

For Release 1:00 P. M.
Mountain Standard Time
May 14, 1970

Remarks of J. L. Robertson

Vice Chairman of the Board of Governors
of the
Federal Reserve System

before the

Boards of Directors of the Federal Reserve
Bank of San Francisco and Its Los Angeles
Branch and Area Bankers and Businessmen

Westward Ho Hotel
Phoenix, Arizona

May 14, 1970

The Task Ahead

It is a great pleasure to be out here in sunny Phoenix. However, there is one difficulty that I encounter when I get out of Washington. I find that people are constantly asking me what is going to happen to the economy, apparently assuming that I know the answer. I do not consider myself to be a prophet, and I am not an expert at economic forecasting. The economists are becoming more and more adept at making projections, but I find that sometimes even they get so wrapped up in trends that they make mistakes similar to the one made by an old friend from my home town, Broken Bow, Nebraska.

She was taking her first airplane ride to Europe. Soon after leaving New York, the pilot announced to the passengers that the number one engine had failed. "There is nothing to worry about," he said, "but we will be about an hour late getting into London." An hour later he came on the intercom again to announce that the number two engine had failed. "Don't be concerned," he said. "We have plenty of power in the remaining two engines, but we will now be two hours late into London." Shortly after, he came on again. "Ladies and gentlemen," he said, "I regret to announce that the number three engine has just failed. Please don't be concerned, but we will be delayed an additional hour in getting to London."

My friend turned to the man sitting next to her and said, "Sakes alive! I certainly hope that fourth engine doesn't fail or we will be up here all day."

Obviously it is not always safe to project a trend, and it is difficult to call a change in a trend in advance. I do not intend to project any economic trends today. However, I would like to say a few words about a different kind of trend that should be of concern to all of us. I refer to the trend away from strict adherence to the law. This is not as easily measured as economic data, but it can be observed. And I think that we can forecast with some assurance what its consequences will be if we do not reverse it.

One of the remarkable achievements of any civilization, including our own, is the establishment of the rule

of law. This involves securing the consent of something like 99 per cent of the population that they will abide by certain rules. I do not know exactly what the percentage is, but it has to be pretty close to unanimous consent for the system to work. If any substantial percentage of the population refuses to observe the agreed rules - the law - then the whole system breaks down. We do not have enough policemen and prisons to make the system work if a substantial portion of the population is determined to ignore or defy the law. This was what the British discovered in India when Mahatma Gandhi and his followers resorted to massive civil disobedience.

This is what we recently discovered in our own country when many of our postal employees flouted the law and went on strike. The postal strike was soon followed by another illegal strike, that of the air controllers. These strikes, because of the number of people involved and the number affected, dealt a serious blow to the notion that the law must be obeyed.

However, viewed in perspective, they are only the latest events in a trend of permissiveness and law-flouting that goes back several years. Those who have engaged in illegal strikes have justified and rationalized their actions by pointing to others who have advanced their own interests by defying the law. Every act of defiance, every violation of law that goes unpunished serves to weaken one of the bedrock principles upon which our society is based - that the law must be obeyed. This produces a cumulative effect, which will in the end profoundly weaken and perhaps destroy the rule of law.

This should be of profound interest to all of us. No group, least of all those in the banking business, can sit back and view these trends with equanimity. I am sure that all of you are well aware of what happened to the Bank of America branch at Isla Vista, California. All of you have probably seen the statement attributed to one of the country's leading opponents of the rule of law, Rennie Davis, in which he said that the 1970's would be the years in which to burn the banks.

If we are to reverse this disastrous trend, we must individually raise our voices to demand that the laws of this country be respected and be enforced. They will not be respected if they are not enforced, and they cannot be properly enforced if they are not respected by the overwhelming majority of the people. All of us, government officials, bankers, businessmen, labor leaders, and, in fact, all concerned citizens, must be scrupulously correct in observance of the law. We are going to be in a weak position to criticize others if we ourselves are guilty of stretching the law as if it were a rubber band, or of cutting legal corners.

