## Roger W Ferguson, Jr: Central banks and markets

Speech by Mr Roger W Ferguson, Jr, Vice-Chairman of the Board of Governors of the Federal Reserve System, at the Bond Market Association 2002 Awards Dinner, New York, 9 October 2002.

* * *

I thank the members of the Bond Market Association for selecting me to receive the 2002 Distinguished Public Service Award. I am particularly honored to join the company of previous recipients, who have included my colleagues Alan Greenspan and Bill McDonough, former Treasury Secretary Rubin, and Senators Christopher Dodd and Kay Bailey Hutchinson.

I understand that the proceeds from this dinner will be used to support the work of the Bond Market Foundation, whose mission includes advancing the financial literacy of disadvantaged Americans. That this is a high purpose is beyond doubt. I know that I could speak for much longer than you care to listen about why the understanding of economics and finance is crucial for individuals in a market economy. Knowledgeable and astute consumers can avoid making those investment errors that come from misunderstanding or being misled. They also promote competition among providers, which benefits us all. Personal financial security enhances individual well-being. And, at a more fundamental level, our social fabric and national image are intimately connected to our material aspirations. The United States cannot be the land of opportunity unless all of our citizens have both the tools and the ability to use those tools to improve their livelihoods and lives. Fortunately, the increasing supply of services provided by our financial system - and the increasing complexity and diversity of product offerings - have increased consumer demand for improved financial education. The Bond Market Foundation, like the Federal Reserve, has been looking for new ways to meet that demand.

There are numerous other ways in which the Federal Reserve and the Bond Market Association, and the fixed-income markets more generally, work together to improve the well-being of our fellow citizens. Obviously, the impulse of monetary policy is transmitted, in part, through interest rates set by the market. We target only the overnight rate, and traders and investors, such as those represented and serviced by those here this evening, determine longer-term interest rates on Treasury and private securities. The resulting structure of rates and spreads in the fixed-income markets can in turn be a valuable tool that we can use when analyzing the current state of macroeconomic conditions and forecasting the future.

Clearly, however, the roles of the fixed-income markets and the Federal Reserve are complementary, not identical. Your role is to allocate scarce savings among competing demands. Ours is to set overall conditions, particularly by maintaining price stability, that allow market prices to accurately reflect supply and demand dynamics. A price system that is accurate in that way supports the market allocation of all resources, including capital, to their most productive uses. At times, markets and Federal Reserve policy are complementary in an additional way. As we saw last September 11, when conditions in markets become so stressed that they no longer function efficiently for pricing and allocating risk, the Federal Reserve may be called upon to provide temporary infusions of liquidity.

However, it is also important to understand the limits of what the Federal Reserve, or monetary policy more generally, can do. First, monetary policy action cannot appropriately be targeted to benefit one industry, region, or economic group. We key our policy on the average macroeconomic condition that prevails, knowing that conditions may vary greatly among industries, regions, and groups. Of course, that means that those individuals and businesses whose conditions are significantly different from the average might feel aggrieved. A closely related logic applies to relative prices. With one major exception, the Federal Reserve does not attempt to adjust the relative price of any class of goods, services, or assets. That major exception is the overnight funds rate. In that market, in which we have a monopoly on supply, we set the price and let the market determine the quantity demanded. We do this because we find that adjusting the price of overnight credit is currently the most efficient way to achieve our mandate of low and stable inflation and maximum sustainable growth. But that is where our monopoly ends. Short-term interest rates are such a powerful tool for central banks because so many other financial assets are priced based, in part, on the price of short-term credit and market expectations about the future adjustment of that price. In all other markets, the forces of supply and demand determine prices.

