MONETARY POLICY...A TIME FOR RESOLVE, NOT RETREAT

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

Before the
Institutional Investor Bond Conference
New York Hilton Hotel
New York, New York
October 15, 1981 - 9:00 a.m.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

I am pleased to have been invited to address this Conference. It's nice to be back in New York. In fact, this is the third time in the past two and one-half years that I have had an occasion to come here to speak to the nation's financial community, and I welcome the opportunity to discuss some of the crucial economic issues currently facing us.

On my two prior appearances I was somewhat critical of the manner in which monetary policy was being conducted. I am happy to say that today I feel much better because although money growth has been somewhat slower than its targeted path for the past four months and interest rates remain stubbornly high, we are now closer to our announced annual money growth paths than we were at this time last year. Furthermore, I am convinced that the Federal Reserve is steadfast in its determination not to exceed its 1981 targets.

And, fortunately, monetary policy is no longer the "only anti-inflation game in town." At long last there is reason for optimism that fiscal policy is headed in the right direction. Tax cuts intended to stimulate private saving and investment have been enacted and significant decreases in government spending have been programmed.

In viewing the recent behavior of financial markets, however, one might reasonably ask the age-old question: "If you're so smart, how come you're not rich?" Or put another way: "If current monetary and fiscal policies are so sound, why aren't we all richer?" Why have financial markets responded so negatively to recent policy actions?

The answer, as I see it, lies partly in some widespread public misconceptions about current monetary policy and partly in exaggerated and unfounded fears about the effect larger-than-anticipated federal

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

budget deficits will have on interest rates. It reflects a crisis of confidence that I believe has very little foundation in fact.

In the time allotted me this morning, I would like to address both of these aspects of the problem.

First, the misconceptions. While it would be impossible in twenty minutes to catalogue and analyze all of the erroneous interpretations of current policy that are circulating in financial markets, there are a few especially disturbing ones that merit mention -- and censure.

A primary misperception is the assertion that the Federal Reserve, even if it so desires, is powerless to control money growth. This argument alleges that, as a result of recent innovations in financial markets, money sloshes from one financial instrument to another, and, thus, from one monetary aggregate to another. Therefore, it is argued, monetary policy cannot be conducted effectively because the monetary aggregates can neither be controlled nor correctly measured.

What's wrong with this point of view? To begin with, money does not slosh from one M to another. If the goal of monetary policy is to impart as much stability as possible to the level of prices and the growth of output, _any_ set of assets that is closely correlated with economic activity _and_ that can be controlled by the monetary authorities can be defined as "money" and become the object of control.

It just so happens that transaction balances, currently called M1B, is the set of assets that best satisfies these two conditions. The emergence of money market mutual funds, repos, and similar financial innovations has not changed the measurability of M1B or its relationship to prices and output. Allegations to the contrary are simply untrue.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A second widely accepted misconception is the belief that the Fed combats inflation by pushing interest rates to astronomical levels, thereby precipitating a recession in order to bring about a decline in inflation. This kind of thinking is particularly disturbing because it implies that we must choose between continued inflation or a politically unacceptable decline in the economy.

First, I would point out that, even if it so desired, the Fed cannot control interest rates, even in the short run. As we all should know by now, the interest rate is the price of credit and is determined by the supply of and demand for credit. It is true that, prior to the advent of persistent inflation, the Fed, to the extent that it could increase or decrease the _supply_ of credit, was able temporarily to influence the level of interest rates. In those days, the Federal Reserve could exert some short-term downward impact on interest rates by injecting reserves into the banking system and could exert short-term upward pressure by draining reserves. These options no longer exist; they disappeared when inflationary expectations related to Federal Reserve policy began to affect both the demand for and supply of credit as well. Since the middle of the last decade, when it became apparent that increases in money supply would lead to increased inflation, changes in money supply have been _positively_ correlated with interest rates. It is now evident that, even on a weekly basis, faster money growth drives up interest rates, while slower money growth is usually followed by a reduction in rates. Thus, those who currently call on the Fed to "loosen its credit reins" in order to bring interest rates down are living in the past; they are completely misjudging how such action would affect financial markets under today's conditions.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A related "common wisdom" has it that current high interest rates somehow are a result of Fed "tightness" and that a lowering of rates would be indicative of an "easing" of policy. Before blindly buying this shibboleth, it would pay to look at what influences the level of interest rates. We all realize that lenders make commitments only if they are convinced that they will receive some positive real return on the loans they make. This means a return in terms of actual purchasing power -- after inflation and after taxes. Let's assume a situation where most lenders and borrowers assume that inflation will approximate 8 percent. As we know, interest income is taxable and interest expense is deductible. The tax on interest income can be roughly measured as the difference between the yields on top quality taxable and equivalent quality tax-exempt bonds. This difference, prior to the advent of "all-savers certificates," was roughly 4 percent. Thus, merely to maintain one's purchasing power after taxes, a lender must charge at least 12 percent . . . 8 percent to cover inflation and 4 percent to compensate for income taxes. After adding a normal "real return" or profit margin of roughly 3 percent, we would have a level of interest rates of approximately 15 percent. That's roughly where rates are currently. There is no rational basis for interpreting current high rates to any "tightness" on the part of the Federal Reserve or interpreting any future decline in rates as an indicator of "ease."

