

The Federal Reserve's Role in Promoting Economic Growth

By Roger Guffey

Each policy directive of the FOMC contains a statement of the goals of Federal Reserve monetary policy. One of those goals is to "promote growth in output on a sustainable basis." It has long been recognized that only through sustained economic growth can we improve living standards, increase job opportunities, and help to achieve other national economic priorities. In addition, several of our current economic problems—such as the international debt situation, the federal budget deficit, and the financial stress in agriculture and other important sectors—can best be managed in an environment of economic growth. For all these reasons, therefore, I believe sustained economic growth should be the preeminent long-run goal of economic policy.

What can the Federal Reserve contribute to achieving this goal? It should be recognized that the Federal Reserve's role in promoting economic growth is a limited but important

one. It is limited because many factors outside the control of monetary policy influence economic growth. It is nonetheless important because the economy cannot realize its growth potential without reasonable price stability,

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which is largely within the control of monetary policy. In my view, therefore, the major contribution that monetary policy can make to sustained economic growth is to ensure reasonable price stability.

Not all would agree with this assessment. Some have argued, for example, that monetary policy can and should promote growth by keeping interest rates low. They reason that low interest rates encourage capital investment, thus raising productivity and economic growth.

The flaw in this argument is that capital investment depends on real interest rates,

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which are affected by monetary policy only in the very short run. It is true that easy money and credit can temporarily depress market interest rates. However, as soon as the inflationary consequences are realized, the inflation premium in nominal rates rises, pushing market rates up enough to restore real rates to their previous levels. As a result, holding market rates down by inflationary growth of money and credit will not stimulate investment. Indeed, past experience suggests that by

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increasing uncertainty, inflation leads ultimately to higher interest rates and lower stock prices. Therefore, keeping market interest rates artificially low is at best ineffectual and at worst counterproductive in achieving sustainable economic growth.

The need to focus on real rather than nominal interest rates demonstrates a more general principle—that economic growth is determined primarily by real factors rather than by credit conditions. The savings rate determines how much output can be devoted to investment; changes in technology and consumer preferences create profitable opportunities for capital investment; and investment increases productivity growth, which is the driving force behind sustained expansion in output. These real factors, not nominal interest rates, are the fundamental determinants of economic growth in the long run.

Economic policy, nevertheless, has a role to play in promoting economic growth. Fiscal policy—the government's taxing and spending decisions—affects incentives for saving and

investment. In this regard, I welcome the national debate stimulated by the Treasury Department's recent tax proposal. If a "flat tax" or some other tax system would enhance incentives for economic growth, such a system should be given serious consideration. It would be unfortunate, however, if discussion of tax reform diverts attention from the most pressing fiscal issue—the budget deficit. With the federal government absorbing up to one-third of private sector savings, too little is left over for the productive investment necessary to sustain economic growth. Moreover, the high interest rates and strong dollar that have accompanied large budget deficits threaten to damage irreparably some domestic industries that could otherwise contribute to economic growth. In short, bringing down the budget deficit is the most important fiscal policy action that could be taken to improve prospects for balanced and sustained economic growth.

Monetary policy has a role, too. That role is to provide a stable financial environment for economic decisionmaking. Such an environment requires stability not only of the financial system but also of the aggregate price level. Reasonable price stability is necessary to ensure that the market system efficiently allocates real resources to the productive sectors of the economy that drive economic growth.

It used to be thought that money was neutral in the long run because growth in productive capacity was independent of the inflation rate. But experience indicates otherwise. While economic growth is determined fundamentally by real factors, experience shows that inflation can depress real growth. In the 1950s and 1960s when inflation was low, output grew at a rate of about 4 percent a year. Since inflation began to accelerate in the early 1970s, though, real growth has slowed to less than 3

percent. To be sure, oil shocks and other real factors were partially responsible for this slowdown. But high and volatile inflation also contributed. Inflation created uncertainty, depressed capital investment, diverted resources from the real to the monetary sector, and impaired the efficiency of the market system. That experience taught us that the economy does not function well with high and volatile inflation. The experience also taught us that the Federal Reserve can best contribute to sustainable economic growth by fostering the expectation and the reality of a stable price level.

The long-run goal of achieving price stability has been the guiding force of monetary policy in recent years. The FOMC has sought to bring inflation down by gradually reducing the annual growth ranges for money and credit aggregates. Although regulatory changes and financial innovation have altered money demand relationships and thus required occasional adjustments in these ranges, the basic strategy has remained intact. This strategy of monetary restraint has led to substantial progress in reducing inflation from the double-digit rates recorded in the late 1970s.

Progress toward price stability achieved in recent years has already improved the nation's economic performance. Lower inflation and the associated improvement in inflation expectations have boosted consumer and business confidence. This improved business confidence has been particularly important because it has created an environment conducive to a capital investment boom, which not only has added to the strength of the current expansion but also has raised future productive capacity. As a consequence, the Federal Reserve's policy of monetary restraint has already borne fruit in promoting long-run economic growth.

Experience in 1984 typifies the Federal Reserve's attitude toward money growth and

inflation. When monetary growth ranges were established in February last year, FOMC members expected that growth within those ranges would be consistent with nominal GNP growth of 9 to 10 percent, divided about evenly between inflation and real growth. In the first half of the year, extremely rapid growth in nominal GNP threatened to intensify inflationary pressures and produce monetary growth above the announced targets. In response, increased pressure was applied on reserve positions of depository institutions, and the discount rate was increased. Some critics described these restrictive actions as being "anti-growth." To the contrary, such actions were designed to support sustainable real growth by preventing reacceleration of inflation. Indeed, as growth of money and spending slowed after midyear and it became apparent that inflationary pressures were being contained, the FOMC responded by reducing pressure on reserve positions and lowering the discount rate.

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Economic developments last year were very favorable. Nominal GNP growth of about 9 1/2 percent was in line with FOMC expectations and was accompanied by growth of M1 and M2 near the midpoints of their ranges. Because of favorable supply-side developments—such as declining oil prices, a strong dollar, and continued moderation of labor costs—this GNP growth was associated with more rapid real growth and less inflation than initially anticipated. It is gratifying that larger output and employment gains were possible without producing incipient inflationary pressure that would ultimately undermine economic growth.

Looking ahead to 1985, I believe the approach to monetary policy should be similar to that of the past year. The announced ranges for monetary growth are consistent with continued economic expansion. Private forecasters predict real GNP growth of about 3 1/2 percent this year. Based on experience last year, I believe the Federal Reserve should be prepared to accommodate this or even higher real growth as long as it is not achieved at the price of a higher trend inflation rate. We do not know how rapidly the economy can grow in this third year of recovery without putting excess demands on labor and product markets. We do know that allowing such excess demands to persist will lead eventually to higher actual and expected inflation that would erode the foundation for sustainable growth. It

would be irresponsible for the Federal Reserve to pursue such a myopic policy of allowing excess demands to persist. We did not do so last year and should not do so this year.

In summary, the nation's overall economic objectives can best be achieved within a framework of sustainable economic growth.

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For this reason, both monetary and fiscal policies should be aimed at achieving this laudable goal. The major contribution that monetary policy can make to sustained economic growth is to ensure reasonable price stability.