

REFLECTIONS ABOUT THE FEDERAL RESERVE
AND THE ECONOMY

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by

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Considering a topic for this distinguished audience, I felt it was appropriate to focus on the state of the national economy. But with Chairman Burns so heavily in the news, I also thought you might want to know a bit about how the Federal Reserve does its work. That's why I entitled my remarks "Reflections about the Federal Reserve and the Economy."

The Federal Reserve is your central bank--serving you, your community, and your country. More accurately, the Federal Reserve is not one central bank but twelve Federal Reserve Banks and the Board of Governors in Washington. Most Reserve Banks, in turn, have branches. Nashville, a branch of the Federal Reserve Bank of Atlanta, serves middle and eastern Tennessee.

Why the Federal Reserve's founders decided against a single central banking institution is a long story. But it basically grew out of fear that one bank might be too powerful. And, based on the same logic, the Federal Reserve's structure has a strong regional flavor and, not unlike the Constitution, has many checks and balances.

Each Reserve Bank, however, does pretty much the same thing. It clears checks. It puts coin and paper money into

circulation, while leaving the actual printing and coinage to the Bureau of Printing and Engraving. Each Reserve Bank checks on the financial affairs of commercial banks. And it helps the U. S. Treasury pay its bills, issuing and redeeming savings bonds and other securities. About 98 percent of the Federal Reserve Bank of Atlanta's employees are involved in these and other operational functions; only 2 percent do the more glamorous work of regulating the amount of money in this country. Related to this monetary-controlling activity, the Federal Reserve System has an influence on the cost and availability of credit as well. Because the Fed has been granted money-creating powers by Congress, however, its influence over money is greater than over credit.

I have seen some audiences shrug their shoulders at this point and say all of that sounds mysterious. How does the Federal Reserve do it?

Actually, the mechanics by which we regulate the money supply is not all that complicated. We have means of increasing and decreasing the money supply. Most of it is in checking accounts, incidentally; they are the principal form of money. Ninety percent of all payments are made by check.

To increase or reduce the money supply, the Federal Reserve buys or sells government securities in the established market. When we want, for example, to increase the money supply, the Fed's open market desk in New York will buy several hundred million dollars' worth of U. S. Government securities. When the Federal Reserve buys securities, it creates, in effect, money that did not exist before. It pays the seller of the securities by check, which he deposits in his bank. So, by a simple stroke of the pen, we have increased an individual bank's deposits and, at the same time, increased the total deposits in this country as well.

From a mechanical, operational standpoint, it's fairly straightforward. What's really hard is deciding how much money and credit the economy should have. Who makes these decisions? How are they made? On what basis? And how do they relate to the present state of the economy?

The man on the street may think only one man in the Federal Reserve makes all the decisions: Arthur Burns. Dr. Burns is, certainly, a man of great intellect. He is most competent and a highly respected economist. He also is a man of considerable conviction. But the Federal Reserve is not a one-man shop. Twelve share the decision-making responsibilities in the Federal Open Market Committee, the top policy group that

includes the seven-man Board of Governors and five Federal Reserve Bank Presidents. Except for New York, the Reserve Bank Presidents' membership rotates. But all are regular attendees and take an active part in the discussions. Incidentally, that's how I spend one Tuesday every month, plus preparation.

These meetings are less secretive or mysterious than they used to be or than our critics make out. Federal Open Market Committee decisions are disclosed a month after each meeting. The Federal Reserve further publishes every Thursday afternoon a financial statement, showing the prior week's changes in its government securities portfolio. It also publishes weekly money supply and interest rate figures. We try in Congressional appearances and speeches to explain our policy stance. And under Congressional mandate we report quarterly on our money growth targets.

We have been gradually reducing the money growth targets in recent years because that's how we think we can help reduce the inflation. It's a necessary but not sufficient step. Slowing down the money supply is, however, the only anti-inflationary remedy available to the Federal Reserve. Just as too much money fuels inflation, a move in the opposite direction eventually reduces the inflation fever.

