INTEREST RATE STABILIZATION-
CAUSES AND CONSEQUENCES

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I want to thank you for inviting me to meet with you today. The Mississippi Bankers Association is a respected and distinguished group, and it is both my honor and pleasure to be here.

There's a quote attributed to George Scott of First National City Bank of New York that I'd like to share with you. Mr. Scott said: "If you feel sick you go to the doctor; if you're in trouble, you go to the lawyer; and if there's anything else wrong, you go to the banker."'

Well, I'm not sick and I don't think I'm in trouble. But, as one who is involved in monetary policymaking, I am deeply concerned about certain things that have gone wrong with the American economy, and I'm coming to you bankers to express some of those concerns.

I'm certain that there are few in this audience who are not aware of the serious economic problems currently threatening our society. Inflation, persistent unemployment, our inability to get a handle on excessive government spending, the decline of the dollar on foreign exchange markets . . . these and similar perplexing issues challenge the wisdom of economists and policymakers alike. Any of these would qualify as a subject worthy of serious discussion.

In the time allotted to me this morning, I have chosen to concentrate on one particular facet of the current economic scene which is very much in the news these days and which I know is of concern to you as commercial bankers. I refer to rising interest rates and increasing pressures upon the Federal Reserve to resist such rises.

As you all well know, the Federal Reserve is the monetary policymaker in America. That policymaking has long had two goals . . . the control of inflation and the stabilization of interest rates. For too long, I think, the Federal Reserve has been under great pressure from the private sector and the political sector to try to accomplish these two goals concurrently, the control of inflation and the holding of interest rates below the levels that the open market would otherwise set.

If is my very strong belief that pursuit of these dual goals is self-defeating. For reasons that I will explain more fully, we cannot do both. We cannot seek to control inflation and to stabilize short-term interest rates, all at the same time, because the methods the Federal Reserve must use to hold down short-term interest rates are themselves inflationary!

We must reject the widely-held myth that holding down short-term interest rates is of primary importance, and instead, make control of inflation as our main goal. Not only is a preoccupation with short-term interest rate control inflationary, but it also removes certain budgetary constraints upon government and gives what amounts to a carte blanche for deficit spending.

The basic object of monetary policy, as you know, is to promote full employment of productive resources while maintaining a stable price level. And, we know that an important factor in whether or not we can achieve price stability is our ability to control the Nation's money supply.

The Federal Reserve conducts monetary policy through the Federal Open Market Committee, a body consisting of seven members of the Board of Governors and the Presidents of the twelve Reserve Banks, five of whom are voting members at any particular time. These individuals meet monthly in an effort to guide monetary policy in the best long-term interests of the Nation. They set ranges for monetary aggregate growth and ranges for Federal funds interest rates.

For the FOMC to avoid causing either inflation or recession, the Committee must aim to keep the money supply growing at approximately the same rate as the economy's capacity to produce goods and services. When the money supply grows faster than that for a prolonged period, inflation is caused. On the other hand, if the money supply were to grow more slowly than the economy's productive capacity, deflationary pressures would be created.

In recent years the money supply has tended to grow too rapidly rather than too slowly. Therefore, most recently the major task confronting the FOMC has been to restrain the rate of growth of the money supply in order to avoid future inflation.

Unfortunately, this same mechanism through which the Federal Reserve System controls the growth of the money supply also enables the System to affect short-term interest rates.

When the U. S. Treasury markets a large volume of government securities, perhaps to finance a federal budget deficit, or when the overall demand for credit increases for any reason, short-term interest rates tend to rise. If the money desk at the Federal Reserve Bank of New York enters the market and buys government securities, the upward pressure on interest rates is alleviated . . . at least temporarily. Such purchases increase commercial bank reserves and the banking system is able to supply more credit. This additional supply of credit tends to lower interest rates. Sounds good. But, unfortunately, there are ancillary consequences of such actions.

What many laymen don't fully understand is that an interest rate is a price . . . the price of credit. Like all prices in a free market, interest rates fluctuate continually in response to all kinds of real and imagined forces. In the absence of action by monetary authorities to maintain interest rates at artifical, below-market levels, prevailing interest rates at any time are the rates at which lenders want to lend the exact amount borrowers want to borrow.

When interest rates are kept artificially low by monetary policy, borrowers are encourgaged to borrow, but lenders receive no additional encouragement to make loans. If monetary policy is designed to prevent interest rates from rising, the Federal Reserve must supply more credit to the economy, and this, simultaneously, causes the money supply to expand.

Persistent attempts to keep interest rates low through monetary intervention cause the money supply to grow much faster than the growth of the economy's productive capacity. When that happens, inflation inevitably follows.

And herein lies what is to me the great irony of the whole process: Because attempts to keep short-term interest rates low cause inflation, their ultimate effect is exactly the opposite of what they were designed to accomplish. Lenders soon see that inflation is diminishing the real return they receive on the funds they have loaned. So, to compensate for the expected effects of inflation, they must increase the interest rates at which they are willing to lend.

If monetary policy remains steadfast in its efforts to keep interest rates down, it must react to this further increase in interest rates by supplying still more credit, and in the process, still more money. This accelerates the inflationary trend. To protect their real rate of return, lenders must again raise interest rates. The monetary authority will have to react again. Lenders will raise their interest rates again. And so on, and on, and on.

