



FEDERAL RESERVE BANK OF SAN FRANCISCO
Office of the President

MONETARY POLICY

Remarks of
John J. Balles, President
Federal Reserve Bank of San Francisco

Twenty-Ninth Assembly for
Bank Directors

San Francisco, California
November 6, 1977

Monetary Policy

I'm delighted to participate in this Twenty-ninth Assembly, as we discuss the broad financial and policy issues that will be affecting your actions as directors in the year ahead. Regarding my assigned topic of monetary policy, I find that this is a very appropriate time for such a discussion, because monetary policy has become a subject of intense debate at this point of the current economic recovery. I find it especially appropriate that we're meeting on Sunday morning to discuss the topic, because I believe that some pulpit-pounding is necessary on that subject.

Our choice of policy of course depends on our analysis of where the economy is going in 1978, so I should first say a few words on that subject. The bedraggled survivors of Wall Street will tell you that we're on the verge of a recession, because all of the six recessions in the past generation have been preceded by stock-market declines. However, there have been at least four other bear markets that weren't followed by recessions--and this is probably just such a case. One important reason is the general air of caution that now dominates the thinking of households as well as business and financial people. This general attitude has produced--and should continue to produce--an expansion that moves ahead by fits and starts. This kind of an expansion will not allow the ongoing recovery to develop into a full-fledged boom, but neither will it lead to a full-blown recession.

General Outlook

Most economists agree that the headlong pace of last winter and spring will not be sustained in the year ahead. What seems more likely is a gradual deceleration, following the rapid 7-percent rate of growth of real output in the first half of 1977. Output might grow at about a 4½-percent rate in the second half of this year, and perhaps at about a 3½-percent pace

between late 1977 and late 1978. At that rate, the economy would be moving roughly in line with its long-run potential, calculated in terms of a steadily growing and more efficient workforce. That is probably the most viable pace for a sustainable prosperity into the 1980's.

According to the standard forecast--if there is any such thing right now--1978 may witness some moderation of consumer spending for autos and other goods, following the speedup in that category earlier this year. Again, in view of the recent record pace of single-family home construction, that sector may be less buoyant in the year ahead. Inventory spending meanwhile should continue to reflect the underlying attitude of caution, adjusting promptly to changes in business sales.

In contrast, several sectors of the national economy could grow at an accelerated pace in the year ahead. Business spending for new plant and equipment is one such area, especially in view of the near-capacity levels of operation evident in at least some industries. Spending by state and local governments looks solid, bolstered by Federal grants, by higher tax rates, and by the expanding economy's boost to tax revenues. Again, defense spending seems more expansive, shown by the growth of military prime-contract awards, which are running roughly one-third above a year ago. On balance, then, we might expect continued growth but a change in the character of the expansion, with the fast-growing sectors of the past year slowing down and the former slow-growers speeding up.

Inflation Problem

Needless to say, we're faced with a number of difficult problems that could undermine the strength of the 1978 economy. The list includes the record deficit in our international transactions, as well as the severe

stock-market decline, the continued high level of unemployment, the cost squeeze in agriculture and other basic industries, the upsurge in energy costs, and the uncertainty undermining business investment plans. But throughout all our problems runs a single common thread--inflation, which continually upsets the delicate balance of our economy. Admittedly, inflation has increased at "only" a 4-percent rate over the past several months, reflecting some easing in food and other commodity prices. But most analysts agree that a 6-to-7 percent rate of inflation has become imbedded in the overall economy, judging either from the past year's trend of prices, or the increases in wage costs incurred by major pattern-setting industries, or the amount of past fiscal and monetary stimulus.

The search for the basic cause of these price pressures always comes back to the long series of Federal budget deficits incurred over the past decade or so. Deficit spending has worked to pull monetary policy off target in an expansionary direction, by supporting excessive growth of money and credit. Over time, these deficits have created substantial demands for goods and services without at the same time adding to the supply of goods and services.

