FRB·SF

FEDERAL RESERVE BANK OF SAN FRANCISCO
Office of the President

THE FED AND THE ECONOMY

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

Rotary Club of Salt Lake City
Salt Lake City, Utah

September 25, 1979

The Fed and the Economy

I'm grateful for this opportunity to appear before Salt Lake's Rotary Club, and in addition, to visit once again this bountiful area of the West. My appearance here gives me the chance to pay tribute to the remarkable institution of Rotary, which has expanded over the past three-quarters of a century, until it now encompasses roughly three-quarters of a million service-minded individuals throughout the world. The high standards attained in our American business system depend greatly on the ideals of community service constantly fostered by Rotarians and like-minded individuals for many decades.

I'm also glad to have a chance to pay tribute to Utah's striking economic performance, which has been so much stronger than the performance of most other areas in recent years. The national economy has generated a substantial one-fourth increase in the number of jobs since early in this decade, but the Utah economy has done considerably better, with employment half again as large as it was in the early 1970's. More importantly, Utah's economy is on the cutting edge of the future, with its strong contribution to the solution of the nation's energy crisis -- and also with a work ethic that is dedicated to overcoming problems, rather than watching problems overcome us.

But today, I'd like to devote my time to telling you what we in the Federal Reserve have been doing to help overcome the problems facing the banking industry and the national economy. First, a little historical background. The Federal Reserve was organized 65 years ago as the nation's central bank. It consists of twelve semi-autonomous Federal Reserve Banks, operating under the general supervision of the Board of Governors, a seven-man body appointed by the President 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 and trade.

When we became organized in 1914, our nine-state District accounted for 6 1/2 percent of the nation's commercial-bank deposits, but today it has 16 percent of the total. In 1914, the San Francisco Reserve Bank opened for business with a staff of just 21 people -- officers, tellers, bookkeepers, stenographers, messengers, one guard and one janitor. Today our offices in five Western cities (including Salt Lake City) employ about 2,000 people, and serve 35 million people and almost 6,500 banking offices in a vast area stretching from the Arctic Circle to the Mexican border and from the Rockies to the mid-Pacific.

Our operations affect the flows of money and credit -- the lifeblood of our business economy -- so that our job is to keep the nation's economic blood pressure under control. We're helped immeasurably in that task by the advice we get from the able individuals who serve as directors at each of our five offices, including such local luminaries as Wendell Ashton, Bob Bryans, David Gardner and Fred Stringham. Those directors bring management expertise to the task of overseeing Reserve Bank operations. They also provide first-hand information on key economic developments, plus invaluable advice on the general direction of monetary policy.

Operations and Regulation

Like every other central bank, the Federal Reserve is in most respects a wholesale bank, dealing largely with the financial community and the U.S. Treasury. Most employees at the twelve Reserve Banks throughout the country work at providing central banking services for their communities -- keeping the wheels of business humming with coin, currency, check-processing services

and the like. Last year, the people at our five offices handled 953 million pieces of currency, 264 million food stamps, almost 2 billion coins, almost 1.4 billion paper checks, and many other chores besides. However, our work load would have been much heavier had we not benefited from all the internal processing that goes on inside the branch systems of the large Western commercial banks.

Monitoring and supervising financial institutions is another major function. We at the Fed supervise state-chartered banks which are members of the Federal Reserve System, along with bank holding companies and various international activities -- and the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the state banking authorities all have different pieces of the pie. The system is complex, and occasionally needs adjustment. At the San Francisco Fed, we set up a special financial-monitoring unit several years ago to ensure that we wouldn't run across any unwelcome surprises among the banks that we supervise. And at the national level, the Board of Governors has worked closely with Congress over the years to improve the protection of the banking public, most recently in 1978 with the passage of the International Banking Act and the Financial Institutions Regulatory Act.

The Federal Reserve is also responsible for preparing regulations which implement the nation's consumer-credit legislation, and the Fed shares enforcement powers in this field with a number of other Federal agencies. This legislation provides for uniform disclosure of credit costs, so that consumers can compare credit terms more readily and thus avoid the uninformed use of credit. Consumer-credit legislation is also designed to help consumers and creditors resolve credit-billing disputes

in a fair and timely manner, and to help ensure that there's no discrimination -- on the basis of such factors as race, sex or marital status -- in any credit transaction.

Scope of Policy

The Fed's major task, however, is to help keep the economy healthy, or as I said at the outset, to keep the nation's blood pressure under control. We get our marching orders from the Federal Reserve Act of 1913 as modified by additional legislation in 1933 and 1935. As far as economic policy is concerned, our basic goals are defined by the Employment Act of 1946, with its commitment to "maximum employment, production and purchasing power." Those are all laudable objectives, and I would add one more -- price stability -- that should have been made explicit in the Employment Act, but wasn't officially made a goal of policy until last year, in the Full Employment and Balanced Growth Act of 1978.