Cutting corners may not be a violation of law, but is it ethical to seek out ways of legally evading laws and regulations adopted to promote the public interest? To be sure, there are those who say that it is up to the authorities to devise perfect laws and regulations that will have the effect of making everything that is undesirable also illegal. But there is a higher standard. A man of character does not require laws that constrain him to do what is ethical or is in the best interests of the community. We rightly look down on those shady types who make their way in the world by skirting along the fringes of the law, observing the letter but ignoring the spirit. The best society is one in which men do what is right because they believe that it is right, not because a policeman is standing over them watching their every move.

I cannot condemn too strongly those who burn banks or college buildings or who advocate illegal violence for any end. But I also shudder at the damage that is being done by those who ignore court rulings, or who interpret the law to suit their own notions of what it ought to say. One could cite examples from almost any walk of life today, but if I looked too far afield I might be charged justly with hypocrisy. So let me use tendencies observable in my own field - banking. But let it be clear that in so doing, there is no intent to leave the implication that banks and bank regulators are the only ones touched by the malady to which I am pointing a finger.

Sticking as closely to my own field of endeavor as possible, let me say that I have seen no great rush by the federal bank regulatory agencies to comply with the law of the land, as expressed by the Supreme Court, in the first decision written by Warren Burger as Chief Justice, over five months ago. (First National Bank in Plant City, Florida vs. Fred O. Dickenson et al, 396 U.S. 122) The actual decision in that case calls for reversals of administrative rulings with respect to whether depositories and pick-up services are branches, and its reasoning calls for a change in the rulings concerning loan production offices.

In the field of commercial banking one need look no further than the devices used by some bankers, in the last year or so, to enable their institutions to avoid the impact of the Federal Reserve's restrictive anti-inflationary monetary policies.

I do not think the banks want to have the Federal Reserve act as an omnipresent policeman, directing every move they make. The Federal Reserve, as a regulatory agency, strives to lay down guidelines for the banks that are generally recognized to be in the public interest. The System has been deliberately structured to insure that its decisions are made after taking into account a wide diversity of views. This is because we know that we must have the willing cooperation of the banks we regulate.

When that cooperation is not forthcoming, our system is in trouble. One of the reasons we have had so much trouble bringing inflation under control during the past year and a half is because we have not had the willing cooperation of much of the banking system. We sought to curb the volume of money and credit chasing after goods and services, driving prices upward at an excessive rate. Our efforts to reduce inflationary pressures by the imposition of monetary restraint were frustrated and delayed by the ingenuity of the banking system in finding ways to get around the restraints of monetary policy and regulation. A large part of this ingenuity was exercised to raise funds with which to honor unwise "commitments to lend", which had

been designed to enable big customers to avoid the impact of "tight money" and force others (like small business, housing, state and local governments, etc.) to take the brunt of it.

As you know, the Federal Reserve has endeavored for a year and a half to combat inflation by tightening the availability and cost of money and credit. Ever since December 1968, we have directed our open market operations to achieve this goal. In April 1969 we increased reserve requirements and boosted the discount rate. Throughout 1969 we maintained the existing ceilings on interest rates under Regulation Q (although we did adjust them upwards early in 1970). By those actions we hoped to achieve a substantial moderation in the expansion of business loans, with some slowdown in the growth of consumer credit as well. If this objective had been achieved and demand curtailed, much of the steam would have been taken out of the inflationary forces early in the struggle.

While some of the expected cutbacks in lending took place, the objective was not achieved because of the use by many banks of various devices to acquire additional loanable funds, free from the restraints imposed by reserve requirements and interest ceilings.

Initially these activities were helpful to the banks in cushioning their adjustments to deposit losses, caused by market interest rates rising well above the ceiling rates that they were permitted to pay on deposits. But as time went on and banks continued to increase their use of these other sources of funds, the devices became escape hatches rather than safety valves. They became massive leaks in our system of monetary restraint.

One result was that commercial bank lending was not effectively curbed in 1969. Business loans expanded at about the same rapid pace as in the latter part of 1968. If we adjust the statistics to take account of sales of business loans under repurchase agreements, the rate of increase of business loans made by weekly reporting banks actually rose in 1969. Monetary policy succeeded only in

curbing business lending by the smaller banks. The big banks found ways to step up their lending while the Federal Reserve was trying to get them to exercise restraint.

