

Research Department
Federal Reserve
Bank of
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New Economic Policy

The policy events of October–November 1978 are the most dramatic that have occurred in the national economy since the New Economic Policy was unveiled in August 1971. The background was similar in the two cases, with inflation undermining the strength of the national economy and permitting a worldwide attack on the world's leading currency. Considerable dissimilarities can be seen in the policy actions taken to meet these problems, however, with the actions of 1978 being more market-oriented and more appropriate to the inflationary circumstances than those taken in 1971. This is a hopeful sign for those who prefer textbook solutions to textbook economic problems.

The first phase of the New Economic Policy (1978 version) began in late October, when the Administration announced a set of wage and price guidelines, designed to put a 7-percent lid on annual wage increases and (essentially) a 6-to-6½ percent lid on annual price increases. The Administration also reiterated its earlier plan to cut the Federal budget deficit to about \$39 billion in fiscal 1979 and about \$30 billion in fiscal 1980. The new program failed to win any plaudits in Wall Street or in overseas markets, judging from the continued declines in stock prices and in the value of the dollar. Thus, the other shoe had to be dropped on November 1, with a \$30-billion package of dollar-propping measures and a tighter anti-inflation credit policy.

What happened

In announcing these moves, the Treasury and the Federal Reserve said that

the fall in the value of the dollar "has exceeded any decline related to fundamental factors, is hampering progress toward price stability, and is damaging the climate for investment and growth." The wide range of policy actions included:

- * A rise in the Federal Reserve's discount rate from an already high 8½ percent to a record 9½ percent;
- * An additional 2-percent reserve requirement on large time certificates, forcing banks to post about \$3 billion more in required reserves;
- * An expansion of credit lines (swap arrangements) with foreign central banks, giving the U.S. as much as \$15 billion worth of marks, yen and Swiss francs for use in buying dollars in the open market;
- * The sale of \$2 billion worth of International Monetary Fund special drawing rights (SDR's) to the governments or central banks of Germany, Japan and Switzerland;
- * A temporary withdrawal of \$3 billion worth of marks, yen and francs from the U.S. reserve account at the International Monetary Fund;
- * The sale in overseas markets of up to \$10 billion worth of Treasury securities denominated in foreign currencies; and
- * An increase in Treasury gold sales henceforth to at least 1.5 million ounces a month.

The Fed's supplementary reserve requirement on large CD's should make it more costly for banks to raise funds through that medium, and should induce them to go to the Eurodollar market instead. The higher level of domestic interest rates should attract an

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inflow of foreign funds and a backflow of U.S. funds. Again, the tighter reserve position and the higher level of interest rates should make it more difficult for banks to participate in covered-interest arbitrage through forward sales of dollars, either on their own account or by providing funds to their overseas branches or foreign commercial banks. The other actions should also have significant effects. For example, the new level of gold sales, which amounts to roughly 60 percent of all newly-mined production, could boost U.S. exports by about \$4 billion a year.

Different setting, different controls
Substantial differences are evident between the economic environment of mid-1971 and the environment of late 1978. Then, the economy was in the early and still uncertain stage of a cyclical recovery; today, it is in the advanced stage of the longest and strongest peacetime expansion of the past generation. Then, consumer prices were rising at about a 4-to-5 percent annual rate; today, prices are rising at about twice that rate. And in 1971, the attack on the dollar occurred within a framework of fixed exchange rates, whereas the 1978 crisis occurred within a system of flexible rates, with the dollar (on a trade-weighted basis) already 23 percent below its early 1970's value and weaker by far against the stronger currencies.

The policy mix differed substantially between 1971 and 1978, partly reflecting the different economic environments, but also reflecting policy-makers' determination not to repeat

the mistakes of that earlier period. The Administration in 1971 imposed a rigid set of wage and price controls, and meantime stimulated the economy with a broadly expansionary set of policies. This time the Administration opted for voluntary wage/price guidelines – without the bureaucracy and (above all) without the rigidities implicit in mandatory controls – and meantime moved to restrict rather than stimulate the economy.

There are precedents for both types of approaches. The mandatory approach has been tried frequently throughout human history, dating at least as far back as Hammurabi in 1750 B.C. In 20th century America, controls were imposed in three wartime episodes – World War I, World War II and Korea – and in the first two of those periods the control period ended in an inflationary blow-off. The closest parallel to the present set of guidelines, however, is the set of measures developed in the early 1960's to restrain cost-push inflation. Those measures eventually came to be based upon a specific standard for average wage increases – 3.2 percent, or the five-year moving average of output per hour. The present wage guideline of 7 percent, however, compares with a much lower level of productivity, which has risen in the past decade at only about half the rate of the preceding period. This suggests that cost inflation could continue to be severe in the absence of a nationwide drive to boost productivity.