Fortunately, we don't have to choose between inflation and low interest rates. Instead, the choice is between low rates of inflation with low interest rates, and high rates of inflation with high interest rates. That would seem to be an easy choice to make. But, here's the catch. To experience reduced inflation and relatively low interest rates over the long term, we must be willing to allow short-term interest rates to fluctuate with the supply and demand for credit. We must be willing, occasionally, to swallow the bitter medicine of temporary interest rate increases to avoid the crippling disease of inflation that is the inevitable result of efforts to keep interest rates constantly low regardless of the demand for credit.

Those who speak out for low interest rates in times of increasing demand are merely paving the way for more inflation in the future.

If all of this is true, you might ask, why doesn't the Fed simply permit short-term rates to find their natural market levels? Unfortunately, the Federal Reserve does not operate in a vacuum. It is subject to pressures from groups which traditionally have seen higher interest rates as something to be avoided. These pressure groups fall into three broad categories: certain economists, the government, and sometimes, even the financial community itself.

One of the arguments some economists make is that higher interest rates discourage borrowing and consequently, spending. They argue that decreased spending causes output to decline and unemployment to increase.

And, indeed, since the interest rate is the price of credit, like an increase in price in any other market, increases in interest rates do tend to discourage demand. But, it isn't at all clear that increases in short-term interest rates cause long-term rates to rise. And, it is the long-term interest rate that affects spending decisions in important activities such as housing and capital investment.

Actually, the economic argument for keeping interest rates low is mainly an attempt to seek short-run benefits in output and employment at the expense of lower output and employment in the future.

A second source of pressure for interest rate stabilization comes from the government. Since the government is the largest single borrower in the Nation's credit markets, it will always benefit from lower interest rates. But the main reason for government to resist increases in interest rates is much more subtle. Interest rate stabilization effectively removes a constraint that society would normally impose on government spending. The only control that the electorate exercises over government spending is in its refusal to accept higher taxes or higher interest rates. If the government wants to increase its expenditures, it can finance them either through increasing taxes or through borrowing in the private credit market. In the first case, the electorate will observe higher taxes, and in the second case, higher interest rates. But if the Federal Reserve is required to stabilize interest rates by buying up newly-created Treasury securities, the electorate does not experience anything until inflation accelerates. This may take a couple of years and by that time, inflation is firmly entrenched and the cause of inflation forgotten. Even if it is not forgotten, there is nothing that the electorate can do about it. Thus, interest rate stabilization is the vehicle through which the government can grow and occupy a larger and larger share of our resources without approval by the public.

The third source of pressure is the financial community. The financial community, including bankers, has a vested, but shortsighted, interest in stablilzation of short-term interest rates. As long as interest rates are kept within narrow bands by monetary authorities for at least a month, it is easier to estimate the short-term cost of money, it is easier to plan loan commitments, and it is comforting to know that reserves will be supplied at a known price. Too often, however, we forget that this comfort is very short-lived. We forget that the price of interest stability for one month may be higher variability two or three months hence. For it is clear that keeping interest rates from rising now means that bank reserves must rise, money stock growth must accelerate, and this acceleration inevitably is translated into inflationary expectations and demands for higher long-term rates by lenders. Nevertheless, even with this knowledge, we often choose immediate security over increasing risks in the future. And it is this choice that repeatedly gets us into long-range problems which, when they appear, seem to be insoluble.

So, my message to you bankers and business leaders is this: You've got to come to grips with the fact that a short-term rise in the price of credit . . . interest rates . . . is not bad for business. A price is a price. Do you want to have prices controlled? No, of course not. Stabilization of interest rates through monetary policy is simply another form of price control!

The business community must realize that it can't have it both ways. It can't have artificially low short-term interest rates and simultaneously reduce inflation.

It was not long ago that our bank in St. Louis, without a great deal of success, was delivering warnings of an impending acceleration of inflation. We no longer need to make those warnings, of course, for the inevitable sequence of events is unfolding.

I do not believe that we must accept a 5-6% annual rate of inflation as inevitable. Inflation can be reduced, and it must be reduced if the American economy is to continue to grow and prosper.

I believe that, if permitted the independence necessary to perform its mission, the Federal Reserve can make an important contribution toward the reduction of inflation. This will entail unpopular actions. We must be prepared to tolerate a reasonable degree of upward movement of short-term interest rates in times of increased credit demand. We must be prepared to resist monetization of government debt where such actions would be clearly inflationary.

These are the sorts of challenges the Federal Reserve faces today in the conduct of its monetary policy. They are difficult; they involve controversy. Yet, they are extremely important, for their solution is fundamental to the survival of our free society.

Essential to meeting these challenges is the continued independence of the Federal Reserve System. There are those who would transfer responsibility for the conduct of monetary policy to the political sector of our society. And at the heart of the independence controversy, lie the issues I have discussed.

If we feel that inflation is indeed a threat to our economic and political institutions, as I firmly believe it to be, the central bank must be sufficiently independent to resist and defy pressures to keep short-term interest rates below their market-determined levels. It must be sufficiently independent to steadfastly manage the Nation's money stock so as to avoid inflationary and deflationary pressures, and it must be sufficiently independent to resist becoming involved in the management of credit markets.

Whether we are able to reconcile our differences and work together to resolve them in the interest of a stronger and a greater America will determine the course and quality, not only of our lives, but of the lives of future generations for years to come.

I hope that you as bankers and, more importantly, as concerned citizens will involve yourselves in the great debate concerning these issues and thereby help us to choose those courses of action which will assure the continued growth and prosperity of this great Nation.