Total Federal spending has grown at an unparalleled pace in the late 1960's and early 1970's. Defense spending has contributed to this budget growth, notably during the Vietnam War period. But the most worrisome increases, which are not even reviewed by Congress after the initial legislation, have been recorded in what budget makers call "uncontrollable" categories--certainly a very apt description. Most of these programs involve the automatic transfer of money to anyone eligible under entitlement formulas written into law. Ballooning expenditures have been the result. The

country was 186 years old before the Federal government spent \$100 billion a year, but by the time of the Bicentennial it was spending almost \$400 billion annually. And revenues have failed to keep up with this spending upsurge, so that deficits have been recorded in 15 of the last 16 years. The cumulative deficit in that period, including spending of off-budget agencies, has amounted to \$337 billion. By failing to increase direct taxes to cover this increased spending, the Federal government decided in effect to impose a silent yet severe inflation tax.

There are hopeful signs in the reform achieved under the Congressional Budget Act of 1974, which provided a mechanism for determining Congressional priorities and relating expenditures to prospective revenues. There are hopeful signs too in some aspects of the recent budget picture. The deficit for fiscal 1977 amounted to \$45 billion--\$23 billion below what the Administration had expected early in the year. This came about partly because of a healthy increase in revenues, and partly because of the unexplained failure of bureaucrats to do what they usually do best--that is, spend money. From these indications, it's possible that the fiscal 1978 budget will also be lower than expected. Still, that's little consolation when we consider that the projected deficit figure--\$62 billion--approaches the worst recession figure, although an expanding economy such as ours should not require that much stimulus from deficit financing.

Money and Interest Rates

Now, the central question for many people is what the Federal Reserve will do in 1978, given the fears of an impending recession and the conflicting reality of a strong yet inflation-prone economy. Let's consider first what the Fed's responsibilities are and how we carry out our tasks.

The Federal Reserve has many responsibilities in the area of wholesale-banking operations and bank supervision, but our most critical assignment is to help keep the economy healthy through the proper application of monetary policy. With its mandate from Congress, the Fed helps promote a fully-employed non-inflationary economy through its ability to influence the cost and quantity of money and credit. The Fed seeks to regulate money at its source by affecting the reserves of member banks. These changes in bank reserves directly influence the ability of banks to expand loans and investments in securities, and indirectly they affect the overall state of the financial markets.

Let's review the weapons we have available to affect bank reserve accounts. The Board of Governors can change the percentage of reserves that member banks must hold against their deposits. Reserve Banks (with the Board's approval) can change the interest rate that they charge member banks for temporary loans to bring reserves up to required levels. But the Fed's most important and most frequently used policy tool is open-market operations--that is, the Fed's buying or selling of Government securities in the open market to influence money and credit conditions. The result is measured by changes in the reserve base of the banking system, and indirectly by changes in the monetary aggregates-- M_1 (currency plus bank demand deposits), M_2 (currency plus bank demand and time deposits, except large CD's)--and all the other M's that financial analysts like to consider. You should also note that open-market operations affect the Federal-funds rate--the price of the unused reserves which member banks lend back and forth in order to meet their reserve requirements.

Much of the confusion over the recent direction of monetary policy arises because of the disagreements about whether monetary stimulus is actually called for at this point of the business expansion. We're told, for example, that we shouldn't worry about the recent upsurge in the money supply because we're not facing circumstances of rapid economic expansion, high employment and a worsening inflation outlook. In reality, the current economic expansion has been the strongest of the past generation, with real GNP rising at about a 6-percent annual rate for the past two and a half years, and with an unprecedented 6½ million new jobs generated during that period. Moreover, we continue to face an ominous inflation outlook, because experience has shown that when monetary policy is dragged off course by the need to finance massive budget deficits, the immediate result is a boomier economy but the eventual result is more inflation.

Again, some observers claim that policy should be more expansive to cure the continuing problem of unemployment in the economy. This argument assumes that there is a trade-off--that we can reduce unemployment if we are willing to put up with a bit more inflation, and vice versa. However, I believe that this is a false dilemma. The experience of a number of countries--the U.S., Great Britain, Canada and others--has shown that inflation sometimes tends to increase rather than to decrease unemployment. This perverse impact of rising prices on unemployment can be explained by the joint reactions of consumers and producers, for whom inflation means increased uncertainty about the future. Households, more uncertain about the future value of their real incomes, tend to cut back on their spending plans. Businesses, more uncertain about the rate of return on new capital, tend to reduce investment in plant and equipment. The actions of both

groups lower the total level of demand in the economy, and thereby tend to raise the jobless rate. Consequently, the goals of reduced unemployment and lower inflation are mutually reinforcing, not conflicting.

