



WHY CAN'T THE FEDERAL RESERVE CONTROL INTEREST RATES?

**Address by
Lawrence K. Roos
President
Federal Reserve Bank of St. Louis**

**Before the
Third Annual Business Forecast Conference
Chapman College
Orange, California**

January 16, 1981

For much of last year, one single question occupied the minds of over 80 million Americans. That question, the product of a fantasy created in large part by the Southern California entertainment industry, was . . . "Who shot J.R.?"

Today, Americans are asking another question. This question is motivated by the disappointments and frustrations of millions of people as they assess the current economic conditions in this country. The question on their minds these days is . . . "Why can't the Federal Reserve control interest rates?" This is a critical and, in my opinion, a deeply disturbing question. Not because it is difficult to answer . . . in fact, the answer is both simple and straightforward.

The problem with this question is that, like the question about J.R., it is based on fantasy. . . in this case, a fantasy that has been created over the years by financial market participants and, on occasion, by members of the Federal Reserve itself. It is the fantasy that the Federal Reserve can and should control interest rates, and that when interest rates get uncomfortably high, as has been the case in recent weeks, the Fed should take action to lower them.

I hope to convince you, this afternoon, that the Federal Reserve cannot control interest rates. And that asking it to do so demonstrates a basic failure to understand the Fed's role in our nation's credit markets. Moreover, I also hope to demonstrate that the Federal Reserve should not attempt to control interest rates . . . that increased governmental interference in credit markets will only produce adverse effects similar to those that have occurred in other markets when government has become involved. And finally, that the popular misconception that the Fed controls interest rates has often generated pressures on the central bank which in themselves have produced many of our current economic problems.

To begin, we should note that an interest rate is nothing more or less than a specific price, in this case, the price of credit. Consequently, interest rates are determined by various demands and supplies of credit in our society. A determination of whether the

Fed can influence interest rates requires assessing the Fed's impact on the demand and supply sides of the credit market.

On the demand side, there is little that the Fed can do directly to dictate or control how much credit is desired at any particular time. The demand for credit arises from the decisions of millions of individuals, thousands of businesses, and large numbers of state and federal governmental agencies that borrow daily in the nation's credit markets. To be sure, their behavior is influenced by their expectations of the consequences of Fed's policies, but quite clearly the Fed exerts virtually no direct control over their decisions.

On the other hand, the Federal Reserve can exert a direct influence on the supply of credit. Much of the supply of credit, of course, comes from individuals and corporations that wish to lend their savings to others, either directly or indirectly through various financial institutions. The Federal Reserve can influence the lending activity of banks and other financial institutions that are subject to Federal Reserve requirements by affecting the amount of excess reserves they hold . . . that is, their reserves over and above the amount they must hold behind their deposits. Put in its simplest form, when available excess reserves increase, financial institutions expand their lending activity; when excess reserves decline, they reduce their lending activity. In this way, changes in excess reserves directly affect the available supply of credit.

There are only three ways by which the Federal Reserve can affect the excess reserves of financial institutions: It can change the discount rate, i.e., the rate at which financial institutions can borrow reserves from the Fed; it can change their reserve requirements, i.e., the amount of reserves that they must hold per dollar of deposits; and it can buy and sell securities in the open market.

An increase in the discount rate raises the cost of borrowing additional reserves from the Fed and thereby reduces the incentive for financial institutions to borrow. A reduction in the discount rate makes borrowing reserves less costly and, consequently, encourages financial institutions to increase their reserves through increased borrowing

from the Fed. Although changes in borrowed reserves resulting from changes in the discount rate have some impact on the supply of credit, such changes are relatively insignificant because they involve only a small portion of the funds banks use for lending. For example, the level of reserves borrowed by member banks from the Federal Reserve last year varied from less than \$.5 million to about \$3.5 billion and is now about \$1.5 billion. This is a drop in the bucket when compared with total bank reserves of \$50 billion and total bank lending of \$886 billion. Moreover, it is difficult to predict the impact of discount rate changes on the volume of borrowing from the Fed. Consequently, this method of affecting the supply of credit is not a very useful policy instrument. Thus, contrary to popular opinion, changes in the discount rate are of relatively minor policy importance; in fact, discount rate changes typically lag behind movements in other interest rates, rather than leading them as you would expect a policy instrument to do.