We have been trying to slow the money supply growth down for several years now but have not been too successful this past year. Therefore, some of our critics who not long ago favored a faster money growth recently complained about too rapid money growth.

The Federal Reserve has tried to check this growth the only way we can. It has used mainly the tool of open market operations, buying government securities at a reduced rate. This had had the effect of pushing up short-term interest rates. Long-term interest rates, on the other hand, are still just about where they were at the end of the last recession.

The short-term interest rate increase has not been insignificant: 2 percent since spring. Historically, however, these rates are not high, nor are they at the point where they significantly drain credit away from housing. Currently, open market interest rates remain below the rates banks and thrift institutions pay on longer-term certificates. Consequently, savings flows to thrift institutions and banks have stayed at high levels. And funds available actually and potentially for mortgage lending remain plentiful. Fears of credit shortages developing for housing, therefore, seem exaggerated even if short-term rates were to rise somewhat further.

Having said that, we still recognize that our stabilization role requires us to pay close attention to every key economic sector, including housing. Let me underscore this point. We don't take actions influencing the money supply and interest rates for their own sake. Going further, I don't believe the true test of monetary policy is the money supply targets or the level of interest rates. It is the effects of them on the state of the economy.

Therefore, I want to tell you briefly how I view the economy at the present time. It is fair; possibly a C+ if I were a teacher. On the other hand, we don't see justification for fearing an impending recession.

True, the economy paused this summer, just as it did in the summers of 1975 and 1976. But recent signals indicate that the pause has ended. Incomes have strengthened. Retail spending has picked up. Production has shown better gains. So, according to many indicators, the economic tempo has quickened from a few months ago.

Does this mean the economy is performing as well as it should? You know better than that, and I do, too. While, for example, the number of jobholders keeps going up, it has not increased any faster than the number of jobseekers. Consequently, the total number of people out of work has been

stuck at around 7 percent since April. For blacks, especially teenagers, the unemployment rate has been actually going up. These represent the inexperienced. They are the last to be hired; the first to be fired. It will take, among other things, a faster growth in the economy than we have had to bring these unemployment rates down.

More federal spending is, of course, one possible way that can be done. In this connection, it's notable that the most recent pick-up in the economy can be partly traced to a federal pay hike and other increases in federal spending. But if we assume that more government spending is not the best solution, the economic thrust will have to come from the private sector.

What are the prospects for a more vigorous private economy? Let me count off the keys to these prospects and then see where we stand.

Consumer spending: Can we expect the consumer to carry the economy on his shoulder like he did these past two years? I doubt it. His pay has not stayed far ahead of the inflation and the increase in taxes. And he may have little extra borrowing capacity left. Recent instalment debt trends are not reassuring. Consumer instalment debt, as a percent of income, now approaches the high 1974 mark. Therefore, it may

be too much to expect the consumer to spark the economy in the year ahead. On the other hand, he does remain in a buying mood, suggesting that the Christmas season, at least, should be good for the merchants.

The auto picture is puzzling. After some prodding, Detroit has finally cut down on car size. The cars need less gasoline. They are well designed. And some are beginning to look increasingly like the popular imports. However, with domestic car prices up another 6 percent this year, the consumer is not likely to rush into such a major purchase, but will hold off as long as he can. Recent ups and downs in '78 model car sales reflect all of these influences.

Residential housing will probably put in a poorer performance than domestic auto sales where, at least, small year-over-year gains seem likely. Single-family housing starts seem close to their peak. The current, extremely high starts level is unlikely to be sustained for long. Looking for protection against inflation, housebuyers have been snapping up homes despite rapidly rising prices. More recently, however, this speculative fever has been broken.

As consumer spending decelerates, other sectors must fill the gap. Can we expect help from more apartment construction? Fortunately, it has picked up. The fall in the vacancy rates

for apartments is already encouraging more multi-family construction, though it may take still bigger rent increases to start another apartment boom. Commercial construction likewise has shown signs of strengthening, while school and street work are still in the doldrums. So, altogether, we see an offset to a slower residential activity.