Still another myth making the rounds these days is that a recession is a necessary condition to the reduction of inflation. As I have stressed on previous occasions, inflation--a persistently rising price level--can occur only when the growth of money and its velocity exceed output growth. In our economy, since velocity and output growth

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

have been roughly equal in recent years, the rate of inflation is closely correlated with long-term monetary expansion. The trend rate of money growth now stands at about 8 percent. This represents the core rate of inflation. Evidence since World War II indicates that a gradual slowing of money growth below its trend reduces inflation, but that if money growth falls _too_ precipitously and is held 2 percent or more below its long-term trend for two quarters or more, a recession is likely. Thus, if the rate of monetary growth is slowed gradually so that money growth does not fall significantly below its previous trend, there is no reason to expect a monetary-induced recession.

Still another common misconception among financial market participants is the belief that Federal Reserve policy can be divined from weekly changes in the money supply numbers. Weekly and even monthly fluctuations in money are a reflection of what the public and banks do with their cash and reserves rather than the amount of reserves being supplied. The Fed _should_ not and _does_ not undertake open market operations to offset short-term fluctuations in the money supply. Thus the weekly money number watching game is not only futile as a means of predicting short-term interest rate movements, it is meaningless as a predictor of changes in the Federal Reserve's policy stance.

So much for monetary policy and misunderstandings associated with it. Unfortunately, these misunderstandings are only part of the malaise currently influencing financial markets. Another contributing factor is a lack of understanding of how monetary and fiscal policy interact.

Recent reports that federal deficits over the next several years might be higher than originally anticipated have wrought havoc in the

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

markets. I believe that investor fears in this regard are, to a great extent, unwarranted.

Let me first emphasize that what I am about to say is not offered as, nor should it be taken as, a defense of deficit spending. Deficits are always undesirable and whenever possible should be avoided. However, I do not believe that recent news of larger deficits should have produced the degree of gloom that it has. Markets should have experienced, at most, a dull headache; instead, they experienced a paralyzing stroke!

In the past, there were two reasons why apprehensions about larger federal deficits were well-founded. Neither reason is relevant to today's circumstances.

Until recently, the Fed was unwilling to tolerate the upward pressure on interest rates produced by budget deficits, and usually countered such pressure by accelerating money growth. As a result, inflation would accelerate and, ultimately, interest rates would rise. There are important reasons why such a response should no longer be anticipated.

Since October 1979, and following the Fed's "learning experience" in 1980, monetary policy has focused primarily on controlling the monetary aggregates rather than stabilizing interest rates. We no longer try to constrain short-term fluctuations in interest rates.

Also, in the past it was always assumed that the Fed, by accelerating money growth, could bring about a reduction in interest rates, at least temporarily. This assumption is no longer valid. As I have discussed previously, the old-time link between faster money growth

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

and lower interest rates is no longer applicable. Therefore, it is erroneous to assume that deficits will generate inflationary responses by monetary policymakers.

Yet, even if we assume that the larger projected deficits will not be monetized by the Federal Reserve, won't government borrowing to finance the deficits drive up rates? The answer is not the unequivocal YES that we might have given in the past.

There is no question that an increase in the government deficit represents an increase in the government's demand for credit. We also know that if the supply of credit, and private sector demand for credit, remain constant, increased government borrowing must cause interest rates to rise. But today there are two mitigating factors that have to be taken into consideration. First, the anticipated increased deficit will not be caused by an increase in government spending but rather by a decrease in revenues collected from taxes. The reduction in tax rates will generate additional savings, and thus, there will be a relative increase in the supply of credit. This, in turn, will lessen the upward pressure on interest rates.

Furthermore, interest rates are affected by total demand for credit, not just government's alone. Much of the anticipated rise in the deficit is associated with a decline in the economy, and this should cause government revenues to be reduced. As we well know, a soft economy also implies a slowing of private borrowing. Under these circumstances, it is doubtful that total borrowing will rise substantially, even in the face of larger government deficits. Thus, concern about the adverse effects of currently anticipated deficits has, in my opinion, been overblown.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

In closing, may I express the hope that my comments about common misinterpretations of monetary and fiscal policy actions are not taken by you as criticism of the basic good judgment of markets and those who participate in them. Experience has clearly demonstrated that in the long run markets are reliable barometers of what is happening and what can be expected in the future.

On the other hand, these are especially critical times in the course of economic events in our Nation. Both monetary and fiscal policy are being conducted in a manner sharply different from the inflation-generating practices of earlier times, and any analysis of their effects must be adjusted to the changed environment. It is important, both for those who formulate policy as well as for those who interpret policy, to have a clear understanding of what is happening. Furthermore, it is essential that the general public understands, and hopefully supports, policies and practices that are necessary to eliminate inflation.

Clear thinking is essential if we are to avoid a repetition of past mistakes. The biggest problem we face today comes from those who advocate abandoning our anti-inflationary effort and returning to expansionary policies that they mistakenly believe would bring relief from the temporary pain of high interest rates and sluggish economic activity.

It would be a tragedy to opt for such an "economic Dunkirk." This is a time for resolve, not retreat! A return to policies of monetary and fiscal expansionism would rekindle the fires of inflation and cause interest rates to rise above their present levels.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

You, as participants in financial markets, have an important role to play in raising the economic awareness of America. I hope that my comments have been of some value and that you will continue to advise your clients in a realistic manner so that they, in turn, will be able objectively and constructively to choose those policy options best suited to our future well-being.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis