The Federal Reserve System in
the Current Environment

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I am pleased to see all of you here today and I welcome you to the second Indiana Executive Bank Management Seminar. In today's rapidly changing and perplexing economic environment, it is essential that the two integral parts of the Federal Reserve System--the member banks and your Reserve bank--get together to discuss the very important issues and concerns that affect both of us so significantly.

You may not be accustomed to thinking about the Federal Reserve System as including the member commercial banks as well as the Reserve banks. But clearly, the unique strength of this financial structure of ours depends on that combination. A smoothly functioning financial environment requires an efficient and effective partnership of commercial banks and Reserve banks. I hope that those of us in the Reserve banks will never forget that fact. I hope that you won't either. Our relationship should never be of the "we versus them" variety. We are not adversaries in any sense. We seek the same broad economic goals. We believe in the same competitive economic system. And to keep our understanding fresh and alive, we need to spend time together so that we can respond to each other's interests and concerns.

Of course, we may disagree somewhat at times. You, as member commercial bankers, and we, as reserve bankers, come with different points of view--differences which we will all admit have complicated at times our lives together. But resolution of these differences, understanding of these differences, can only come about through meetings such as this where we can discuss these matters face to face. Our directors at the Chicago Fed representing, as you know, members of the banking, business, and public communities have frequently and fully stressed this fact.

Our objective this afternoon, then, is to communicate with you-- to tell you more about what we are doing at the Chicago Fed and why, and to hear what you have to say. In a sense, we might call this a meeting of stockholders. Most of our senior officers are here to listen and respond to you and before the day is over, the members of our Board of Directors will be here as well and so will Governor Holland from Washington.

We want to focus in our discussions on the major areas of concern that we share:

-- the economy and monetary policy, on which I want to make a few comments;

-- the concerns with bank liquidity and soundness, the financial structure and developing regulatory approaches, which Jim Morrison will consider;

-- the changing payments mechanism which is brewing an alphabet soup of RCPCs, EFTs, ACHs, and CBCTs, which Harry Schultz will discuss;

-- the seeming schizophrenia of the Reserve banks as we wear the dual hats of regulator and provider of services, which Dan Doyle will comment on;

-- the important service role which we have which will be discussed by Lou Purol and Al Wolkey;

-- and the capstone from the Chairman of our Board of Directors, Peter Clark, on public attitudes of the Federal Reserve System.

We have had no difficulty in finding mutually shared concerns to talk with you about. That is obvious from this program. I only hope that we have time to do them justice.

Let's begin then with a little background for our exchange of views by looking at the economic environment. Where are we now? Where are we going? What are the major obstacles in our path?

We are now emerging from the deepest recession in the postwar period. The major evidences of economic recovery are found in the increasing strength of industrial production and employment. In August, industrial production increased for the fourth straight month. With a gain of better than 1 percent, output was at its highest level since January. Advances were widespread among final products and materials and even business equipment, which has been especially weak, showed its first increase after a ten-month decline.

Although the unemployment rate remained at a high level of 8.4 percent in August, employment developments have been very encouraging. Total nonfarm payrolls showed a good rise in July (200,000) and a very strong increase in August (over 500,000). Manufacturing employment showed its first sizable boost since 1973. The factory work week rose again and the jobless rate for adult men declined to 6.6 percent.

These indications of a strengthening economy reflect in part a reduced pace of inventory liquidation--a major item in the sharp decline of activity in the first half of the year. Consumer attitudes have also improved. Retail sales have been strengthening overall, despite what appears to be a leveling off in August on the basis of preliminary data.

Farm income prospects seem to have turned for the better. During the first half of 1975, farm income for the nation was running at about a $20 billion annual rate--well below the $27 billion for last year. With rising livestock and grain prices, the second half should be significantly stronger, running perhaps at a $23 to $24 billion annual rate.

Of course, weak spots remain. The most important from the standpoint of our Federal Reserve District is in producer durable equipment. The sluggishness remains, with most observers arguing that a true turnaround isn't in the works until late fall or early 1976.

And housing, although improved, is hardly off and running. The improvement has been largely in the single-family dwelling area. There seems to be little hope for a rapid advance in apartment and condominium construction in the Midwest.

But the upturn in the economy generally is gaining momentum. The prospects for further strengthening of business activity are good. More and more businessmen are completing inventory liquidation programs. With the strength of industrial production, together with the narrowing of the gap between the production of materials and final goods, a moderating pace of inventory liquidation is likely.

The advance economic indicators look good too. New orders received by manufacturers of durable goods have risen sharply. Commercial and industrial building prospects are improved. Business fixed investment plans appear to have stabilized.

So we are coming up and out of the recession. How fast is up? Given the factors I've mentioned, labor market improvement, income growth, and possible consumer attitude improvement, reversal of inventory liquidation or rising production and, later, resuscitation of now-dormant capital spending plans, I can see a basis for arguing that recovery in real output, real GNP, might well be within the range of a normal recovery. To be more specific, for the first year of economic recovery we might achieve a 7 to 9 percent increase in output. That would be most respectable, especially when you consider how much that means in nominal or dollar terms of expansion.

This outlook for the next few quarters does not differ basically from those presented by others. Why then is such concern being registered about our economy? As someone suggested to me the other day, "I feel as though I were in a motor boat heading away from the falls. But I'm low on gas and I have a short anchor. My only hope is an early freeze."

I think we have more to hope for than an early freeze, but I can well understand the concern. We are coming out of this recession with the highest unemployment, the highest federal deficit, the highest interest rates, and the highest rate of inflation of any correction in the peace time, postwar period. No wonder we view the current period and prospects with less than euphoria!

These are not the kinds of "highests, biggests, or largests" that we want to see. These superlatives have understandably spawned more than the usual array of prescriptions for action. Many worry that the recovery will leave us with far too much in the way of unutilized resources--especially labor. Many worry that the recovery will leave us with even more rapid inflation. Many combine the concerns with worry that inflation and credit stringencies will nip the recovery in the bud.

Attempts to deal with all of these worries completely in a few minutes is obviously impossible. But let me try to make some headway by looking briefly at several points that underlie my thinking on economic policy for the current environment.

First, the either-or question; should economic policy and monetary policy, in particular, fight recession or should it fight inflation? Along with Chairman Burns and my other colleagues at the Board of Governors and in the Reserve banks, I think it is a tragedy that we have so often defined our economic problem as either inflation or unemployment. This choice doesn't exist--certainly not in the long run. I doubt that there is very much scope for this choice even in the short run. The experience since the mid-1960s clearly indicates that it is increasingly difficult to trade off more inflation against less unemployment; we can't switch from unemployment fighting to inflation fighting and then back again. In a very real sense it is the inflation that caused the unemployment.

A myopic policy strategy can only work if the public has what the economists call a money illusion--that is, they confuse changes in nominal income with changes in real income. If the public is confused or alternatively doesn't expect the rate of price increases to accelerate, then you can have an initial impact on unemployment by efforts designed to increase money income. So the so-called "Phillips curve" seemed to work in the early 1960s when the variations in the inflation rate were low and the public was slow to perceive the changes in inflation rates. But the public has become attuned to inflation, so watch out! The period of time in which the trade off will work has become shorter and shorter.

I will hasten to add that this doesn't mean you can't use a flexible monetary policy. I don't subscribe to the monetarists' fixed steady rate of money supply growth. But the time period within which you can get favorable results is shorter and the size of the monetary stimulus you can use with favorable results is smaller than in earlier periods.

Some argue that because we have so much slack in the economy, we can be strongly expansive without setting off renewed inflation. But if to these limitations on the trade-off between inflation and recession, you add the fact that monetary policy has a lagged impact on the economy, you have to come to the conclusion that a massive monetary stimulus now is not called for. With the recovery now underway, a strong spurt in money and credit would add more to inflationary prospects than to immediate employment gains. It would produce significant problems next year as we again would be forced to switch back and forth from one objective to another.

Monetary policy must keep its eye on both employment and prices if we hope eventually to approach full employment <u>and</u> stable prices.

