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Statement by
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President and CEO
Federal Reserve Bank of St. Louis

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As I am sure all of you know, Friday, January 30, will be my last day as president of the Federal Reserve Bank of St. Louis. It is customary for our staff, when they leave the Fed, to have an exit interview with our personnel department to discuss their job experiences. Today, in response to several requests, I am having my "exit interview" with you. I have prepared a short statement outlining my views, based on 12 years of experience, of the Federal Reserve System's role in our economy.

The Fed has responsibilities in three areas – monetary policy, the supervision and regulation of banks and bank holding companies, and the payments system. To properly carry out its mission of promoting economic growth and maintaining financial stability, the Fed, in my view, should be substantively involved in all of these areas. For example, in supervising banks and in providing various payments services to them, the Fed obtains insights into the condition of the financial system that could prove invaluable in the event of a crisis, if not in the day-to-day conduct of monetary policy. Should a lender-of-last-resort response be called for, the Fed must be in a position to monitor the condition of financial intermediaries and to ensure that the payments system continues to function.

The Federal Reserve recently issued the final report and recommendations of its Committee on the Federal Reserve in the Payments Mechanism, a committee chaired by Governor Rivlin of which I was a member. In concluding that the Federal Reserve should remain a provider of payments services, and also play an active role in the evolution of new payments instruments, the committee recognized that close Fed involvement in the operation and development of the payments system helps ensure the system's integrity and efficiency, and that payments services are widely available.

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While the day-to-day business of supervising banks and providing payments services to them are important for maintaining the integrity of the payments system, monetary policy, on a very fundamental level, is also crucial for preserving financial stability. Historically, financial crises have been associated with major cycles of inflation followed by disinflation. In the 1980s, for example, thousands of banks and thrifts failed in the disinflationary wake that followed the high inflation of the 1970s. Sudden shifts in relative prices – especially energy and real estate prices – were the driving force behind both the boom and the bust. But, by obscuring fundamental values, inflation had encouraged the speculative excesses that disinflation revealed. At the same time, inflation caused interest rates to rise. Rising interest rates interacted with the regulatory system to cause disintermediation and a general weakening of the condition of banks and thrifts. In their weakened state, financial intermediaries were unable to weather disinflation and, especially, the collapse of energy and real estate prices. Thus, while sudden shifts in relative prices were principally responsible for the occurrence of financial distress in the 1980s, inflation made the disruption worse than it had to be. I believe that a different monetary policy – one that had preserved stability of the price level – would have better served the country by withholding the inflationary fuel that only made the financial conflagration worse.

Monetary policy, in my view, should focus on ensuring long-run stability of the price level. Not only would price stability promote financial stability, but it also would provide the stable price backdrop that is required for the economy to achieve its maximum sustainable rate of growth and high employment. Monetary policy simply cannot create

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jobs or cause growth to outpace the limits of physical capacity – and attempts to use monetary policy in this way cause only inflation. We must disabuse ourselves of the notion that there exists an exploitable tradeoff between inflation and employment or economic growth. Price stability and growth are not incompatible. Rather, if the public can confidently expect that the value of money will be stable, then our market economy will operate more efficiently, interest rates will be lower, and we will stand the best chance of achieving maximum growth.

How can monetary policy ensure a stable price level? In the short-run, it cannot. From time-to-time, various shocks, such as fluctuations in the price of imported goods, will cause the price level to rise or fall. Sustained inflation, however, is always the product of monetary policy – specifically an excessive rate of increase in the quantity of money. Central banks, including the Fed, often implement policy by manipulating interest rates. However, it is important not to lose sight of the growth of monetary aggregates, since ultimately it is money, not interest rates, that reflects the stance of policy and determines the rate of inflation.

For this reason, I believe that central banks should maintain the flexibility to control the growth of monetary aggregates in the event that circumstances warrant such action. I recently submitted a public comment opposing a proposal under consideration by the Board of Governors that the Fed return to a system of lagged reserve accounting. My principal concern is that this proposal could, under certain circumstances, hamper the Fed's ability to control monetary and reserve aggregates and thus, ultimately, inflation.

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Finally, let me say a word about the Fed's unique structure. I believe that this structure has served the System and the nation well. The public/private nature of the Federal Reserve is the hallmark of an institution that was "reinvented" from the outset. It has the capacity to operate efficiently and to stay in touch with the public at a grass roots level.

My experience has been that the private-sector input we receive from our boards of directors brings to the Fed real discipline in terms of controlling expenses, operating efficiency, and strategic planning. Furthermore, director's insights on current economic conditions, combined with other anecdotal information gained through a Reserve Bank's visible and active regional presence, enhance the monetary policymaking process. Finally, the participation of Reserve Bank presidents in monetary policymaking brings to the table different perspectives supported by independent research and helps to insulate policy from direct political pressures. With such pressures limited, I believe, we get better policy.

We sometimes hear arguments, however, that the Fed is not accountable for its policies. An open, accountable government is certainly very important. The way to make monetary policy more accountable, in my view, is not by interfering with the deliberative process or by placing the Fed under more direct political control, but rather by establishing a clear, achievable mandate for monetary policy. That mandate should recognize what monetary policy can do, and what it cannot do. Specifically, I favor establishing price stability, defined as reasonable stability of a widely recognized and transparent measure of consumer prices over a multi-year horizon, as the mandate for monetary policy. The Fed would be judged on its success or failure at achieving this goal, and accountability

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would be properly placed on the outcome of policy where it belongs. If price stability were made the paramount goal of monetary policy, accountability would be achieved and, at the same time, the nation would have a monetary policy that best promoted stability in the financial and payments systems, and the maximum sustainable rate of growth for our economy.

I have enjoyed immensely my 12 years with the Fed. I am proud to have been a part of many initiatives to enhance the integrity of our nation's payments system and to sustain its economic well-being. I look forward to the challenges that lie ahead. Thank you.

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