

# ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

## Must the Fed Fight Growth?

by Jerry L. Jordan

If all of your information about the economy came from the nightly news and the daily press, your thinking would probably go something like this:

"A funny thing happened on the way to this economic boom. The economy gave a party and the Federal Reserve didn't come. Just as U.S. business activity was poised to burst from under the lingering shadows of the 1990-91 recession, monetary policy took a decidedly restrictive turn this year. Apparently, central bankers have been willing to sacrifice economic expansion in order to tilt at inflation windmills existing only in their own hyperactive imaginations."

For evidence that this interpretation of policy is widespread, one need look no further than a recent headline reporting the Federal Open Market Committee's (FOMC) latest move: "Federal Reserve Raises Key Rates to Curb Growth." So said the *New York Times*. So says Conventional Wisdom.

But is Conventional Wisdom in fact wise? I think not. This *Economic Commentary* examines what I believe are three fundamental misconceptions about current monetary policy:

- Interest rates paid by households and businesses would have remained low if monetary policy had remained stimulative.
- Rising federal funds rates — or, more specifically, overnight interbank loan rates — will shorten or retard the current expansion.

- The monetary authorities control inflation by regulating the real growth of the economy.

These beliefs have arisen as false corollaries to two general observations about modern industrial economies, namely, 1) the level of interest rates affects private spending, and 2) periods in which spending on current output accelerates are followed by periods of higher inflation.

These familiar assertions are a standard part of macroeconomic analysis. As such, I would not enjoy the task of undermining their acceptance and make no attempt to do so here. What I do want to accomplish is to confront the current mythology surrounding monetary policy actions by combining these propositions with two others: 1) inflation results from too much money chasing too few goods, and 2) the Federal Reserve is charged with achieving multiple — and often conflicting — economic objectives, as opposed to being held accountable for price stability alone.

I want to emphasize this last point. Not only does the U.S. central bank lack a clear statutory responsibility for price stability, but the very meaning of that term is subject to a great deal of ambiguity. The absence of a fully credible commitment to the stable purchasing power of the dollar has led to over-interpretation of every twitch, sneeze, and cough by monetary policymakers.

In a recent speech, Federal Reserve Bank of Cleveland President Jerry L. Jordan responded to critics who assert that the Federal Reserve intentionally slows the real growth of the economy in order to keep wage and price pressures in check. In Jordan's view, the critics have it backwards: Monetary policy actions aimed at stabilizing the purchasing power of money are the best way to enhance real growth in the long run.

### ■ Why Do Interest Rates Rise?

By way of analogy, let me start with a different question. Why does the price of apples rise? The answer, of course, is simple. The price of apples rises along with the cost of everything else when the purchasing power of money falls — the phenomenon referred to as inflation — or when there is a fundamental change in demand or supply. If demand increases or supply falls, prices rise.

This simple example is directly relevant because an interest rate, after all, is really just a price. In particular, it is the price paid to savers and by borrowers. Like apple prices, then, interest rates pick up either because the rate of inflation increases (more precisely, because the *expected* rate of inflation increases), or because there is an excess demand for the funds that are provided by national saving.

For instance, an orchard blight would boost the price of apples while reducing the quantity demanded. In this case, we would be inclined to believe that the price increase is unwelcome news for apple lovers. However, suppose a credible scientific report indicates that apples can prevent a variety of diseases. Prices then rise because of a boom in apple demand — and a corresponding drop in the demand for something else, such as oranges — and everyone is perfectly willing to see the hikes for what they are: the natural consequence of market forces responding to buyers' increased desire to consume apples.

The failure to think carefully about what is happening to the demand for credit leads some people to ignore the possibility that rising interest rates are merely a by-product of better times. In periods of expanding output, economic prospects brighten, and households and firms respond with a heightened desire to consume as well as invest. In financial markets, these desires translate into a reduced incentive to save and a greater incentive to borrow. The result is higher interest rates.

Economic developments over the past several years have been highly unusual. The first two years of the recovery that commenced in April 1991 were anemic by postwar standards. Dramatic cuts in defense spending, problems in the commercial real estate sector, and a striking weakness in job markets have been a hallmark of this business recovery. Because of these extraordinary factors, expectations of better times were slow to materialize. As a result, demand pressures in the aggregate economy did not emerge, and both short- and long-term interest rates continued to fall until last October — *two and a half years* into the expansion.

As of last autumn, market expectations of nominal growth had been converging to 6 percent, and the subsequent drop in long-term bond yields reflected that consensus forecast. Sometime during the second half of 1993, the tide began to turn, and the economy entered a period more like the first year of a typical recovery than the third. After languishing for more than two years, the long-anticipated pickup in employment finally materialized in the first six months of 1994, and most forecasters now expect the rate of output growth for the current year to reach its highest level since 1988. As sentiment has shifted in the direction of somewhat faster real growth — and somewhat greater price increases — expectations about total spending in the economy have risen.

In such an environment, higher market interest rates were inevitable. Apart from engineering steps to reduce the public's expectations of inflation, there was nothing the monetary authorities could have done. And, with the exception of adopting such a policy stance, there was nothing they *should* have done.

### ■ Tacking toward Neutrality

Rising market rates are indeed important for understanding recent monetary policy actions, but not for the reasons that are generally believed. The central bank does not control mortgage rates, car loan rates, or corporate bond yields. It controls the supply of money. Unfor-

tunately, though, the monetary authorities have considerable difficulty in estimating — and certainly do not control — the amount of money balances people want to hold. This is critical because, in the words of Milton Friedman, inflation is everywhere and is always a monetary phenomenon.