My <u>second</u> point concerns the problems posed for price stability and monetary policy by continuing food and fuel price increases. What are the best guesses of the price increases likely in these two sectors? Estimates of the impact of the Soviet purchases on <u>food</u> prices range from 1.5 to 2.5 percent--on overall prices less than a quarter of those figures. Most of the variation is accounted for by differences in the time period covered, in sales already made and potential sales and in the amount of price increases associated with other factors. It is clear to me, however, that the more important elements in determining the rate of advance in food prices during the rest of the year are the expected cost increases in transportation, processing, and marketing--not in the cost of the basic commodities at the farm level. Consequently, we need to be cautious about attributing all of the prospective food price increases to the Soviet Union. And similarly, we should be cautious about reading too much into the recent small monthly gain in the consumers price index (or in the prior month's big gain either, for that matter).

The price impacts from fuel are similarly only rough guesses. Staff projections based on total decontrol, removal of the import fee, and a $1 OPEC price increase suggest a rise in the average price of crude oil of about $1.90 a barrel, an increase of about 15 percent in the wholesale prices of refined products, and a rise in retail gasoline prices of something like 5 cents a gallon.

In my view, the adverse effects on the economic recovery of these increases are not likely to be substantial in the sense that they would abort the recovery. However, they will be adverse and we can't view them with complacency. The general price level will be affected. But also important is the fact that the adjustments of the various parts of the economy to these jumps in prices will take time. Therefore, I argued at the time of the initial oil price increase--and I continue to argue now--that the increases must be partially accommodated by monetary policy as they materialize. We would be foolish to ignore them completely. This accommodation must, however, be only a short-run action. We cannot and should not allow these shocks to our price level to turn monetary policy into an inflation accelerator.

My third point relates to the issue of the federal deficit and Treasury financing plans. Treasury financial needs have been--and will continue to be for longer than we would like--one of the greatest elements of concern to financial markets. The dilemma in which the Federal Reserve System has been placed is now common knowledge. If not accommodated by the Fed, heavy Treasury borrowing piled on top of reviving private credit demands could force interest rates even higher, crowding out many non-federal borrowers. Yet full accommodation by the fed might hold interest rates down temporarily, insure non-federal borrower access but lead quickly to higher rates of inflation and higher interest rates in turn.

In my view, there was some overreaction by the market to these fears in the early stages of the recovery, forcing interest rates higher than was justified by the underlying demand and supply conditions. Certainly, private credit demands have not as yet taken off and we are still seeing more reaction to anticipated problems than actual problems.

I do not and cannot take a sanguine view of the Treasury deficit, however. The current Treasury estimate of $44 to $47 billion of new cash in the second half of 1975 must be viewed with concern. A continuation of deficits on the current scale cannot be countenanced by anyone truly concerned with the viability of the private sector of this economy.

For my part, I see no basis for the Fed to accommodate all borrowing demands--both federal and private--by trying to keep interest rates artificially low. To do so would mean giving up efforts to reach ultimately full employment with stable prices--even when we define both of these terms rather flexibly. But not accommodating all of the growing non-federal needs in the face of continuing budget deficits of this magnitude means federal government control over a larger and larger portion of our total spending. This disturbs me greatly but I am convinced that monetary policy cannot and should not be required to make the decision on the allocation of spending between the private and the public sectors. Fortunately, we have recently established procedures to improve the federal government's approach to planning national priorities. Hopefully, the full implementation of the Congressional Budget and Impoundment Control Act of 1974 will serve to lift this unwanted and inappropriate burden from the shoulders of monetary policy.

But that will take time. For the near term, the financial outlook depends critically on whether or not the federal deficit can be held at or near the Administration's target. And, of course, the record on the growth of private credit demands is still to be written. I must concede that the kind of strong recovery I suggested earlier, with its attendant private credit demands, cannot help but put some pressure on interest rates. My hope is that renewed vigor in the economy and tight budgetary control will allow the markets to handle the emerging credit demands in a reasonable manner during the period ahead. Of one thing I am certain, however. The interest rate levels which will emerge will be far lower if we continue to hew to a longer-term path of moderate monetary expansion than they would be if we gave in to the short-run monetary over-stimulators we find around us.

One final point. I have purposely chosen today not to view the world through rose-colored glasses. Public and banker concern with our economic problems and participation in their solution are vitally important. Chairman Burns last Friday in Georgia called for "a reopening of our economic minds." I agree with him fully. I would only add that we need to "reopen our awareness of our economic responsibilities" as well. I am confident that we will.