

Great Monetary Myths

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Why “Great Monetary Myths”? Why not “Great Monetary Truths”? I will certainly be discussing some great truths in the process of discussing great myths. My motivation, though, is this: In any important area of public policy, mistakes are often driven by public misunderstanding of the issues. We live in a vigorous democracy, and at the end of the day, at least in the long run, the Federal Reserve will pursue policies the voters want. As most of you know, the U.S. President appoints, and the Senate confirms, members of the Board of Governors of the Federal Reserve System. The U.S. Congress can amend the Federal Reserve Act at any time. If the public “knows” things that aren’t true, this misinformation will ultimately work its way through our democratic government and damage monetary policy.

Before proceeding, I want to emphasize that the views I express here are mine and do not necessarily reflect official positions of the Federal Reserve System. I thank my colleagues at the Federal Reserve Bank of St. Louis for their comments, but retain full responsibility for errors.

I will discuss four important monetary myths. These are, first, that tight monetary policy increases unemployment. Second, that tight monetary policy raises interest rates. Third, that higher interest rates depress the economy. And fourth, that monetary policy decisions—the Federal Reserve’s actions meeting by meeting—are fundamentally political. In discussing these myths, I’ll rely on economic information that I hope convinces you that these claims are, in fact, mistaken.

MYTH ONE: TIGHT MONETARY POLICY INCREASES UNEMPLOYMENT

The financial press likes to refer to Fed officials as either “inflation hawks” or “inflation doves.” The hawks are assumed to be insensitive to unemployment issues, whereas the doves show true compassion for the unemployed or potentially unemployed.

As an inflation hawk who believes firmly that sustained low inflation is employment-friendly, I find this myth particularly troublesome. I think the myth has two origins. First, economist A.W. Phillips, writing in the late 1950s, proposed that there is a tradeoff between unemployment and inflation. Second, there have certainly been periods in the past in which Federal Reserve policy mistakes caused increases in unemployment, at least for a time. Let me address both of these issues.

Phillips’ work sparked an enormous academic literature. Based on his analysis of U.K. data, Phillips claimed that unemployment was consistently higher when inflation was lower, and unemployment lower when inflation was higher. This relationship became known as the Phillips curve. A few years after the Phillips paper appeared, U.S. economists argued the same about U.S. data.

In the mid-1960s, Milton Friedman and Edmund S. Phelps independently published papers disputing the existence of a Phillips curve tradeoff between unemployment and inflation. The gist of their critiques was that the apparent empirical regularity was a short-run phenomenon, not one that could continue over the long haul.

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Subsequent work and actual experience around the world confirmed the validity of the Friedman-Phelps view. The Phillips curve tradeoff was at most a short-run phenomenon. Some of the monetary policy mistakes of the 1970s, however, were a direct consequence of the earlier acceptance of the Phillips tradeoff view. But over the course of the 1970s, we learned that policies consistent with sustained higher inflation did not produce sustained lower unemployment.

Let's look at the common sense and fundamental economics aspects of the Phillips curve issue. Suppose you travel to Europe and see in the newspaper that the weather will be sunny with temperatures around 18° Celsius. Do you take a coat when you leave your hotel room? If you are not familiar with the Celsius scale, it is easy to make a mistake. But after you have gone outside a few times, you will understand that 18° Celsius is pretty close to 65° Fahrenheit. Your decision to wear a coat will have nothing to do with whether your thermometer reads 65° Fahrenheit or 18° Celsius.

By the same token, your behavior in the labor market may well be affected as the inflationary environment changes. If you are accustomed to living with low inflation, as people were in 1965, you may find your decisions affected by higher inflation that is rather a surprise. Some of these decisions may stem from your expectations that the inflation will be temporary. Such expectations are natural if the economy has enjoyed a substantial period of low inflation.

The unemployment rate did fall significantly in the late 1960s as the rate of inflation rose. Workers responded to higher money wages by accepting jobs more readily, thereby decreasing unemployment, only to discover that higher inflation was eroding the purchasing power of the higher money wages. Real, or inflation-adjusted, wages just weren't as high as workers had expected. Similarly, firms increased production in response to higher prices, only to find that profits were elusive as production costs rose more than anticipated. Both workers and firms misread the wage and price signals, just as American tourists traveling abroad might misread the thermometer.

As higher inflation continued, people became accustomed to the new environment. And as people adjusted to higher inflation, they no longer made the decisions they made in the late 1960s when inflation was new and surprising. The unemployment rate rose back to the levels seen earlier, and indeed rose significantly higher during several severe recessions.

