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The Fed: Return to Interest Rate Control?

The Europeans are putting increasing pressure on the US administration to follow an economic policy which takes their interests more into account. At the top of their list is the wish for lower interest rates so that they will not be forced to choose between too high interest rates and too expensive dollars. The second wish which the Europeans express with one accord is that for steadier dollar rates.

The Europeans are flogging a willing horse with these wishes in Washington. The Reagan administration is just as interested as they are in a realistic dollar rate. For while an overvalued dollar gives wings to American direct investments abroad, it also weakens the international competitiveness of the American economy. Nor are high, fluctuating dollar interest rates a goal of US economic policy but, rather, a by-product of the collision between monetary anti-inflation policy and high, steeply rising budget deficits. If the US government had a prescription for fighting inflation, and for financing rearmament while at the same time drastically reducing taxes, without having to put up with high interest rates and – as a result – exaggerated appreciation of the dollar, then she would certainly be only too pleased to do so. And the Federal Reserve System (Fed) would be just as willing to follow any proposal which promised an effective anti-inflationary monetary policy without fluctuating interest rates and with a low real interest rate. But there are no obvious simple solutions for the entire problem.

Moral appeals in the course of consultations will change neither American policy nor the Europeans' situation. Consultations can only hold promise of success if alternative policies are put forward which serve American interests at least as well as, if not better than, current economic policy and at the same time are less harmful to the Europeans.

In this situation it would make sense to consider suggestions for easing at least a part of this complex of problems: it has been observed for some time that the American money markets react to the weekly publication of the money supply data with hectic interest rate changes – not, as might be expected, with reductions in interest rates when liquidity was particularly high, but with increases in interest rates due to the anticipation of restrictive measures on the part of the Fed. But fluctuations in money supply from week to week should not cause unrest – and certainly not panic – in either the Fed or the markets. Within these short intervals random factors are dominant, which does not allow the drawing of conclusions as to the direction of monetary policy. A conclusion can only be drawn when the changes in the money supply are lasting. A contribution to calming the money markets could probably be made simply by publishing monthly data instead of weekly data, and this with a time-lag.

These attempts to achieve stabilisation within the framework of a policy geared to money supply cannot, however, offset the fluctuations in money supply, interest rates and exchange rates caused by the spreading of financial innovations in the USA's financial sector and which are, not least of all, due to the removal of regulations in the banking sector. This results, namely, in drastic changes in the behaviour of the demand for money, which make it difficult for the Fed to delimit the relevant quantity of money at all – as shown by the repeated

revisions of the definition of narrow money supply (M1) – and, in addition, to determine the appropriate amount by which the money supply should be expanded. Since the cause of these difficulties is to be found in the rapid changes of monetary structures and behaviour, even the principle of gearing monetary policy to the money supply must be called into question. After all, control of the money supply prevailed against a monetary policy aimed at a target interest rate with the argument, money supply policy was superior because the demand for money tended to be stable and instabilities would be introduced into the economy predominantly by real shocks – such as changes in expectations regarding profits. If, however, monetary upheavals are clearly dominant, then a theoretical analysis leads us to recommend the control of interest rates. The present situation is, however, characterised by an upheaval of both monetary and real structures. The reduction of direct taxes leads to a redistribution of disposable income; the inflation of the military budget alters the structure of production in favour of the armaments industry, raises the latter's prices and possibly increases inflationary expectations; all that is known regarding the budget deficits is that they will be unusually large – what effect this will have on interest rates and inflation is, however, hotly disputed. All of this has made the markets extremely insecure. Their reactions are last but not least due to their vacillation between euphoria and disappointment.

Considering the disorientation which emanates from the US government and from the decreasingly informative content of the money supply target as an indicator of the monetary impetus to be expected, there is much to be said, in the case of the USA, for again attaching more importance to the control of interest rates, which was abandoned two years ago, and for doing so at least until the US financial markets once more show stable structures with foreseeable reactions. A steadying of short-term interest rates on the part of the Fed would have the advantage that the fluctuation of long-term interest rates and of the dollar rate would also be reduced. Whether or not the resulting fluctuations in the growth of the money supply would be stronger and more disadvantageous than before, remains to be seen.

Such a change in monetary control would be a relief also to the Europeans, whose interest rates and exchange rates are, with free movement of capital, closely tied to the dollar area. Of course, the Europeans could escape the American influence on their interest rates by allowing the dollar rate to free float. However, they are afraid that this would provide an impetus for inflation or even lead to a vicious circle of inflation and depreciation. Moreover, a fluctuating dollar rate is a disturbing factor for foreign trade and the producers of internationally traded goods. The European central banks therefore seek to offset erratic behaviour of the dollar rate by intervening in the foreign exchange market. The US Treasury could meet the Europeans halfway by intervening on its own account, especially if the Fed cannot bring itself to decide in favour of interest rate control. This would make it possible to offer an appropriately large supply of dollars to iron out the rate in the case of erratic fluctuations in dollar demand. Of course, such interventions carry the disadvantage that they may cause expectations regarding the exchange rate which could counteract the intervention. The US Treasury's negative attitude towards the European requests for intervention is therefore quite understandable.

The return to a steadying of interest rates would, of course, only marginally contribute to solving the problems of the economy. The greatest feelings of insecurity stem from the immense changes in financial policy, which are intended to lead to an increase in productivity and economic growth but which have not as yet exhibited the hoped-for dynamic. One reason for this is reserve on the part of financial circles – Wall Street saw in Reagan's programme both the renewed threat of inflation and short-term strains on capital markets due to higher budget deficits. This assessment of the situation kept interest rates high and at the same time confirmed investors and consumers in their attitude of wait-and-see. The initial impulse therefore did not take place, so that the expected increase in government revenue also failed to materialise and ever rising deficit estimates took the place of the promised balancing of the budget. It is, above all, the risks of this programme which are now the centre of attention, so that the Reagan administration has no choice but to retreat to somewhat less extreme positions.

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