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The Fed--A Case Study

Remarks by

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I'm not sure how well all you financial tigers have done since you transferred your expertise from the banks of the Charles River to the shores of San Francisco Bay, but you all look prosperous, so it would seem your balance sheets must be in pretty good order. Since you're all hard-bitten veterans of the case-study method, I'd like to give you a case study to ponder--the management of a regional Federal Reserve Bank. I'll begin by outlining some of the new management initiatives I've taken during my three years as President, and then discuss that important case study which we analyze every month at the meetings of the Federal Open Market Committee--the state of the national economy. Then you can start firing questions, and those that I don't want to handle I'll toss to my associate, Gerald R. Kelly, Senior Vice President in charge of Branch Operations.

The Fed was organized sixty years ago with twelve semi-autonomous Federal Reserve Banks, operating under the general supervision of the Board of Governors, a seven-man body appointed by the President of the United States and confirmed by the Senate. The West was the logical area for the location of a new Reserve Bank, and that logic has become more evident over the years with the westward flow of population. Between 1914 and today, our nine-state District has increased its share of the nation's commercial-bank deposits from 6½ to 14½ percent.

In 1914, the San Francisco Reserve Bank opened with a staff of just 21 people--officers, tellers, bookkeepers, stenographers, messengers, one guard and one janitor. When I arrived several years ago I had the impression that some of those people were still on the payroll. Seriously, any institution is bound to gather some cobwebs over a period of time, and that is especially true of an organization like ours which was largely dominated for the first 50 years of its existence by just two individuals. As I took over, it seemed to me that new approaches were necessary in each of our major fields of activity--operations, regulations and monetary policy.

Public Relations and Regulations

My first job was to let the world know that we were here, and this meant more public appearances by me and my staff, and an expanded publications program directed toward key opinion leaders in the business and financial worlds. This program was designed to bring solid information on major national issues to the public through an annual report, reprints of my speeches and a weekly newsletter. But the job of showing the flag frequently meant extensive travel, and in one case involved a 35,000-mile tour of nine Far Eastern countries to meet foreign monetary officials and commercial bankers.

That trip, not incidentally, was involved with my second initiative--the area of bank regulation. During my meetings both here and in the Far East with legislators, regulatory officials and bankers, I became closely involved in the question of foreign-bank regulation in this country. The work of many people in this problem area has now helped formulate legislation designed to extend Federal regulation, on a nondiscriminatory basis, to all foreign banks operating inside the United States. But that was only one of my worries in the regulatory field. Early in my tenure, the U.S. National Bank of San Diego closed its doors, and although that was not within our area of supervision--national banks are examined by the Comptroller of the

Currency--it became clear that we and the other regulatory agencies needed a better early warning system to detect financial problem areas. I've spent a lot of time on that problem, and eventually decided to set up a special financial-monitoring unit to make sure that there would be no more U.S. Nationals or Franklin Nationals in this area.

Restructuring Management

But along the way, I decided that we needed not just one or two new units but a complete restructuring of our management and operations. So what did we do? Right—we called in the consultants. I wanted three questions answered. Could we improve our organization chart? Could we improve our operating procedures? Could we improve our salary structure? A separate set of consultants went to work on each problem, and (you won't be surprised to hear) their answer was yes to each question.

First, it was evident that there were several drawbacks to the Bank's former structure. The old organization chart showed five headquarters officers reporting directly to me, and nine other officers (five of them here and four others at branch offices) reporting directly to the First Vice President. This unwieldy structure frequently caused slip-ups in communications and delays in decisionmaking. With our restructuring, top-management decisions can now be implemented smoothly through a five-man Managing Committee consisting of the heads of three new administrative groups plus the First Vice President and myself. Mr. Kelly is the overseer of our District-wide central banking services, heading up the five branches--a newly-organized branch here in San Francisco, plus the four offices in

Los Angeles, Portland, Salt Lake City and Seattle. Another Senior VP heads up a group of District Departments, including such activities as economic research, bank examination and credit. The other Senior VP heads up Corporate Staff, including such activities as computer systems, budget and other housekeeping chores.

While we were redrawing the organization chart, another consulting firm conducted a diagnostic review of all internal Bank operations. This study led to the creation of a productivity-improvement program which has resulted in a basic overhaul of operations, in an attempt to improve cost effectiveness and to develop more clearly defined jobs and improved working conditions. On balance, we reduced our staff by 16%, even after certain additions to some departments that needed beefing up in order to perform effectively.

To my mind, this program was essential, so that we could handle sharp increases in workload without unacceptable cost increases. But it was also essential that we reward adequately those of our personnel who were contributing to these productivity improvements. Thus we implemented a new job-evaluation program for official and mid-level staff positions, and in addition, conducted new salary studies to ensure that our salary scale remains competitive with that of progressive firms elsewhere.

