THE FEDERAL RESERVE AND THE ECONOMY

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by

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The Federal Reserve is the central bank of your country. More accurately--it is not one bank but twelve Federal Reserve Banks and the Board of Governors in Washington.

Because they feared that one bank might be too powerful, founders of the Federal Reserve decided against a single central banking institution. By the same logic, the Federal Reserve's structure has a strong regional flavor and 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. It checks on the financial affairs of commercial banks. And it helps the U. S. Treasury pay its bills, issuing and redeeming securities. About 98 percent of the Federal Reserve Bank of Atlanta's 2400 employees in our six offices 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. Nevertheless, for the Federal Reserve System as a whole, influencing the cost and availability of money and credit is its principal function.

Three tools are available to the Federal Reserve to change bank reserves and the money supply. One is the discount rate, which is the rate charged member banks when they borrow from the Federal Reserve. The second is the ability of the Board of Governors to require member banks to maintain a larger or smaller percentage of their deposits as reserves. The third and most important is known as open market operations. The Trading Desk at the New York Federal Reserve Bank buys and sells government securities in the open market. When the Federal Reserve buys securities, it creates additional bank reserves, which in turn are used by commercial banks to expand the money in our nation's checking accounts.

From a conceptual standpoint, our influence on reserves and money is fairly straightforward. The real difficulty is deciding how much money and credit the economy needs.

Some observers may guess only one man in the Federal Reserve makes these decisions: the Chairman. Dr. Burns is, indeed, a man of strong personality and enormous ability. But even under his chairmanship, the Federal Reserve has not been a one-man shop. Twelve people 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.

Federal Reserve authorities face a continuing dilemma of how much money growth should be sought. Faster monetary growth will bring more economic growth and more jobs, but it will also saddle us with more inflation and will add to the international weakness of the dollar. Faster monetary growth also tends to hold down interest rates, at least temporarily. Slower monetary growth, on the other hand, tends to dampen economic growth and job growth, retard inflation, and give a temporary boost to interest rates.

That dilemma is particularly acute right now for two reasons: First, no one is satisfied with either unemployment or inflation prospects; and, second, actions are interpreted so quickly because of the unusual degree of uncertainty about the economy. The stock market is the most visible example.

For several years now, we have been trying to slow money supply growth; until the fourth quarter, we have not been too successful. In fact, some of our critics who not long ago favored a faster money growth are now worried about too rapid money growth. If you're going to be criticized, it's somehow reassuring to be criticized from both sides. The fact remains, though, that we are worried, too.

We tried to check rapid money growth the only way we can--slowing the creation of more bank reserves in the economy by restraining our purchases of U. S. government securities. This has had the unavoidable effect of pushing up short-term interest rates--more than 2 percent since last spring. Long-term interest rates, on the other hand, are still lower than they were at the end of the last recession.

A discerning question is now being asked: Are interest rates at or close to the point where they will drain credit away significantly from housing? Probably not. Currently, open market interest rates remain below the rates thrift institutions pay on longer-term savings certificates. Consequently, the flow of savings to mortgage lenders has remained at relatively high levels. Funds available for mortgage lending appear plentiful, both actually and potentially. Fears of credit shortages developing for housing, therefore, seem exaggerated even if short-term rates were to rise somewhat further.

Viewing the economy more generally, an appraisal of "fair" seems appropriate. If a college professor were grading, he probably would assign a grade of C+. On the other hand, there seems virtually no justification for expecting a recession this year.

True, the economy paused last summer, just as it did in the summers of 1975 and 1976. But later signals show that the pause ended. Incomes in recent months have strengthened. The retail sales trend has been up. Production has shown widespread increases. And job growth has been swift--three million persons added to payrolls this past year alone. So, according to many indicators, the economic tempo has been strong in recent months.

This does not mean the economy is performing as well as it should. Weaknesses are still evident. For example, the number of jobholders keeps going up but that number has not increased much faster than the number of jobseekers. Women and teenagers keep streaming into the labor force. For blacks and teenagers, the unemployment rate has actually increased. To bring these unemployment rates down any time soon will require a growing economy; merely avoiding a recession will not be enough.

One possible way this can be done is more federal spending. The most recent pick-up in the economy can be traced partly to a federal pay hike and other increases in federal spending.

Federal spending is slated to increase more in 1978 than in 1977, while state and local governments should equal their increases in spending last year. Unlike Uncle Sam, many state and local governments have accumulated substantial budget surpluses; these will be spent.

But there is also a revenue side to the equation, and here it's too early to tell. Much will depend on national legislation. Although some is in place, much is still in debate. Already-enacted minimum wage legislation will raise business costs and increase unemployment, especially for teenagers. Higher Social Security taxes will also increase business costs, besides cutting take-home pay. Congress is debating new energy legislation, involving tax proposals that most likely will result in more inflation and less economic expansion.