Fiscal, monetary differences
Fiscal policy now promises to take a different direction from the path taken in 1971. Back then, policy had already

turned stimulative when controls were imposed, with a rise in the Federal budget deficit from \$3 billion in fiscal 1970 to \$23 billion in fiscal 1971. Policy then remained stimulative in the following fiscal year, with another \$23-billion deficit, which created a great deal of inflationary tinder whose presence was masked by the existence of price controls. But this time an upsurge of inflation has already occurred, abetted by a series of massive deficits. The Administration has tried to combat that problem, however, by reducing the deficit from \$49 billion in fiscal 1978 to \$39 billion in fiscal 1979, and then to \$30 billion or less in the following fiscal year.

Monetary policy was stimulative in the year prior to the August 1971 imposition of controls, with an 8-percent increase in the M₁ money supply — reflecting the upsurge in deficit financing during that period. Over the following year, M₁ increased only about 5 percent, but the rise in real terms was greater than the year-before increase, because of the slowdown in prices during that price-control period. In 1978, the M₁ money supply again has shown an 8-percent year-to-year increase, matching the sharp rise of the 1970-71 period. (Still, that represents a relatively smaller increase, given the fact that prices recently have been rising at double that earlier pace.) The Fed's attempt to lower the recent rate of money growth should be strengthened by the latest tightening moves, which in the context of rising credit demands have helped boost interest rates to record levels. For example, the prime business-loan rate, at 10¾ percent, is now 4½ percentage points above its 1977 low.

Different international context

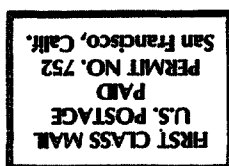
On the international front, strong differences can be found between the 1971-style and 1978-style actions. Policymakers in the former case accepted a 10-percent dollar depreciation, but then tried to maintain a jerry-built structure of fixed exchange rates for another year or more, until this effort to maintain the Bretton Woods system finally collapsed. That period exhibited all of the hallmarks of a fixed-rate system at its worst. But the 1978 period, at least to some observers, has exhibited some serious failings of a flexible-rate system, with the dollar appearing to be in a free fall and with an old-style financial panic threatening to erupt. Also, in the Administration's view, the problem has been aggravated by the existence of roughly \$500 billion in foreign hands, compared to the \$360 billion in the U.S. (M₁) money supply.

Policymakers realize that market intervention is no final solution to the problems of the dollar, but such a policy permits the line to be held while basic measures are undertaken to cure the inflation that underlies all our problems, domestic and international alike. Again, there is no evidence of any attempt to prop up a failing system, as happened in 1971. On balance, then, the policymakers of today deserve a reasonably good grade for addressing real problems with realistic solutions — unlike their counterparts of 1971, who swept problems under the rug or even adopted counterproductive solutions whose effects still bedevil our lives.

William Burke

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 10/25/78	Change from 10/18/78	Change from year ago	
			Dollar	Percent
Loans (gross, adjusted) and investments*	119,152	- 189	+ 17,391	+ 17.09
Loans (gross, adjusted)—total	96,206	- 164	+ 16,812	+ 21.18
Security loans	1,722	- 186	- 220	- 11.33
Commercial and industrial	28,037	- 139	+ 3,919	+ 16.25
Real estate	33,738	+ 107	+ 7,482	+ 28.50
Consumer instalment	17,975	+ 53	+ 3,962	+ 28.27
U.S. Treasury securities	8,559	+ 32	+ 753	+ 9.65
Other securities	14,387	- 57	- 174	- 1.19
Deposits (less cash items)—total*	114,294	+ 394	+ 15,400	+ 15.57
Demand deposits (adjusted)	30,683	- 1,395	+ 1,874	+ 6.50
U.S. Government deposits	959	+ 531	+ 674	+ 236.49
Time deposits—total*	80,786	+ 1,196	+ 12,869	+ 18.95
States and political subdivisions	6,564	+ 73	+ 1,224	+ 22.92
Savings deposits	31,769	- 115	+ 7	+ 0.02
Other time deposits‡	39,540	+ 1,038	+ 10,722	+ 37.21
Large negotiable CD's	19,090	+ 945	+ 8,453	+ 79.47
Weekly Averages of Daily Figures	Week ended 10/25/78	Week ended 10/18/78	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves(+)/Deficiency (-)	+ 74	- 27	+ 26	
Borrowings	36	25	8	
Net free(+)/Net borrowed (-)	+ 38	- 52	+ 18	
Federal Funds—Seven Large Banks				
Interbank Federal fund transactions				
Net purchases (+)/Net sales(-)	+ 455	+ 1,629	+ 1,315	
Transactions with U.S. security dealers				
Net loans (+)/Net borrowings (-)	- 371	+ 93	+ 416	

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

Editorial comments may be addressed to the editor (William Burke) or to the author. . . .

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