Will business investment give strong support to the economy? Is there a likelihood for an investment boom? We think not. According to a recent McGraw-Hill Company survey, businesses are planning to increase their capital spending in 1978 below this year's modest rise. Should they repeat this year's performance, the extra money will be spent for equipment, while major constructions projects will remain in the doldrums.

I see no reason why these trends in capital spending should change. To hold down costs, modernization is required. But before you build a new factory, you think twice. Profit margins must improve and uncertainties about government policies must be resolved before major industrial construction projects are built in greater number. Therefore, we look for an unspectacular business capital spending sector in the year ahead.

What about business inventories? They appear generally between normal to slightly above normal. This suggests that

we need not fear the order cancellations and layoffs that develop when inventories are too high. By the same token, businesses--with growing computer use--have been correcting their inventories much more quickly than in the past. That's a plus factor. Current satisfactory inventory conditions, however, also mean that we cannot expect the economy to get the stimulus from inventory rebuilding it did in 1976. So, altogether the business sector will probably not provide the degree of thrust the economy needs.

On the international side, we, too, expect no dramatic changes. Although U. S. exports may pick up, the degree of improvement hinges on the strength of the economic recovery abroad. If recent foreign government stimulus succeeds in speeding up the European expansion, their demand for U. S. exports should pick up. That would be welcome news for our own economy.

Imports are a different story. Our heavy reliance on foreign oil won't change in the near future; nor is the non-oil import problem likely to change. Foreign oil, actually, accounts for one-third of total U. S. imports; steel, TV's, shoes, raw materials, and the rest account for two-thirds.

One small source of help I see there is the recent decline in the value of the dollar against most foreign currencies.

This is making our goods cheaper relative to those abroad. Citing the decline of the dollar against the yen, Toyota and Honda, for example, have raised their car prices four times this past year. As a result, some U. S. models are now cheaper than the foreign makes, which should have a negative impact on foreign sales. So, there is some brightness on the import horizon, though we expect sizable deficits in the U. S. merchandise trade to continue.

All in all, it looks as if the private sector of the economy will grow in 1978 but at a sub-par rate.

Will the government sector add much to the economy in the year ahead? It will on the spending side. Federal spending is headed considerably higher. State and local governments should spend much more, too. Unlike Uncle Sam, they have accumulated substantial budget surpluses.

But there is a revenue side to the equation, and here it's too early to tell. A lot will depend on legislation. Although some is in place, much is still in debate. Already-enacted minimum wage legislation will raise business costs and reduce employment growth. Congress is about to make changes in Social Security and pass new energy legislation. Both involve tax schemes that could have enormous effects on the economy.

To offset the higher Social Security and energy taxes, the President has promised us substantial tax reductions next year. I don't want to prejudge his proposal. But I do hope the fiscal program will have adequate emphasis on encouraging investment. The emphasis should be on investment because expanded investment holds the key to the success of controlling inflation and cutting unemployment.

For the short run, the Federal Reserve has very general ways for helping push the economy ahead. However, it may not be prudent to give too much push. An excessive money supply growth could ignite new inflationary expectations, causing businesses to hold up on their capital spending.

Inflationary expectations and inflation are something we can't seem to get away from for long. Fortunately for us consumers, the inflation rate is down from what it was last winter--largely thanks to lower food prices. But the underlying inflation rate is still around 6 percent. And now that food prices have again picked up and minimum wage and other inflationary developments are on the immediate horizon, prices could rise more rapidly next year than this one.

Under those circumstances, the Federal Reserve will have to tread a narrow line. While it cannot let the economy starve from too little money, neither can it allow too much.

In summary, monetary policy may be simple in the strictly mechanical sense. But those responsible for it see it as a difficult art and are heavily influenced in their decision-making by the state of the economy.

I, personally, think 1978 will not be an outstanding year. But if the federal government encourages business investment, there will be extra reason for cautious optimism.