The Federal Reserve also has the authority to prescribe the level of required reserves of financial institutions. A change in reserve requirements, say an increase, has the effect of requiring banks and other financial institutions to hold more reserves behind their deposits, and this reduces their ability to extend credit. However, increasing or decreasing credit by changing reserve requirements is seldom used for monetary policy purposes, because even very small changes in reserve requirements produce enormous changes in the amount of excess reserves available to financial institutions. As a result, wide and erratic swings in credit supplies and interest rates would accompany even minor changes in reserve requirements and would cause considerable instability in credit market conditions. In fact, to avoid the jarring impact of reserve requirement changes, the Fed has typically acted to offset the effects of such changes through the use of open market operations.

This brings us to the third method, the buying and selling of securities in the open market through the Fed's open market operations. When the Fed purchases securities, it pays for them by creating additional reserves. When it sells securities, it reduces reserves. Both the timing and the amount of these reserve changes can be handled in a precise

manner. This is, in fact, why open market operations are the primary policy instrument that the Federal Reserve uses to affect the supply of credit to the banking system.

Now if I were to terminate this analysis at this point, you would probably conclude that the Fed can, indeed, control interest rates. You might think that all that is required, regardless of the demand for credit, is for the Fed, through its open market operations, to supply the proper amount of reserves, and financial institutions would supply the proper amount of credit at whatever interest rate the Fed desires. The only problem with this reasoning is that it is totally and utterly false. It is false, because it ignores one other crucial factor that influences interest rates.

What is generally overlooked in assessing the Fed's impact on interest rates is that, when the Fed changes the reserves of financial institutions through its open market operations, it also causes changes in the money supply. When reserves rise following the Fed's purchase of securities, financial institutions are able to expand their lending activities by creating new checkable deposits. This, in turn, increases the amount of money available for spending. Such changes in the money stock frustrate the Fed's ability to control interest rates.

Suppose, for example, that the Federal Reserve decided today to reduce interest rates by purchasing securities in the open market, thereby increasing reserves to financial institutions. As banks and other institutions, fueled by the additional reserves, expanded their lending activity, both the supply of credit and the supply of money would increase. Now a funny thing happens to interest rates as a result of this. While the increase in the supply of credit has the effect of temporarily holding down short-term interest rates, the faster growth of money increases the public's expectations of inflation. This, in turn, tends to counteract the changes in interest rates arising from the changes in the supply of credit alone and results in effects that are the opposite of what was originally intended.

Whenever the Federal Reserve, as it has done over the past six months, "eases" monetary policy by permitting credit and money to grow at relatively high rates, interest

rates rise, not decline. This is because the public quickly perceives that such a policy portends increased inflation in the future. If the Federal Reserve "tightens" policy by slowing the rate of money growth, interest rates tend to fall, because inflationary expectations are reduced.

It is surprising how often observers misinterpret the causes of interest rate movements. In recent months, high interest rates have been attributed to "tight money policies of the Federal Reserve." Nothing could be farther from the truth. In the period from June to December 1980, the basic money supply grew at 14%, well above the Fed's announced target ranges and far in excess of the inflation-generating rates of growth that have occurred over the past several years. The present high interest rates are not caused by "tight" credit policies, but rather by overly expansive monetary policy, prospects of a sizable budget deficit in 1981-1982, and a strong demand for credit.