Although the economy does seem to work better and more efficiently when the rate of inflation is in the 2 to 3 percent range than when it is in the 8 to 10 percent range, the most important point is that, as a first approximation, the unemployment rate is little affected on the average. People do learn how to function pretty well even when they have to use a rubber monetary yardstick—a yardstick for which the purchasing power of a dollar gets smaller and smaller year after year. People adjusted pretty well to a world in which wages and prices were rising at 8 or 10 percent per year; most learned not to make mistakes from assuming that the average level of prices was likely to remain roughly unchanged, when in fact prices were rising significantly.

So, it is simply a myth that the Federal Reserve can follow an easy monetary policy that leads to higher ongoing inflation with the benefit of sustained lower unemployment. The argument that the long-run Phillips curve is approximately vertical—that there is no sustained tradeoff between unemployment and inflation—is accepted by all mainstream economists, whatever their political persuasion. There are important and interesting professional disputes about whether a short-run tradeoff exists and, if so, how long it takes for the economy to undergo the transition from the short run to the long run. But in the economics profession, the long-run issue has been settled for 25 years.

U.S. experience in recent years certainly reinforces the lesson that there is no inconsistency between sustained low inflation and sustained low unemployment. Last year, the unemployment rate averaged 4.2 percent; the rate had been 5.6 percent in 1995. Based on the annual average of the consumer price index, the inflation rate was 2.2 percent last year; the rate had been 2.8 percent

in 1995. I think there is a strong case that sustained low inflation contributes to a somewhat lower unemployment rate on the average; A.W. Phillips was simply wrong. And I think there is an absolutely compelling case that sustained low inflation reduces the instability of the economy.

The bottom line? Sustained low inflation, achieved through disciplined and predictable tight monetary policy, is employment-friendly.

MYTH TWO: TIGHT MONETARY POLICY RAISES INTEREST RATES

The Federal Reserve conducts monetary policy in the short run by setting a target for the federal funds interest rate—the rate banks charge one another on their loans of reserves on deposit at Federal Reserve Banks. The Fed calls its target the “intended federal funds rate.”

In common language, when the Fed increases the intended federal funds rate, people say that monetary policy is tighter. In this sense, the claim that tight monetary policy raises interest rates is true by definition. The interesting issue, though, is whether a Fed policy that is successful in keeping inflation low has the effect of raising interest rates. A jump to the wrong conclusion is pretty easy. The Fed raises the intended fed funds rate to keep inflation under control. Therefore, it seems, a policy to keep inflation under control leads to higher interest rates. The problem is to sort out short-run fluctuations from longer-run fundamentals.

The way to understand this fallacy is to suppose that the Fed had some other policy instrument, not involving direct control of interest rates, to maintain low and steady inflation. With sustained low inflation, market forces will sometimes push interest rates up and sometimes down. For example, when economic conditions are particularly strong, people will want to borrow funds to support new business investment, new household purchases of cars and houses, and so forth. In times like these, interest rates will be on the high side. When the economy weakens a bit, those

forces will push in the other direction and interest rates will be somewhat lower. On average, over time, if inflation remains low and steady, interest rates will fluctuate around a level that is determined by non-monetary forces in the economy. When the Fed conducts policy to sustain low inflation by changing the intended fed funds rate, what it is trying to do is to more or less mimic how these market forces would cause interest rates to fluctuate.

Suppose that the Fed resists market forces that are pushing up interest rates at some particular time. The result is that the Fed creates an excessive amount of liquidity in the economy, unleashing inflationary forces. As inflation rises, lenders demand an inflation premium in the interest rates they charge, and borrowers are willing to pay that premium. Where does the inflation premium come from? Suppose you are debating whether to spend \$1,000 on the economist’s favorite object—the widget. You are considering waiting a year and investing the funds in a savings deposit earning 4 percent. The inflation rate is 2 percent, and let’s assume that the price of the widgets will increase along with the general level of prices. Your choice then is whether to buy now, spending \$1,000, or next year, spending an expected \$1,020. If you spend next year, you will take the funds out of your savings account; at 4 percent interest, the \$1,000 will have become \$1,040. In this example, the real, or inflation-adjusted, rate of interest is 2 percent—nominal interest of 4 percent less inflation of 2 percent.

Now suppose you expect 6 percent inflation instead of 2 percent. You expect that in a year, the widget will cost \$1,060. If interest on your savings account remains at 4 percent, you will certainly want to buy now instead of waiting a year. At 4 percent interest, lots of people will be spending instead of saving, because the real rate of interest is now negative—4 percent interest less 6 percent inflation, or minus 2 percent. The reduced supply of saving will force up nominal interest rates. When nominal rates reach 8 percent, the real rate will again be 2 percent—8 percent interest less 6 percent inflation.

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If inflation gets away from the Fed, as it did starting in 1965, nominal interest rates will rise—perhaps sooner, perhaps later—to reflect inflation expectations. The home mortgage rate, for example, went from 5.81 percent in 1965 to 14.70 percent in 1981. If Fed policy is to keep inflation low, the Fed will have to permit rates to rise or fall from time to time. However, on the average, interest rates will be substantially lower in a period of low and stable inflation than during a period of high inflation.

The bottom line? A Fed policy that resists market pressures by holding interest rates down can be successful for a few months or even a few quarters at a time, but eventually both inflation and interest rates will end up higher than they would have had the Fed acted early to prevent inflation from becoming embedded in the economy. Thus, a tight monetary policy that is successful in keeping inflation low and stable will keep interest rates on average lower than they would be under a policy that permits higher inflation.

MYTH THREE: HIGHER INTEREST RATES WILL DEPRESS THE ECONOMY

The claim that higher interest rates will depress the economy is a myth. So too is the claim that lower interest rates will stimulate the economy. These myths reflect confusion over whether, in any particular circumstance, rates are being driven up or down by supply or demand conditions.

Let's start by emphasizing simple fundamentals. Take out a scrap of paper, or just use your imagination. Draw a supply and demand diagram with price on the vertical axis and quantity on the horizontal axis. The supply curve slopes up and the demand curve slopes down. The intersection of the two defines the equilibrium price and quantity in the marketplace. What can we conclude about quantity from the knowledge that price is higher? Nothing. Price can be higher either because the supply curve has shifted back, sliding

along an unchanged demand curve or because the demand curve has shifted out, sliding along an unchanged supply curve. In one instance, price is higher and quantity is lower; in the second instance, price is higher and quantity is also higher.

Let's use this simple model to better understand the relationship between interest rates and economic activity. To concentrate on the policy effects on economic activity, let's assume that Fed policy is successful in keeping inflation low. On the vertical axis we'll measure the interest rate, which is a type of price, and on the horizontal axis we'll measure gross domestic product (GDP). There is a complicated sort of demand curve relating the interest rate to GDP—this demand curve slopes down. That is, along this curve, lower interest rates are associated with higher GDP. There is also an upward-sloping supply curve that is influenced by Federal Reserve policy actions. If market forces shift the demand curve out, the result will be higher interest rates and higher GDP. If the supply curve, influenced by Fed policy actions, shifts back, the result will be higher interest rates and lower GDP. Thus, at the equilibrium of these two curves, a higher interest rate may be associated with lower GDP, but not necessarily. Similarly, a lower interest rate may be associated with higher GDP, but not necessarily.

The Fed's job is to try to adjust monetary policy so that the supply of goods and services is matched by the demand for goods and services at a low and stable inflation rate. If the Fed does its job correctly, interest rates will rise as economic fundamentals drive them higher, but inflation will remain subdued. And, when required by economic fundamentals, the Fed will push interest rates down so that the equilibrium of supply and demand for goods in the macro economy occurs with no sustained change in the rate of inflation.

Anyone with an Internet connection can observe interest rates minute by minute, but there is no way to observe economic activity minute by minute. When we observe interest rates changing, we can only guess at what is going on with the level of activity. The myth is that higher interest

rates are usually, or often, associated with lower economic activity, and lower rates with higher activity. If you spend some time looking at the data, you will see that it just isn't true that higher rates are typically associated with lower activity. Indeed, you will be struck by the fact that historically, unemployment tends to be low when interest rates are high and vice versa. This cyclical pattern to interest rates goes back to the middle of the 19th century, at the beginning of our systematic observations of interest rates and the business cycle.

The reason for this pattern is that the Fed has not always been successful in timing its policy actions to achieve balance in supply and demand at stable and low inflation. Often, in the past, higher interest rates were associated with a booming economy, and an economy in which inflation was rising. Also, often in the past, the Fed did not act quickly enough to push interest rates down when the economic fundamentals were pointing toward a weaker economy.

