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THE FEDERAL RESERVE AND THE ECONOMY

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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

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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 have felt only one man in the Federal Reserve made these decisions until recently: Dr. Burns. The former Chairman is, indeed, a man of strong personality. But even under his chairmanship, the Federal Reserve was not 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. G. William (Bill) Miller, the new Chairman, strives for a greater degree of consensus than Dr. Burns.

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 inflation; second, actions are interpreted so quickly because of the unusual degree of uncertainty about the economy. The yo-yo

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stock market behavior is the most visible example. And, third, the Fed must move carefully as the business expansion matures; otherwise it gets blamed for setting off a recession.

For several years now, we have been trying to slow money supply growth; 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 2-1/2 percent this past year. Long-term interest rates have increased by much less than that and are still only slightly higher 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 from housing? Probably. Open market interest rates exceed the rates thrift institutions pay on savings accounts and longer-term certificates. Consequently, the flow of savings to mortgage lenders has been significantly reduced. At the moment, however, funds available for mortgage lending still appear satisfactory and should get a boost from recent policy actions. Fears of credit shortages developing for housing, therefore, seem exaggerated.

Viewing the economy more generally, an appraisal of "fair" seems appropriate. If a college professor were grading, he probably would assign a

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grade of C+. On the other hand, there seems virtually no justification for expecting a recession this year.

True, the economy paused in the first quarter. 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--more than two million persons added to payrolls over the last six months 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. Recent strength in economic activity represents a strong rebound from the cold weather and strike-depressed levels early this year. Women and teenagers, meanwhile, keep streaming into the labor force. To keep the unemployment rate from rising requires a growing economy; merely avoiding a recession will not be enough.

One possible way this can be done is more government spending. The most recent pick-up in the economy can be traced partly to increases in government spending.

Government spending is slated to increase more this year than last, although federal spending continues to fall short of budgetary expectations. 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

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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 urged substantial tax reductions before he cut back the tax package and agreed to a delayed January 1 date. 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 achieving sustainable economic growth. 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, has set a new record. Judging from strong retail sales and survey data, 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.

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The auto picture is puzzling. After some prodding, Detroit finally slashed car sizes. The cars need 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, held off as long as possible. Disappointing car sales in late '77 and early '78 reflect these influences. Then, boosted by the strength in incomes, auto sales took off in March and April. But we doubt whether this recent surge will persist for too long.

Residential housing will probably register a poorer performance as the year progresses. 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, credit tightening, and the dwindling number of families who can afford to pay them.

Quite fortunately, apartment construction has shown signs of picking up. Commercial and office construction likewise has shown signs of strengthening. So, altogether, we see offsets to slower residential activity. We are especially encouraged that increases in short-term interest rates have not been matched by a surge in long-term rates.

According to recent surveys, businesses have raised their sights and are now planning a greater 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

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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. However, let's keep in mind that inventory explosions have accompanied most maturing business expansions and rapid inflation periods. If an inventory boom were to develop, it would be difficult to avoid a recession.

On the international side, the sharp decline in the dollar's value in late 1977 and early '78 injects an air of uncertainty. Nevertheless, we expect no far-reaching improvement in either the dollar or our trade position. U. S. exports may pick up, especially agricultural exports. But the degree of export improvement hinges largely 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.

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

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abroad pressed the price of the dollar down too far, and we saw an upward correction. The lower price for the dollar has begun to make our goods cheaper relative to those abroad. Therefore, some of our exports should become more attractively priced for foreign sales. Much of that impact, unfortunately, doesn't develop right away. Meanwhile, foreign goods like Toyotas are up in price and this price rise has spilled over to domestic competitors--like the Fords.

On balance, several policy responses seem desirable to help the dollar and our balance of payments. Active intervention in the exchange markets, U. S. gold sales, and Federal Reserve tightening measures 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 government spending, in commercial and apartment construction, and in the international demand for our exports; less strength from housing and the consumer; and uncertainties about business investment and inventories. 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

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new inflationary expectations, with the perverse result that businesses and consumers would hold back on their spending.

While the unemployment rate is down, the inflation rate is up from last winter--due largely to higher food prices. Consumer nonfood prices have also accelerated, raising the inflation rate to about 9 percent. Now that wages have picked up and higher minimum wage, farm support, import controls, and other upward pressures on prices, such as Social Security taxes, confront us, I don't see much improvement from continuing 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 the rest of this year will be an outstanding period for our economy. But if the federal government encourages business investment, reduces its deficit, and accomplishes a reasonable energy policy, there will be ample reason for cautious optimism.

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