We tried to plug up some of the loopholes. One big one was the banks' use of Euro-dollars. The big banks doubled their Euro-dollar liabilities in the first seven months of 1969. This led us to impose a reserve requirement on funds acquired through overseas branches, effective last October. This has helped discourage increased use of this source of funds.

Some banks also made heavy use of commercial paper, mainly that of their newly created one-bank holding companies, to obtain so-called nondeposit funds with which to make more loans. We have had under consideration for some time measures designed to plug this loophole, but they have not yet been applied. The loophole still exists, and commercial paper liabilities of the banks rose nearly 50 per cent in the first quarter of 1970.

There are those who have described the success the banks have had in finding ways to avoid the impact of tighter monetary policies as imaginative and healthy. They have certainly been imaginative. But I question whether they have been healthy.

It is true that these actions were not strictly illegal or contrary to existing regulations, but only because when the regulations were drafted, both the regulators and the banks knew that deposits were deposits, and no one thought they could become nondeposits when called by another name. However, the frantic search for ways to increase lending activity at a time when the whole nation, including the entire banking fraternity, was alarmed at the inflationary pressures that were so apparent, did not reflect a high degree of intellectual consistency.

Is it really necessary and desirable that the Federal Reserve find itself in what one official has described as the "undignified position of chasing after commercial banks to plug up loopholes or throttle overworked safety

valves?" I guess I am only saying what was said better by the president of the New York State Bankers Association, Mr. Patrick J. Clifford, about a year ago. He said: "Banks have a moral obligation to live up to the intent - even more than the letter - of the regulations designed to reduce inflationary pressures."

It is most unfortunate, for many reasons, that the drive to bring inflation under control has been so long delayed. Aside from the disastrous effects on those people least able to protect themselves, this lack of effective action contributes to the erosion of faith in government and respect for law. Those who are hard hit by inflationary price rises have a legitimate grievance against those of us who have, by our actions or inactions, let inflation get so far ahead of us.

I am convinced that we are now on the right track and that inflation will be curbed without a depression - despite the many doubters still in our midst. However, it is incumbent upon us to examine the experience of the last few years with great care, to determine what our mistakes have been and how they can be avoided in the future. We simply have to find better and quicker ways of achieving our objectives - full utilization of our human and material resources, with a reasonable degree of price stability.

Our dilemma is well known. We know that inflation can be checked if we put the brakes on economic expansion hard enough. This has been done in the past and it has been successful in bringing inflation under control, though admittedly at the cost of keeping the economy operating below capacity for too long. We have been searching for a better way of reconciling the conflicting demands of price stability and the maintenance of a high rate of utilization of our productive resources. Some despair of achieving this goal, but I do not. I think it is possible, but only if we can reach broader agreement on the rules of the game. All concerned, management and labor, bankers and business, consumers and government, must understand the agreed rules and then follow them - not try to find ways to evade them.

The government's responsibility is especially heavy, for others will not be inclined to collaborate willingly in a battle against inflation if they do not see government doing its part. Government must provide the leadership, and it must lead by itself adopting and adhering to proper policies. The people must be convinced that the government is serious when it says that it intends to bring inflation to an end. In short, we must have a credible anti-inflationary program and the willingness to bear whatever pain may be involved in making it effective. We cannot again permit the development of a credibility gap which leads businessmen to believe that government will not follow through on its program when the going gets rough.

Now we have in place a program that can do the job. It is causing some pain, evidenced by a profit squeeze, higher unemployment, lower stock prices, etc.; all of which I regret. However, the pain of the hangover is the fault of the binge, not the fault of the black coffee and tomato juice. If we wanted to avoid the pain, we could simply prolong the binge, but the results would in the end be something worse than a hangover.

Superficially, it would seem that quicker results could be obtained by adopting controls over wages and prices, but the consequences of that make me shudder. It would take an army of policemen to enforce the rules, and we would truly lose a large part of our precious freedom. Those who had increased their wages and prices through the exercise of their economic muscle would be frozen into position and the more public-spirited members of society would be precluded from catching up.