So, the myth is that Fed action to propel interest rates higher automatically points to a weaker economy. Indeed, some monetary policy mistakes in the past have arisen precisely because too many people believed the myth. Fed policymakers sometimes recognized that inflation pressures were building, but thought that rising interest rates indicated that policy was restrictive. In many of these cases, however, the Fed was holding interest rates down from where the economic fundamentals would have driven them. As a consequence, the Fed was actually following an expansionary policy at a time that inflation pressures were building. For a simple analogy, you cannot assume that your car is slowing just because you are stepping on the brake. If you are going down a steep mountain, you might not be stepping on the brake hard enough, and your car may be picking up speed. Similarly, in periods of economic weakness in the past, the Fed and many other observers sometimes confused falling interest rates with an expansionary policy. The most tragic example of such a miscalculation occurred during the early years of the Great Depression. Even though interest rates were falling

through most of the period from 1930 until the bottom of the Depression in March 1933, monetary policy was in fact contractionary. Rates simply were not falling as rapidly as they should have, given the economic fundamentals of that period.

There is, unfortunately, no simple way to tell when interest rates are rising or falling rapidly enough to maintain a balance between the economy's supply of goods and its demand for goods so that inflation will remain low. The Federal Reserve evaluates a vast amount of information in the process of reaching its policy decisions. We in the Fed acknowledge that we do not always get the analysis just right. But certainly for some years now the Fed has been close enough to getting things right that the outcomes for the economy have been highly favorable. Fluctuations in the inflation rate have been small, and the trend rate of inflation has remained low. What you will find looking at a chart covering this period is that inflation has remained remarkably low and steady, the unemployment rate has gradually fallen to today's level of 4 percent and interest rates have fluctuated up and down. There is little obvious relationship between the interest rate and the level of economic activity over the last five years, but what little we can observe is in the direction of higher rates when GDP growth is higher and lower rates when GDP growth is lower.

MYTH FOUR: MONETARY POLICY DECISIONS ARE FUNDAMENTALLY POLITICAL

Today we are in the middle of a primary election campaign, and in a few months will be in the middle of a national election campaign. Discussing politics and the Fed can be a sensitive issue, but I think it's best to deal with this issue forthrightly. The bottom line for me is certainly that monetary policy decisions are not at all political.

What is meant by the claim that monetary policy decisions are political? One possible

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meaning is that Fed decisions are designed to strengthen the position of one political party or the other. Another possible meaning is that the Federal Reserve makes its decisions for the purpose of favoring certain groups over other groups. I am convinced that Fed policy is not political in either of these ways.

It is important to understand that the Federal Reserve has essentially only one policy instrument. I like to think of that instrument as being the rate of money creation, or more generally the rate of liquidity creation, for the economy as a whole. In the short run, the Fed controls the creation of liquidity by adjusting the intended federal funds rate. Whether you look at policy through a money growth lens or through an interest rate lens, the fact is that there is just the one policy instrument. You can think of Fed policy either in terms of liquidity creation or interest rates, but not both, because the Fed cannot independently control liquidity creation and interest rates.

With one policy instrument, the Fed can at most achieve one policy objective. For the Fed, that objective is the rate of inflation. The goal is to keep the rate of inflation low and stable. The Fed also has some freedom to adjust the timing of its policy actions to contribute to overall economic stability. For example, the FOMC reduced the intended fed funds rate three times in quick succession in the fall of 1998 in an effort—one that turned out to be quite successful—to keep the financial disruption following the Russian default from affecting the U.S. macro economy. Last year, as the financial disruption faded, the Fed took back those three rate cuts. Thus, the Fed was able to take policy actions to reduce rates and then raise them again to smooth the course of the overall economy, and it was able to take these actions without jeopardizing its basic goal of low and stable inflation.

So that is what the Fed is trying to do. Is there any particular political agenda to achieving low and stable inflation? I think not. The goals of low inflation and high employment are broadly shared across all segments of U.S. society.

Does low inflation tend to redistribute income away from one income class toward another?

There is a substantial professional literature on the effects of inflation on the distribution of income. The fact that the goal of low inflation is shared by both low-income groups and high-income groups suggests that any redistribution effects of inflation are likely to be small. Indeed, the evidence is pretty clear that a higher rate of inflation would have very mixed effects in terms of redistribution of wealth and income. Lower income people, for example, have most of their wealth tied up in assets that suffer reduced purchasing power as inflation rises. By the same token, their debts become less onerous when the inflation rate is higher. However, those within any income class have quite different financial situations; within each income class, unanticipated inflation helps some and hurts others. In short, there is no obvious way that the central bank could affect the income and wealth positions of higher or lower income groups by choosing a different rate of inflation.