To offset these higher costs, the President has urged substantial tax reductions after mid-year. Predicting Congressional response to his proposals is difficult. Yet we can hope the fiscal program will have two characteristics. First and foremost, it should place heavy emphasis on encouraging investment. Expanded investment is an essential element for achieving success in controlling inflation and cutting unemployment. Second, the fiscal program should include lower sales taxes and other measures aimed at reducing inflation. Despite the important influence of fiscal actions on prices and jobs, however, the underlying economic thrust must come from the private sector.

A look at some of the prospects for a more vigorous private economy might be helpful.

With respect to consumer spending: The consumer is unlikely to continue the strong support for the economy he has contributed the past two years. His pay has barely exceeded inflation and the increase in taxes. And he may have little extra borrowing capacity left. Recent increases in instalment debt are not reassuring. Consumer instalment debt, as a percent of personal income, now approaches 13 1/2 percent, the high 1974 mark. Judging from strong December department and chain store sales, the consumer does remain in a buying mood but it may be too much to expect him to spark the economy over the year ahead.

The auto picture is puzzling. After some prodding, Detroit has finally slashed car sizes. The cars needs less gasoline. Some are beginning to look increasingly like the popular imports. However, with domestic new car prices up another 6 percent late last year, consumers, rather than rushing into such a major purchase, are holding off as long as possible. Disappointing '78 model car sales reflect these influences. We have felt for months that auto industry forecasts of over 11 million in total units sold were too optimistic, and others now seem to be moving to that opinion.

Residential housing will probably register a poorer performance in 1978 than in 1977. Single-family housing starts seem close to their peak of 1.6 million units. The current, extremely high level is unlikely to be sustained for long in the face of higher prices and the dwindling number of families who can afford to pay them.

Quite fortunately, apartment construction has shown signs of picking up. Commercial construction likewise has shown signs of strengthening, while weakness persists in school and street work. So, altogether, we see offsets to slower residential activity. We are especially encouraged that increases in short-term interest rates thus far have not been matched by significant upward movements in long-term rates.

According to the most recent Commerce Department survey, businesses are planning a smaller increase in their capital spending this year than the modest rise last year. To hold down costs, modernization is required. But before building a new factory, management thinks twice. Profit margins must improve and uncertainties about government policies must be resolved before major industrial construction projects are started in greater numbers. Therefore, we do not look for spectacular business spending for capital investment in the year ahead.

Business inventories appear generally between normal to slightly above normal. This reduces the fear for order cancellations and layoffs that develop when inventories are too high. At the same time, businesses--with growing computer use--have been correcting their inventories much more quickly than in the past. So, altogether, investments by businessmen probably will not provide the degree of thrust the economy needs for high rates of growth.

On the international side, the sharp decline in the dollar's value in 1977 injects an air of uncertainty. Nevertheless, we expect no far-reaching changes. U. S. exports may pick up, but the degree of improvement hinges on the strength of economic recovery abroad. The economic pace abroad remains extremely sluggish. Unless European expansion speeds up, demand for U. S. exports will lag. Without larger exports, our trade balance and our economy suffer.

Imports are a different story. Our heavy reliance on foreign oil will not change in the near future; nor is our high level of other imports likely to be significantly reduced this year. 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 is the oil cartel decision to freeze prices for the time being; another is the decline in the value of the dollar in terms of major foreign currencies. True, speculation against the dollar abroad has pressed the price of the dollar down too far. Hopefully, we will see an upward correction. Nevertheless, the lower price for the dollar has begun to make our goods cheaper relative to those abroad. Some of our exports should become more attractively priced for foreign sales.

On balance, several policy responses seem desirable to help the dollar and our balance of payments. Active intervention in the exchange markets and the discount rate increase underscore a U. S. resolve to support the dollar. But the key to the dollar problem lies elsewhere. A strong energy program, encouraging domestic sources and conservation, is needed to reduce oil imports. A strong tax program to encourage investment would be helpful. A vigorous program to hold down domestic inflation is necessary. And foreign governments, especially

Germany and Japan, can help with actions to bring about faster economic growth in their countries and provide easier market access for American exporters.

So as we look at our economy, we see sources of strength in federal spending, in commercial and apartment construction, and in the international demand for our exports, but less strength from business investment, inventories, imports, and, in particular, from the consumer. This is the context for our monetary policy dilemma.

In this context, what is appropriate money supply growth? Without advocating a specific figure, we believe too much money growth could ignite new inflationary expectations, with the perverse result that businesses and consumers would hold back on their spending.

Fortunately, the inflation rate is down from last winter--thanks largely to lower food prices. But the underlying inflation rate holds tenaciously at about 6 percent. Now that food prices have again picked up and higher minimum wage, farm support, import controls, and other upward pressures on prices, such as Social Security and energy taxes, confront us, prices may well rise somewhat more rapidly this year than in 1977. It would seem reasonable to anticipate more rather than less inflation.

Under these circumstances, the Federal Reserve will have to tread a narrow line. While it cannot let the economy grind to a halt from too little money, neither can it provide too much, thus feeding inflation unnecessarily.

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

Personally, I do not think 1978 will be an outstanding year for our economy. But if the federal government encourages business investment and accomplishes a reasonable energy policy, there will be ample reason for cautious optimism.