

THE ROLE OF INTEREST RATES IN FEDERAL RESERVE POLICYMAKING: DISCUSSION

Stephen H. Axilrod*

I have no genuine quarrel with Benjamin Friedman's excellent paper. It has covered the important questions at issue and has done so with Friedman's usual combination of analytic and empirical acumen. My comments should be viewed mainly as cutting across his subject matter with a different slant now and again, drawing in part on my experiences on the staff of the Federal Reserve Board in Washington and of the Federal Open Market Committee. It was of course in connection with the debates on monetary policy of the 1970s and 1980s that I came to know Frank Morris as a person of intellectual distinction, with an eclectic, pragmatic, and thoughtful approach to monetary policy that enabled him serve the country so well at times of considerable structural change in finance and the economy.

INTEREST RATES OR MONEY AS A GUIDE

The great appeal of interest rates, or more particularly some one interest rate, as a guide for day-to-day implementation of monetary policy is precisely that a rate target may lead you less astray than monetary aggregates in the face of shocks that affect the structure of finance. Of course, nothing—whether some aggregate or some interest rate—works well as a guide if policymakers are too sluggish in their adjustments. Indeed, one of the main practical arguments against using an interest rate guide was that policymakers in the nature of the case tend to move slowly and carefully in changing their policy directives. In that

*Global Economic Consultant. Formerly Staff Director for Monetary and Financial Policy, Board of Governors of the Federal Reserve System.

light, a money guide seemed to have the advantage of forcing more interest rate movements more quickly than would occur if policymakers were voting directly on a particular interest rate. I hasten to add that I am not arguing that policymakers should always make large changes; obviously, at some times, under some circumstances, it pays to be sluggish.

A money guide, rather than an interest rate, is a good thing mainly if shocks to the economy are coming from the side of demand for goods and services, but it is not such a good thing if shocks are coming from the money demand side, as Bill Poole long ago pointed out. Indeed, the FOMC got itself into considerable trouble in the 1970s, losing credibility as the inflation became larger than either it or the public expected. This happened in part because the FOMC did not adjust its rather weakly held, but not uninfluential, intermediate-term narrow money targets downward quickly enough in response to the shifts in money demand under way at the time, with the effect of leaving money market interest rates too low too long. To be fair, it also happened because the Fed tended to overshoot money targets even at times during the decade when demand shifts were not a significant complicating factor and then, by shifting the target base, failed to compensate for the overshoot.

The only time the Fed held firmly to a money guide and let interest rates go more or less where they might was in the famous and historically unique 1979–82 period, when the FOMC adopted a money supply guide, implemented through a nonborrowed reserve target, for the Trading Desk in New York. The federal funds rate was permitted to vary without constraint (within a broad range). This was termed “practical monetarism” by then Chairman Paul Volcker, and the policy approach was adopted as a way of bringing inflation down fairly quickly and reestablishing the credibility of the Fed.

There was much discussion at the time in the press about whether the FOMC adopted the new policy approach because it believed in money or because it just wanted an excuse, so to speak, that would let it try to avoid direct responsibility for the very high interest rates that ensued. Whatever the reasons for each member’s vote—and the reasons apparently were diverse—the policy was presented to policymakers largely on the technical grounds that if the FOMC wanted closer control over money, such control was more likely to be achieved with a nonborrowed reserves day-to-day target than if the Committee attempted to judge, with whatever help the staff could give, the day-to-day federal funds rate the Desk should aim for. Taking account of the clear and present danger of an ongoing inflation that was threatening to get even more out of hand, the innate conservatism of decision-makers dealing with so powerful an instrument as monetary policy also tended to argue for adopting a target that did not have to be changed frequently or by large amounts in order to have substantial effects.

In any event, the policy of practical monetarism lasted for only about three years, until it had to be abandoned as demand for money proved to be even more unpredictable and more highly interest elastic than thought and as focus shifted to encouraging economic growth following the sharp recession and the surprisingly low rate of inflation that resulted from the policy. The Fed's relationship to interest rates was then restored to center stage—well not quite, since the Fed remained reluctant, as ever in those days, to admit that it made a decision to set any particular interest rate.