As you know, Fed policy has been attacked recently from two opposite directions, which may be evidence in itself that we're on the right track. Those critics who closely follow money-supply trends argue that policy has been too easy, and that it will inexorably lead to severe inflation. Those critics who closely follow every basis-point rise in interest rates claim that policy has been too tight, and that it will condemn us to a credit crunch and a renewed recession. Our duty, however, is to thread a middle course between those two extremes, recognizing our responsibility for supporting the sometimes conflicting goals of economic growth, high employment, price stability and stable financial markets. In today's economic and financial context, the best policy prescription is to pursue a gradual reduction in the growth rates of the monetary aggregates, to a level consistent with long-run price stability. This is the course on which the Fed set out in March 1975, when it began the practice of making quarterly reports to Congress regarding our targets for monetary growth over the year ahead.

Let's consider specifically the charges of those who claim that monetary policy has been too restrictive. Generally, they back up this argument by pointing to the rise of almost two percentage points in short-term interest rates since last spring. However, that attitude ignores the fact that other factors besides monetary policy affect short-term rates--including the state of credit demands, which have been expanding in line with the growing economy. Furthermore, all interest rates have not risen since last spring. Long-term rates, such as the yield on new issues of prime-quality

utilities, have remained virtually flat over this period. One important reason is that long-term rates incorporate the market's expectation of future inflation. The stability of these rates suggests that marketmakers are relatively optimistic about the ability of policymakers to keep inflation at bay. The professionals apparently have interpreted the rise in short-term rates as an indication that the Fed is taking appropriate measures to prevent runaway money growth.

Some critics claim that even the past year's high rate of money growth has been inadequate to support the growth of the economy, because the growth of the real (price adjusted) money supply has been modest in the context of a 6-percent inflation rate. Their prescription, then, is to increase the rate of money growth to step up the growth of the underlying economy. I would have thought that that type of analysis went out of style with the German inflation of the 1920's, when people ran around with baskets of money trying to buy loaves of bread. More rapid growth now would guarantee even more inflation in the future, which according to the argument I cited, would call for a further increase in the rate of money growth. But at some point, it would be necessary to slam on the brakes, with disastrous consequences for the economy.

I believe that, if we are to be effective in carrying out our monetary-policy responsibilities, continued Federal Reserve independence is essential-- indeed, now more than ever. The founders of the Federal Reserve early in this century introduced a measure of discipline into policymaking by ensuring the independence of the central bank within the structure of the Federal government. For example, the law provides that the Fed's Board of Governors shall have seven members appointed to staggered 14-year terms to prevent

packing the Board. The law also gives the Fed an independent source of revenue, the interest earnings on its portfolio of government securities, to prevent it from being coerced by Congressional control of its purse-strings.

Within that structure, we in the Fed have been able to make prompt and (if need be) frequent changes in monetary policy, in contrast to the necessarily ponderous processes of fiscal policy. We have also been able to make the hard decisions that might be avoided by decision-makers subject to the day-to-day pressures of political life. Certainly, the Fed has stumbled on some occasions, but it's hard to imagine our problems would have been solved if the control of the monetary authority had been turned over to the Executive branch or to Congress. Indeed, if the spending propensities of Federal officials had been given freer rein through easier access to the "printing press," our inflation problem of the past decade likely would have been far worse. As evidence, consider the fact that the two industrial nations with the strongest central banks--Germany and the United States--are the two with the best records of curbing inflation.

Concluding Remarks

To sum up, the national economy (with certain exceptions) is in relatively good shape as we approach the new year. Production, employment and sales are still growing substantially in most areas. Indeed, today's diverse and solidly-based expansion could continue for the rest of the decade if only--and it's a big if--we could get prices under control. And as I've said, the best way to stop inflation is to get the Federal budget under control.

When fiscal policy results in chronic and massive budget deficits, the Fed comes under tremendous pressure to provide more reserves to the banking system to help finance such deficits. This reserve expansion increases the rate of monetary growth and ultimately leads to more inflation. The independence of the Fed within the government gives it some room to resist these pressures. But if we are to bring inflation under control, it will be necessary for fiscal policy to complement monetary policy. The achievement of fiscal restraint is perhaps the greatest policy challenge in the years ahead.

#