Public misunderstanding of circumstances such as these compounds our problems because it leads to pressures on the Federal Reserve to act in a manner which further destabilizes the economy. For example, when the housing industry suffers because of high mortgage rates erroneously attributed to "tight control of credit" by the Fed, we are inevitably called upon to attempt to lower interest rates by injecting additional credit and money into the economy. As we have seen, however, this does not lower interest rates; it heightens inflationary expectations and leaves us with higher rates of inflation and higher interest rates. Or at times when the international value of the dollar is falling, the Fed is often called upon to prop up interest rates by reducing the growth of credit and money. Consider, however, the cost of such action. Whenever the Fed slams on the monetary brakes and dramatically reduces the rate of money growth for a quarter or more, it precipitates a recession. In response to recessionary conditions, the Fed tends to reverse policy and inject additional credit and money as a means of reducing interest rates in order to stimulate economic activity. The resulting monetary expansion merely leads to more inflation and higher interest rates.

The moral of this story is that attempts to control interest rates have perverse and destabilizing consequences. They lead to lower output growth, higher unemployment, higher inflation and higher interest rates.

There still remains, however, the issue of whether the Federal Reserve should have the authority--which it does not have now--to fix interest rates by decree, or quantitatively to control credit markets. This issue directly concerns the extent of economic power that we, as citizens of a free nation, wish to give to the central government. It has always amazed me that people who are only too willing to provide numerous examples of inequities and inefficiencies that arise when government steps in to regulate economic behavior, are often the very same individuals who want the Federal Reserve to control interest rates. To see what would happen if the Federal Reserve could control interest rates directly, all we need do is observe what actually occurs in other nations.

All countries have central banks which are empowered to create and destroy money. In some countries, the central bank can also legally set interest rates. Where this authority exists the efficiency of financial markets has inevitably been impaired and the economic welfare of their citizens reduced. In others, where the central bank is closely tied to the government and is required to buy all or some government debt, accelerating inflation has inevitably resulted. We are fortunate that the Federal Reserve System is among those central banks that have no direct control over interest rates or credit allocation.

Now, this is not to imply that the Federal Reserve does not have an extremely important role to play in conducting monetary policy. It can bring about lower interest rates, it can help reduce inflation, and it can help restore stable economic conditions. But not by attempting to control interest rates! Instead, the Fed must concentrate on doing what it is capable of doing -- controlling monetary growth.

The best way for the Federal Reserve to perform the task for which it was created is to establish a long-range target for the gradual reduction of money growth, publicly

announce that target and its plans for meeting it, and above all to demonstrate that it will, indeed, achieve the announced target.

An important step forward in this regard was taken on October 6, 1979, when Chairman Volcker announced the Fed's intention to concentrate on reducing the growth of money and credit as a means of achieving a lower rate of inflation. His announcement was hailed by many as a signal that the Fed was abandoning its disproven practices of seeking economic stabilization by controlling interest rates, and instead would concentrate on what it can do best.

After little more than a year's experience, however, no one can say that the Fed's new program has met with unqualified success. The 1980 targets for growth of the monetary aggregates have not been uniformly achieved. During the year the money supply both overshot and undershot our announced targets to such an extent that some observers are questioning both the ability and the determination of the Fed to achieve its new objectives.

I do not believe that the experience of one year is proof of the success or failure of the Fed's new operating procedures. After twenty years of failure to stabilize the economy by fine-tuning interest rates, it would be tragic to pass judgment on the feasibility of the Fed's new procedures after a relatively short time.

We know from the experience of Germany, Switzerland and elsewhere that inflation can be reduced by controlling the growth of money. We also know that the Federal Reserve has the capability over a period of time to achieve targets of money growth appropriate to the reduction of inflation.

So I would hope that the Federal Reserve reaffirms its commitment to its program of monetary control as announced in October 1979, and revises, if necessary, its operating techniques in order to enable it better to hit its targets. Above all, in the process of doing this, it is essential that the Fed resist any tendency to revert to interest rate stabilization.

The credibility of the Federal Reserve System is on the line. More importantly, the economic viability of our nation depends on our ability to bring inflation under control. Surely, a society which has demonstrated its ability to improvise and adapt through 200 years of unbelievable economic growth and prosperity can meet this latest test. This, as I see it, is the economic challenge of the 80's.