The day-to-day target became borrowing by banks at the Fed and not free reserves, which the Desk can in fact control, partly because (I am guessing) that term seemed to recall a policy that was regarded by some as old-fashioned, not to say antiquated. But borrowings were set with an expectation that the funds rate would behave in a certain way. When it did not, something of a problem resulted. In practice, the staff had the right to alter the assumption necessarily made about excess reserves for operating purposes, which helped keep the funds rate within its desired area. But sometimes, and the near failure of Continental Illinois Bank in 1984 was a case in point, the conflict between a borrowing objective and an expected funds rate was unavoidable. The funds rate actually rose above expectations at the time because large banks suddenly wanted to avoid borrowing at the discount window for fear of being tarred with the same brush as Continental. To avoid the rise, the borrowing target would have had to have been lowered. Thus, the issue arose, and Frank Morris was a key participant in the debate, about whether the Desk should or should not have paid more attention to the funds rate, given the sudden downward shift in banks' demand for borrowing.

This is one example, among others, of a practical way in which the Fed's traditional desire to be as silent as possible about interest rates, even to the extent of a certain ambiguity about a rate chosen as an operating target, led to a policy outcome that was both unanticipated and avoidable. The Fed's attitude is understandable. It has the power to set a single interest rate. If it expresses a desire, and follows through in action, that will be the rate in the market. For the rate that is chosen as an operating target—the funds rate in today's world—that would seem to pose no real problem. Nonetheless, if policymakers want a bit of flexibility within a limited operating range, then there is the temptation to avoid focusing on the rate alone, and thus permit a bit of discretionary variation in it during the course of operations in response to market forces, as it were, making the rate appear to be a bit more market-determined than Fed-determined. This is not unrelated to the main argument for the central bank keeping silent about interest rates other than its operating target. In that very clear case, if the Fed expresses a desire about any of them, and here I would include stock prices, and does not follow through (as was the case with money supply guidelines in the 1970s), the Fed will lose credibility and presumably bad things will ensue (as they did in that earlier decade) in

terms of the Fed's ability to attain its basic economic objectives without untoward economic and financial dislocations.

NOMINAL OR REAL RATES OF INTEREST

Whatever ambiguity the Fed may have harbored about being extremely clear about its short-term interest rate operating target in the past, it no longer feels that way. Since early 1994, a nominal federal funds rate objective for open market operations has been announced. Moreover, a real funds rate appears to be in its mind when setting the nominal rate. In that respect, however, the Fed's attitude seems less than crystal clear to me. Whether it is clear to the policymakers I do not know, but it probably should not be, given uncertainties about the prevailing real return on capital and its measurement, questions about how to measure the real funds rate itself, uncertainties about the relation of any particular real funds rate to the real rate of return as perceived by businessmen, and questions about how a given funds rate will affect behavior of the yield curve and the stock market, which are more important determinants of the real cost of capital than the funds rate itself.

Indeed, if one takes the position that, under current economic conditions, the real funds rate needs to be higher than whatever was its past norm because the real return on capital has increased (as evidenced by the productivity and profits boom)—a view that the Fed appears to have expressed (and with which I agree)—it is not so very clear why one should not directly set and adjust as needed a long-term interest rate target instead of a short rate, since, for instance, the corporate bond yield should be more closely connected with the longer-term real return on and cost of capital than a short rate. (Short rates would seem to have been more important at times when inventory cycles were a more dominant factor in economic variations than they are now.) Of course, I am being more provocative than practical and I do recognize how advantageous it is to leave the bond market vigilantes free to do some of the work in containing inflation. But at least the question helps make clear that the one interest rate, or monetary aggregate for that matter, that the Fed chooses as a guide to policy is little more than a convenience for instructing the Desk, and the real questions revolve around how quickly and with what intensity the Fed alters these instructions and how the Fed views whether it is or is not doing enough.