We are right to press forward with an impersonal stabilization program, based on sound monetary and fiscal policies. But we must do our utmost (much more than we have done thus far) to bring about a broad understanding of the fact that this program will succeed, that evasive tactics are not praiseworthy, and that inflation will be halted. When, of course, depends upon how long it takes for businessmen, labor leaders, bankers, and others who make the decisions that are pushing wages and prices up,

to understand that they, too, have an obligation to society to take a broad view of their own interests and the public's interest.

As I said before, we must have agreement that everyone will not only play by the rules, but will cooperate in achieving our common objective. This is easily said, but I have no illusions that it will be easy to achieve. We have had some experience with labor-management councils, and we have tried to obtain voluntary compliance with economic guideposts. These methods had some success for a time, but they could not withstand the pressure created by the failure of government itself to abide by the rules. Too much inflationary pressure from the budget washed out the guideposts and created tremendous problems for monetary policy. Fine tuning will help an automobile that is fundamentally sound run better; but a tune-up will not help if the transmission is bad.

I think that a large part of our problem has been in the transmission - the transmission of the basic ideas that must be understood if everyone involved in this joint effort is going to pull together and move in the same direction.

Ultimately, it is ideas that move the world. The political leaders, the consumers, the bankers, the businessmen and the labor leaders will cooperate only if they all share a common goal and agree on the best way to achieve it. This is not something that we can hope to accomplish overnight. It takes time for ideas to penetrate and produce results. John Maynard Keynes pointed this out when he wrote: "But soon or late, it is ideas, not vested interests, which are dangerous for good or evil."

This being the case, we might reasonably conclude that our frustrations in dealing with inflation in recent years have been caused in large part by the ideas about inflation and economic policy that were popularized in past decades. If we want to ameliorate these problems in the future, we should give the highest priority now to the dissemination of the ideas that will help us combat inflation.

Put more specifically, people must understand that maintenance of the integrity of the dollar is of foremost importance. Without it we are in for trouble - trouble from which even our bright younger generation will not be able to extricate us. Consequently, one of the most important services we can perform now is to educate the public about the evils of inflation and the measures necessary to prevent it.

What do we tell them?

First, we must make it clear that our governmental and economic institutions exist to benefit the people, balancing as equitably as possible the diverse demands that must be satisfied in our pluralistic society. This is fundamental, because if a substantial number of people are hostile to our institutions, it will be difficult to get them to play the game by the rules, whether the game is combatting inflation or something else.

Second, I think we can agree that while our system is predicated upon individualism, we should teach people to take a broad view of self-interest. Maximization of profit or maximization of wage increases may be self-defeating if the result is to add to inflation and create losses in real income for important segments of the population. People must understand that the proper functioning of the system is in their own best interests. They should be guided not only by immediate personal opportunities for gain, but by a broader understanding of what helps our economic system to function properly.

Third, we must teach in every possible way the elementary principles of economics that explain what inflation is, what its effects are, and how it can be avoided. It is not enough these days that this information be confined to the experts. Our policies are being influenced by popular opinion, which is only proper. But where popular opinion is swayed by information that is false, and theories that bear no relationship to reality, countries are in trouble. It is inevitable in such circumstances that economic messes are created, and such messes either have to be lived with

or cleaned up by rulers who override public opinion. We do not want either result in our country.

I suggest, therefore, that we have an obligation not only to carry out forcefully, with no backsliding, the policies that are indicated at this juncture. We have an equal obligation to use our resources of talent to educate ourselves and the public concerning the facts about inflation, its causes, its effects, its dangers to people and to the nation, and how we must manage economic policy to keep our economy on an even keel. Our nation cannot escape from the consequences of failing to abide by the laws of economics, any more than it can escape from the consequences of a breakdown in respect for its legal laws. I have always been an optimist, and I still am. But I realize that today we have our work cut out for us if we are to halt and reverse the trends that spell grave trouble for our country. We must individually and collectively dedicate ourselves to the task of teaching by both example and precept that our nation can continue to be great only if its leaders and its people understand and observe both its legal laws and the laws of economics.