandate. Legislation requires the Fed to pursue full employment and maximum real growth, as well as a stable price level. The public tends to think that the Fed can raise the level of employment or economic growth by lowering interest rates. However, such a policy is also thought to increase the rate of inflation. This way of approaching policy sets up an apparent trade-off between faster growth and lower inflation. As a consequence, the public is never quite sure which goal the Fed is going to pay more attention to--promoting faster growth or holding down the rate of inflation. People who tend to think the Fed is overly concerned with inflation believe that the Fed is not doing enough to

boost the levels of employment and output. In any event, there's always uncertainty about which goal the Fed will pursue at any given moment.

We could eliminate a lot of this uncertainty if the Fed were given a mandate that recognized what monetary policy can do, and what it cannot do. In my view, monetary policy can reliably affect only the price level, so I favor a mandate that requires the Fed to pursue price stability. This does not mean that I'm unconcerned about employment or economic growth. Quite the contrary. But we need to recognize that printing money in the hope of pushing down interest rates and stimulating growth cannot work—at least not for long. The more money we put into the economy, the faster that money will decline in value. Moreover, as people become accustomed to expecting that money will not hold its value, they become less willing to save, and investors eventually demand higher interest rates to compensate for the declining purchasing power of money. This is a crucial point: When monetary policymakers attempt to *lower* market interest rates by pushing too much new money into the economy, the resulting inflation can actually cause interest rates to *rise*. Because the central bank cannot increase output or employment, inflation will be the only outcome of such a policy.

So, if monetary policy has little or no direct role in increasing output or employment, what, exactly, is its role? In my view, the primary role of monetary policy is to preserve the value of money. A clear mandate to the Fed to preserve the purchasing power of the dollar would eliminate much of the current uncertainty about policy and provide a stable price backdrop for the efficient operation of our market economy. This is the best way to promote maximum employment and economic growth.

It is important to emphasize that price stability is a *long-run* objective. The price level will inevitably move up and down from month to month, even from year to year, as the movement of individual prices pushes the average price level around. There is nothing that monetary policy can do to prevent price fluctuations, but sustained price-level changes are caused by monetary policy. Excessive growth of the money supply inevitably leads to inflation, and inadequate growth leads to deflation. Price stability is an achievable goal of monetary policy only over a fairly long horizon.

Another source of uncertainty about the course of monetary policy stems from the Fed's fragile political independence. I believe that much of the talk about reducing the Fed's independence stems more from frustration over the apparent lack of focus of monetary policy than from concern about the Fed's recent performance or the accountability of individuals. The Fed should be held accountable as an institution for what it can, and should, achieve: namely, average price stability over time. Make the Fed's mandate explicit and achievable, and accountability will be clear.

Independence from political pressures is a very important contributor to a central bank's ability to achieve low inflation. Looking across countries, scholars have found that the more independent the central bank, the lower a nation's inflation rate is likely to be. Inflation tends to be higher where the central bank is an arm of the treasury, or otherwise under the direct control of politicians. Speaking bluntly, central bank independence ensures that the policymakers charged with maintaining the stability of the nation's money supply are not the same people who spend the taxpayer's money. Pressure to finance the government by printing money--in essence to hold the yields on government debt artificially low--has been a source of inflation in many countries. Limit

such pressure, and a country will have a better chance at achieving price stability. There has never been a case of hyperinflation except when massive amounts of money have been printed to finance government expenditures. And hyperinflation has never been stopped except when the money supply growth rate has been made independent of government finance.

### Conclusion

I've covered a lot of ground in this talk, so let me take a moment to sum up by ticking off some key points:

- First of all, I've tried to dispel the notion that the Fed is unconcerned with economic growth. On the contrary, maximum sustainable economic growth should be, and *is*, the ultimate goal of monetary policy.
- Monetary stimulus cannot boost output or employment over the long haul, however. Inflation is the *only* permanent outcome of an increase in money supply growth.
- But, monetary policy *can* help to create a climate for economic growth by preserving stability of the price level.
- An environment of price *level* stability ensures that the signals coming from changes in the relative prices of individual goods and services are clear. Such clarity promotes the efficient operation of our market economy.
- If the Fed had a clear mandate to achieve price stability over time, much of the uncertainty about the course of monetary policy, and consequently about the meaning of individual price changes, would be removed.

- At the same time, by giving the Fed a mandate to achieve price stability, we would enhance the System's accountability without compromising its political independence.

So, should the Fed go for growth? The answer, of course, is "yes." Should the Fed, therefore, stop worrying about inflation? The answer to that question, in my view, is definitely "no." The Federal Reserve has no more important task than preserving the value of our nation's money. In doing so, we are laying the groundwork for maximum sustainable economic growth.

Thank you.