PROJECTIONS OF REAL ACTIVITY

One way of focusing on whether action taken is sufficient unto the day is to rely on projections of changes in economic activity and in the average price level. The Fed staff are probably better at that than anyone else, but even they are not perfect. Moreover they, like anyone else,

would have to make assumptions about future policy. The most common one would be to leave policy unchanged, whatever that can be interpreted to mean, since even if a funds rate were assumed unchanged, yield curves and the stock market, not to mention the unmentionable money supply or liquidity conditions in general, would be likely to alter their behavior. At any rate, if the staff has any leeway with respect to policy assumptions or related market impacts, the tendency might well be to use it to avoid projecting significant recessions or inflations. After all, why should, and how in practice can, an institution assume that it would be undertaking policies that it sees as leading to a distinctly unfavorable outcome?

Whatever the extent to which policymakers rely on projections for making policy moves, they still need something current, something that is happening now, at the same time policy is changed, to help them judge whether they are going in the direction they think. Obviously, the exchange rate and interest rates other than the funds rate are key indicators, along with the many well-known real economic indicators, but they all reflect demand conditions within the economy as well as whatever changes have been wrought by that great force exogenous to the economy and its financial markets, the Federal Reserve. For instance, the Fed may think it is easing by lowering the funds rate, but it may be doing much less than it thinks. How to judge it on a current basis? What represents the Fed itself? I am afraid one has to look at the monetary base. If it has not accelerated from recent trends after a drop in the funds rate, one can argue that the Fed has not added more to supply than it had been doing, that the drop in the rate was driven by weakening money and credit demands, with the Fed just riding along, not basically being an impelling force.

THE CURRENT ROLE OF MONEY SUPPLY MEASURES

Of course, in interpreting monetary and reserve aggregates, there remains the enormous problem of judging whether the structure of the public's demand for money assets has or has not shifted in ways that the Fed should be accommodating. That interpretive problem would loom even larger if I were arguing that the monetary base, or some measure of the money supply, should be a primary guide to policy. I am not. Instead, I am arguing here that the Fed at least needs to look at second differences in such measures over a relatively short-run period, to help in judging whether it is merely being passive in the face of changing conditions or is instead getting ahead of the curve, so to speak.

Still, something can be said for keeping in mind that the Fed should not ignore its need for a nominal anchor over the longer run. Friedman has discussed this at some length, and much more ably than I can. With monetary aggregates apparently no longer perceived as adequate to the

task in many countries, inflation targets themselves have come to be seen as a reasonable substitute. On that issue, if they must be expressed numerically, my sympathies lie with expressing them in a relatively broad range, since that will allow a central bank sufficient flexibility also to take account of the state of real economic activity in its policy adjustments. Best of all, though, is probably the Fed's traditional stance of giving its inflation target in the qualitative terms of reasonable price stability—which, of course, has practical significance only so long as the Fed has anti-inflation credibility.

A final brief word about the stock market and value of assets as policy guides. They are not really guides but just one more factor among many in setting day-day policy objectives. I would interpret the stock market rise in the few years up through the spring of this year as in good part inflationary, and also in good part real, reflecting the productivity boom. I do not mean that the inflationary part of the stock price increase necessarily presages a lot more inflation in goods and services prices. It already has to a minor degree this year. Rather, I mean that the stock prices are, to a degree, part of inflation, in the sense that too much money has to some extent been chasing too few stocks, just as too much money often chases too few goods. As a result, businesses are tempted to make excessive investments because the cost of capital seems so cheap and consumers are tempted to spend a lot and incur debt because they feel so wealthy.

Seldom has inflation, whether reflected in goods and services or stock prices, been wrung out of the economy without a recession. The Japan of the 1990s is an obvious recent example of a recession induced by the collapse of an overheated stock market at a time when inflation in goods and services was quite moderate. The stock market crash in the United States in 1987 was not immediately followed by recession, but I would argue that the Fed created more inflation in goods and services prices in the following years to avoid such a result, and that the subsequent recession in the early 1990s can be attributed to efforts to suppress that upsurge of inflation. (I understand that interpretations are clouded by the influence of the Gulf War.) Perhaps the coming years will be an exception, but who really knows? We certainly have the fiscal flexibility now to help monetary policy out, should the worst occur.