The Federal Reserve helps the nation attain these economic goals through its ability to influence the availability and the cost of money and credit. As the nation's central bank, it tries to ensure that money and credit growth is sufficient over the long run to provide a rising standard of living for our growing population. In addition, it works in the short run to counteract recessionary and inflationary influences as they arise. Moreover, as lender of last resort, it utilizes all available policy instruments when necessary in an attempt to forestall national liquidity crises and financial panics. The Fed achieves its ends by influencing the reserves held against bank deposits, utilizing such tools as purchases and sales of Government securities in the open market, as well as changes in reserve requirements and discount rates.

But of course, monetary policy is only one of the many factors affecting the health of the economy. Government tax and expenditure policies bear critically on the economy's performance, and so too does the government's international economic policy. Government credit policies that affect housing, small business and agriculture also influence the broader economy. The wage and price policies of business firms have very important effects. And finally, there are innumerable other private and public decisions, many of which are independent of monetary and fiscal policies, but related rather to such crucial non-economic factors as technological innovations, international crises, population shifts and public confidence.

Dimensions of Present Problem

Now let's consider the situation which faces monetary and other policymakers in the fall of 1979. Generally, we appear to be in the early stage of the most widely heralded recession of recent times. Real gross national product -- that is, GNP adjusted for inflation -- moved practically sideways in the first quarter of 1979, and then dropped at about a 2 1/2-percent annual rate in the second quarter of the year. This recent development followed the longest and the strongest peacetime expansion of the past generation. But the distortions introduced into the economy by the worsening inflation of the past several years undermined this solid expansion and finally brought on the day of reckoning.

Most observers doubt that things will turn out as badly in 1979 as they did in 1974-75, although there are some eerie parallels, such as a renewed energy crisis. The last time around, we suffered from the previous boom period's unsustainably high production levels in

autos, housing, capital goods, and inventories. However, the relatively well-balanced expansion of the 1975-79 period kept output in most of those areas much closer to sustainable long-term needs. And even the oil-price shock has been relatively lighter now than it was in 1973-74. In this somewhat confused situation, we may have difficulty deciding what indicators to use as policy guides.

If past experience is any guide, we may soon hear demands for a substantial stimulus to the economy, because a key indicator, the unemployment rate, jumped last month from 5.7 to 6.0 percent of the national labor force--the highest level in more than a year's time. Some people still think that the nation isn't fully employed until the jobless rate drops to 4 percent, whereas in actuality, inflationary pressures develop when the jobless rate is in its present range, because of all the demographic and institutional changes that have occurred over the past several decades. For example, the sharp rise in the number of inexperienced women and teenaged workers has pushed up the average jobless rate, because these individuals enter and re-enter the job market more often than the average, and thus exhibit higher-than-average jobless rates. For another example, the unemployment-insurance program has been liberalized several times over this period, with coverage extended and benefits increased, and changes such as these have helped extend the duration of unemployment and hence raise the overall jobless rate. In any event, people who insist on using an outdated jobless measure as a signal for policy remind me of people who drive around with a broken speedometer, claiming that the car is going only 55 miles an hour when it's actually speeding along at an overheated 75 miles an hour.

In somewhat similar fashion, some people are now demanding an easier policy because of the signals they're receiving from record-high interest rates. True enough, short-term rates at least have soared over the past year, with the Treasury bill rate (at about 10½ percent) and the prime business-loan rate (at 13¼ percent) both about 3½ percentage points higher than they were this time a year ago. But it should be emphasized that the Federal Reserve doesn't take any perverse pride in watching interest rates rise in this fashion. The Fed has attempted to slow money-and-credit growth in the past year only as a means of curbing inflation, because the only certain way to keep rates low over the long-haul is to wring inflation expectations out of the economy. After all, it is inflation expectations that cause lenders to demand more for the use of their money, and that cause borrowers to be willing to pay more for that money.

The point to remember is that the inflation rate remains the crucial indicator to watch at this particular stage of the business cycle. Consumer prices have soared more than 13 percent, at an annual rate, to date this year. This matches the worst upsurge of the 1973-74 period. Moreover, the food and energy sectors have not been the only sources of the problem. Those volatile sectors account for only about one-fourth of the consumer market basket, so we have to look to the rest of the market basket to measure the "underlying" rate of inflation. Well, the prices of those other goods and services increased at more than a 10-percent annual rate during the January-July period, which shows that our inflation problem is quite widespread and not simply restricted to a few headline-catching items.

Restrictions on Monetary Policy

Our severe inflation problem can be traced in part to the OPEC cartel's decision to boost prices, in part to a series of problems affecting the food industry, and in part to the price pressures brought about by the 1977-78 decline in the value of the dollar. But a crucial inflation factor has been the excessive growth of the money supply during the past several years. The broad money supply, M_2, defined as currency plus all bank deposits except large time certificates, increased at a 9-percent annual rate over the four-year business expansion -- and this was close to or even above the top of the target ranges successively set by the Federal Reserve during this period.