Some have suggested that under some circumstances central banks should adjust the overnight funds rate to affect intentionally the relative price of another asset class, namely equities. But if a central

bank elevates another set of relative prices to being targets of policy, I believe that it should have strong conviction in two areas. First, that its tool, the provision of reserves to the banking system, will predictably influence that relative price, and with minimal unintended consequences. Second, that adjusting that relative price will, in turn, have a predictable and significant role in achieving our mandate. In the case of equities, I believe that we cannot hold a strong conviction in either regard. The link between overnight reserves and prices of equities is too remote and indirect, and the impact of equity prices on the balance of aggregate supply and demand is too uncertain, for those prices to be a target of policy. To be clear, this is not an argument for never considering prices in asset markets when determining how well we are likely to do in achieving our goals. Monetary policymakers follow developments in the equity and other asset markets as part of the process of evaluating and forecasting economic conditions. That is, the values of equity claims affect spending decisions and help forecast economic activity. But, in that regard, a similar role is played by many other important determinants of spending, including long-term interest rates, the foreign exchange value of the currency, the government's fiscal position, and economic activity abroad. We can employ our one instrument to temper or augment the net effect of changes in these factors on spending and production, but we do not have the tools to respond to each individually. Our tool is most efficiently deployed to adjust overnight interest rates.

There is a more general principle at work here. No doubt, the balance sheet of the Federal Reserve is large and the attention paid to our pronouncements intense. Nobody would deny that central banks can be quite powerful and that monetary policy works, over time. But in the scheme of things, a central bank's ability to smooth asset prices (if it wanted to) or to buffer shocks to spending or production is somewhat limited. The textbooks teach that monetary policymakers can vary interest rates to offset fluctuations in aggregate demand. The reality is that when the shortfall in desired spending is large or arises quite quickly, as was the case last year when businesses slashed their investment plans in light of a perceived overhang of capital, the initial monetary policy offset can be only partial and not necessarily synchronous. Eventually, of course, monetary policy does work; but the lags continue to be unpredictable and both the level of rates and the time required for policy to have the desired equilibrating impact depend greatly on the force of the macroeconomic instability that must be confronted and are not knowable at the start of a cyclical event.

Similarly, the central bank can meet elevated demands for liquidity during times of crisis, but the private sector cannot look to the central bank to eliminate all risk, just as it cannot look to us to support specific subsets of the economy or alter relative prices. Real decisions result in uncertain outcomes, and sometimes the result is adverse. What we can do, of course, is strive to minimize macroeconomic risks - such as the risk that the general price level will fluctuate erratically and unpredictably, as is the case when inflation is high, or that the adjustment of economic activity will be made more difficult because the overall price level is declining.

We can also make your job in pricing and trading risk easier by reducing uncertainty about the goals and tactics of monetary policy in dealing with macroeconomic forces. There have been many changes over the years in how the Federal Reserve communicates with the public. Currently, the Federal Open Market Committee issues a statement to the public shortly after every meeting. The statement provides information about and a rationale for the policy stance adopted at the meeting, the Committee's view about the balance of risks to the outlook, and a tally that identifies how each member voted. The balance-of-risks statement does not itself predict the future course of monetary policy but rather provides the Committee's assessment of the risks to good economic performance going forward. Although this judgment may have obvious implications for policy if those risks are realized, it is up to investors to draw out the expected path of short-term interest rates, looking primarily to incoming data and changed forecasts of the real economy.

The Committee recently chose to identify the votes of members, including the policy preferences of any dissenters, in order to give market participants a more accurate view of its opinions. On too many prior occasions, market participants formed inferences about the Committee's vote, from indirect and frequently misleading sources of information, before the vote was released as part of the minutes after the next meeting. Therefore, we decided to eliminate that potential source of misunderstanding, and, for a central bank, we made that decision relatively quickly. I am pleased with the Committee's quick response, since I believe that part of the trust that the Federal Reserve now enjoys is built on the belief that we will attempt to minimize sources of misunderstanding.

Let me close by thanking you again for bestowing this honor on me. Public service has many benefits. Working directly and indirectly with members of the Bond Market Association was an expected benefit, but receiving this award was certainly an unexpected and much appreciated honor for me.