This crucial point is often muddled because the central bank employs interbank lending rates to control the quantity of money. If the job is done correctly, money growth will equal money demand, so the price level will be stable. This requires that as general economic conditions change, the interbank interest rate consistent with this result will also change.

Sailing provides a good analogy. The helmsman of a boat leaving New England bound for the Bahamas must set the tiller based on wind direction, tides, and currents. Those of you familiar with sailing the Atlantic know that it won't be long before the sailor is confronted with different wind and water conditions than those that prevailed near the coast. Experience, of course, will lead him to adjust the tiller in response to evolving conditions. This certainly does not imply a change in destination. Quite the opposite. The adjustment is *required* if the boat is to have any hope of reaching the Bahamas as planned.

This is how I would like the public to think of recent monetary policy moves. In response to the changing economic weather, it is imperative that the central bank adjust the monetary tiller, lest we drift further and further away from the goal of price stability.

### ■ Are Recent Policy Moves Pro-Growth?

The rationale for focusing on the purchasing power of money is rooted in the overriding goal of maximizing social welfare. By any rational calculation, this requires that policy be devoted to promoting conditions that yield the highest rate of sustainable economic growth in the long run. Sound money is crucial to sustained prosperity.

Any drift in the price level, even if fully expected, induces expenditures aimed at insulating the fruits of labor and investment from inflation-created increases in tax burdens. Even so-called stable and moderate inflation requires excessive churning of financial assets, as ever more sophisticated cash management strategies are needed to avoid the ongoing erosion of the purchasing power of money. All of these activities absorb resources, which boosts the cost of production and ultimately hampers the economy's long-run growth.

Furthermore, when the price level is uncertain, market participants face the prospects of capricious and unanticipated redistributions of wealth. As a result, doubts about the dollar's future purchasing power channel resources away from the direct production of consumption and investment goods and toward activities that serve only to protect decisionmakers from the negative-sum reallocative consequences of inflation.

Achieving price stability would be like a positive technological advance. It would release resources from inflation hedging/risk avoidance activities and boost the amount of real goods and services that can be produced with the economy's existing resources. In this way, moving toward price stability is pro-growth.

#### ■ Does Price Stability Require the Fed to Fight Growth?

Bond market participants, the financial press, and so-called "Fedwatchers" consistently react to economic indicators that point toward stronger real growth by citing the possible inflationary consequences of an economy that is expanding too quickly. I believe that this view is largely a reflection of the absence of a credible commitment to price stability. Announcement of clear and verifiable multiyear targets for the price level would be one way to build credibility. With such a commitment, short-run deviations from these targets could be accommodated without eroding the public's confidence in the purchasing power of the dollar. At the least, the lack of such a credible commitment

traps public discourse into the unproductive and perverse rhetoric of treating growth as undermining price stability. At the worst, we are all duped into accepting the rhetoric as reality, ultimately leading to policies that are destructive of both economic growth and a stable and predictable monetary standard.

#### ■ Communication Breakdown

Many economists, and the news media in general, think that central bankers are more interested in inflation control than in economic growth (as if there is a trade-off) and that we must deliberately slow the economy in order to achieve an inflation objective.

The economic view leading to these conclusions is a combination of a "slack model" and a perceived need to fine-tune aggregate demand. The Federal Reserve is regarded as responsible for continuously manipulating the level of total spending in the economy to equal some estimated level of potential output. (Parenthetically, this line of thinking also exposes the monetary authorities to all of the political problems that arise when actual levels of output and employment are not "high enough" to suit the needs of the electoral cycle.)

If households and businesses throughout the nation — as well as our elected political leaders — knew and agreed that all central bank actions were, and should be, focused on achieving the highest sustainable rate of real economic growth, the timing of particular actions would not generate much news. If it were generally believed that monetary policy would be steered to achieving this end by a single-minded pursuit of sound money, then specific short-run adjustments would have no more meaning than the helmsman's adjustment of the tiller when the wind shifts.

From now on, when you see a story that says "Fed Raises Interest Rates to Slow Housing Starts" (or auto sales or economic growth), I hope you will think about matters differently. The short-term interest rate policies of the FOMC cannot be simply characterized by references to "tightening" when interbank rates rise or "easing" when they fall. A 3 percent federal funds rate with inflation expectations of 3 percent, and rising real interest rates, would be quite expansive and inconsistent with the pursuit of price stability. However, that same funds rate may be perfectly appropriate when inflation expectations are falling toward 1 percent or so.

Progress in the conduct of monetary policy would be greatly enhanced by a vigorous effort to eliminate the notion that adjustments in monetary policy are intended to manipulate real economic activity in order to control inflation. In reality, it's the other way around. Monetary policy actions geared to promoting price stability will enhance real growth over time.

Just as a boat cannot sail toward two destinations simultaneously, the tools of monetary policy are not capable of achieving multiple goals — at least not in the short run. An explicit commitment to a multiyear price level objective would increase the short-term flexibility of policy and also promote higher standards of living in the future by steering us toward the one destination that the central bank — and the central bank only — can reach: a stable currency.

*Jerry L. Jordan is president and chief executive officer of the Federal Reserve Bank of Cleveland. The text of this Economic Commentary was excerpted from a speech that President Jordan presented in Cleveland on June 24, 1994.*

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