The Economy and Monetary Policy

But so much for internal reforms. Our greatest task is to help keep the economy healthy, and here we can best contribute through our work with that key decisionmaking body, the Federal Open Market Committee. I attend all of the monthly meetings of that committee in Washington, and attempt to make a contribution through a searching analysis of the issues as presented by my own research staff as well as the Board of Governors' staff. Several years ago I reached out to the Midwest and hired an economist from the St. Louis Federal Reserve Bank--world famous for its independent approach--to head up our research staff. But I too am from the Midwest; although a native of Illinois, philosophically I'm from Missouri, so I make sure to get inputs not just from economists but from as wide a circle of informed opinion as possible. This is where a good Board of Directors can be helpful. Each Federal Reserve Bank (and each branch) have directors representing local business and financial communities as well as the public interest. These boards have some of the management powers that corporate boards exercise, and in addition, they are immensely valuable to me as sources of economic information regarding the various industrial and regional sectors in which they operate. Here again is another example of the virtues of the regional structure developed by the founders of the Federal Reserve System 60 years ago.

Now let me give you an example of the context in which the Federal Open Market Committee operates, by reviewing briefly the state of the economy and the complexity of the factors which influence monetary policy. We begin with an economic turnaround which became visible during the late spring and summer months. This recovery should be sustained by consumer buying along with some inventory restocking, but it's liable to be somewhat uneven because of the structural problems of the key auto and housing industries.

Business spending for inventories was the weakest link in last winter's severe slump, but because of its self-correcting nature, it should be one of the stronger elements of the outlook for the next year or so. Business inventories declined at a $25-billion annual rate in the first half of this year, so that stockroom shelves have now been cleared of most of their excess supplies. Just ending the cutbacks, without any net increase in inventories, would thus remove a $25-billion depressant on GNP.

Now, the major factor in the late-spring turnaround in real GNP was an upsurge in consumer spending. After adjustment for price increases, consumer spending rose at more than a 6-percent annual rate during that period, reflecting an unparalleled 22-percent rate of gain in real disposable income. Take-home pay was boosted about $48 billion this spring by the provision of the Tax Reduction Act, including actual tax cuts as well as increases in social-security and other transfer payments. That stimulus was reinforced by a slowing of the inflation rate, which also helped boost real income.

The catch is that the upturn could now be endangered if the price situation turns around and the inflation rate speeds up once again. I'm sure you've all noticed the recent increases in food, fuel, and industrial-goods prices. I should add that recent price and wage gains are significantly smaller than last year's increases, but they are still extraordinarily high in the context of the worst business slump in the past generation. Far stronger anti-monopoly policies may be needed to keep this type of cost-push inflation under control.

The greatest danger, however, is a price upsurge generated by the same basic forces that have been behind the powerful groundswell of prices throughout the past decade; that is, unparalleled Federal budget deficits and a necessarily accommodative monetary policy. On the heels of fiscal 1975's $44-billion deficit, fiscal 1976 will have the distinction of breaking the World War II record with a deficit currently estimated at $59 billion.

More Federal spending would aggravate the pressures already evident in financial markets, with unparalleled Federal demands piled on top of gradually reviving private credit demands. This is the well-publicized and all-too-real problem of crowding out.

Some observers argue that the Federal Reserve's task is to ensure that all borrowing demands--both Federal and private--are accommodated at stable or declining rates. Such an approach, by flooding the markets with liquidity, could prevent current credit-market strains but at the expense of fueling inflation anew as the recovery builds up steam. But, the question goes, with so many idle resources in the economy, how could inflationary pressures arise from easy money at this stage?

The answer, at least in part, involves the lags in the effects of monetary policy, which seem to be much shorter for production, employment and profits than for prices. Our knowledge about the length of those lags is still imperfect. Still, it's reasonably clear that when an easy-money policy is adopted, the "good news" appears first, with production, employment and profits expanding within 6 to 12 months or so. But the "bad news" comes later, in the form of increased inflation with a lag of 1 to 3 years. Conversely, if a tight-money policy is adopted, the bad news of a dampening of economic activity comes first, whereas the good news of a diminished rate of inflation is delayed. Is it any wonder that elected officials who must face the voters at regular intervals usually prefer an easy-money policy?

Concluding Remarks

With this broad-brush treatment, I've tried to show that the economy is much more complex now than it was in 1914, so that the institutions which deal with the economy must make every effort to keep up to date in their own operations. There are some signs that our task in the future will be even more complex. In one crucial area, the Brave New World of electronic funds transfers could call for completely new approaches in central-banking services--for example, by revolutionizing our check-processing activities--as well as in the field of bank regulation. In an even more important area, monetary policy, the growing size and interdependence of the world economy is bound to create ever-more-complex problems. With developments like these, we can be certain that the B School will never run out of new cases to study.

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