Could the Fed adjust the timing of its policy actions in the short run to favor one political party or the other? In principle, the answer is yes, but in practice the protections built into the structure of the Fed make the risk remote. I'll discuss these protections in enough detail to convince you, I hope, that Fed policy is not at all partisan.

In terms of the backgrounds of Fed policymakers, I detect no predominant political outlook. Members of the Board of Governors are appointed by the President. Thus, given that governors have 14-year terms, at any one time some governors were appointed by a President from one political party and some by a President from the other political party. Moreover, there is no consistent pattern in the political affiliation of the governors appointed by any particular President. President Carter initially appointed Paul Volcker as Chairman, but President Reagan re-appointed him. President Reagan initially appointed Alan Greenspan as Chairman, but President Clinton twice re-appointed him.

Among the Reserve Bank presidents, party affiliation is pretty obvious for some, like me, who may have served in a previous position in a particular political administration. I am not at all

sure, however, of the political affiliation of most of my fellow presidents. If you read their speeches, I doubt that you will find it obvious either.

Members of the boards of directors of Federal Reserve Banks are also of varied political persuasion. Here again, I really don't know what the political persuasion is of the boards, including my own. Of course, I can make some guesses, but the issue really does not come up.

Each Fed board has three of its nine directors from the commercial banking industry. Sometimes people claim that commercial bankers are predisposed to high interest rates. That is certainly not my experience with bankers on the St. Louis Fed board. I see no evidence that they are uniformly predisposed in either direction when it comes to interest rate changes. In fact, at least in today's economy, it's not so clear whether commercial banks benefit even in the short run from higher interest rates. Commercial banks live off the spread between the interest rates they charge and the interest rates they must pay to attract funds. The principle is easy to understand by considering a bank with a substantial credit-card business. Credit-card interest rates are very sticky; they change infrequently. The cost of funds to a bank responds pretty sensitively to changes in short-term market interest rates. A bank with a credit-card business is likely to be unhappy when market rates rise because its business will be less profitable.

Exactly how any one bank is affected by higher interest rates is dependent on the nature of the bank's business and how the bank has positioned itself. I think that banks generally tend to benefit in the short run when the Fed lowers interest rates, because the rates banks pay on funds they borrow are typically a bit more flexible than the rates banks charge on the funds they lend. This analysis is consistent with recent comments by some stock market observers who have argued that rising interest rates over the last year explain the relatively weak performance of bank stocks.

In any event, bank managers and shareholders do have an intense interest in seeing that the overall economy remains stable. Any developing situation that might lead to a recession will be a

threat to bank earnings because loan defaults rise. Thus, I think that bankers, as well as others in the economy, have a strong reason to favor continuing low and stable inflation, which helps to maintain continuing growth in business without a recession.

Finally, if you believe that the Fed's short-run policy decisions are political in nature, I urge you to take time to read the transcripts of FOMC policy deliberations. The transcripts are released with a lag of about five years. The transcripts for 1994 will be released soon and transcripts for most earlier years are already available. The transcript is taken from the tape of FOMC meetings; the only changes reflect minor corrections to grammar and deletion of references to particular firms and foreign governments that would violate confidentiality. I challenge you to read those transcripts and find any convincing evidence that monetary policy is set on the basis of political considerations.

One final consideration is that the Federal Reserve has elaborate provisions preventing political activity by Reserve Bank officers and directors. Each Reserve Bank has an ethics officer who oversees these matters. You will not find Federal Reserve officials or directors involved in any political campaigns; they do not engage in fundraising for candidates or in any overt political activity whatsoever. You will not find any Federal Reserve officials serving as advisers, unofficial or otherwise, to the candidates.

The bottom line? Federal Reserve policy decisions simply are not political in any usual sense of that term.

CONCLUDING COMMENTS

I have discussed four great monetary myths. First, that tight monetary policy increases unemployment. Second, that tight monetary policy raises interest rates. Third, that higher interest rates will depress the economy. Fourth, that monetary policy decisions are fundamentally political.

To understand why these claims are myths, it helps to understand some economics. For infla-

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tion to remain low and stable, interest rates must sometimes be higher, sometimes lower. We must distinguish between shifts in supply conditions and shifts in demand conditions. We must distinguish between short-run and long-run conditions. If you put some effort into understanding the basic economics of these issues, and if you spend some time reading, you can form your own independent judgment on the claims I have labeled “myths.” I think you’ll reach the same conclusion I have—a conclusion I reached long before I came to the St. Louis Fed two years ago.