Why did the money supply grow so expansively? To answer that question, we've got to understand the institutional factors which complicate the Federal Reserve's policy task. We central bankers can forcefully present our views on sound financial policy, and within the limits of our authority we can implement appropriate actions. But in the last analysis, a central bank in a democracy does not have -- and should not have -- the authority to nullify continually the policies of the nation's elected representatives.

Another complicating factor is the lagged impact of monetary policy. The economy does not respond instantly to each change in the cost and availability of money and credit. Rather it responds only after a lag of time, and that lag (unfortunately) is not constant and predictable. Moreover, in practical terms, monetary policy cannot offset the inflationary effects of large budget deficits during boom

periods, because fiscal policy and monetary policy affect the economy in different ways. Monetary policy operates less directly and on a narrower front than fiscal policy, through its influence basically on the rate of growth of bank credit.

Yet problems arise because the various sectors of the economy don't all depend equally on bank credit -- and bank borrowers don't all have equal power or credit standing. Very large corporations, and of course the Federal government, can also obtain funds from such sources as the money and capital markets. But those markets are not as readily available, if at all, to small businesses, consumers, farmers, home builders, and state-and-local government units. Hence, these groups are usually the first to be affected, and the most seriously hurt, by any program of monetary restraint. Consequently, it may not be desirable, or even practically possible, to rely on monetary policy alone to combat inflation, especially when that problem is aggravated as it has been by heavy deficit financing in a period of high employment.

Need for Integrated Policies

It's evident to me that we need a broad-scale and well-integrated set of policies to combat inflation and recession, involving all types of private and government policy-makers. First, we must institute a moderate fiscal policy -- one which will not destabilize the 1980's as it did the 1970's. For this decade as a whole, we'll have a combined Federal budget deficit of roughly $320 billion -- just about equal to the combined deficit for the entire earlier history of the Republic. Admittedly, the size of the annual deficit is much smaller now than it

was several years ago, but the essential goal of a balanced budget at full employment continues to elude us. Indeed, some of the estimates coming out of Washington these days suggest that the deficit could reach $50 billion in fiscal 1980, under the impact of a business slowdown and tax-cut pressures.

A key step in reducing Federal budget pressures on the economy is to bring under control the so-called "uncontrollable" categories of income-transfer payments, which have jumped from $27 billion to $197 billion annually just within the past decade and a half. Once such open-ended programs are established, funds are disbursed -- without specific Congressional action -- in response to changes in business conditions, prices and so on. (Indeed, more than half of the expenditures in the Federal budget are now indexed to rise with inflation.) Another necessary step is to bring under control all the legislated cost increases which may add a full percentage point or more to the basic rate of inflation. As you know, there's a long list of such factors: environmental, health and safety regulations; increases in the minimum wage and social-security taxes; farm price-support legislation, and all the subsidies and restrictions surrounding the rail, maritime, trucking, steel, construction and energy industries.

Meanwhile, we must unleash the productive American economy and get back on the productivity track from which we've strayed so badly in the past decade. There are some prospective plus signs in the productivity outlook. That famous baby-boom generation -- the one that we parents despaired of in the 1960's -- is now magically being transformed into a bumper crop of experienced and productive adults. But to reach their

full potential, those people need lots of new capital equipment to work with. We can no longer be satisfied with spending less than 10 percent of our GNP on capital investment, when the Germans spend 15 percent, and the Japanese 20 percent, of their GNP for that purpose.

To stimulate productivity-enhancing investment, we must do a great deal more to improve our tax structure. Reductions in business taxes would be useful, as a means of releasing funds that could be channeled into efficient new plant and equipment. Equally useful would be a major overhaul of depreciation allowances, such as the "1-5-10" formula which Treasury Secretary Miller proposed while he was still Federal Reserve Chairman. This formula stands for a new policy of liberalized depreciation, under which all mandated investments for health-safety-environmental purposes would be written off in one year, all new investments for productive equipment would be written off in five years, and all capital in structures and permanent facilities would be written off in ten.

Concluding Remarks

To conclude, I hope that you now have a better feel for the scope of the Fed's activities, ranging from the mundane handling of checks, coin and currency all the way to the intricacies of monetary policy. In this latter area, we face a real dilemma today. Business-cycle considerations dictate relatively easy monetary and fiscal policies, as a means of offsetting the downturn in the economy. But other considerations -- inflation at home and a weakened dollar abroad -- dictate a tighter set of policies, as a means of restoring the stability which is so essential to our own welfare and to the welfare of the entire world economy.

Monetary policy can play a major role in solving our problems, by moving gradually to a rate of money-supply growth which is consistent with long-term price stability. But as I've indicated, we need an integrated and broad-scale set of programs to deal with our multiple problems. In particular, we must strive for better control of our fiscal policy, to reduce inflationary pressures from that source -- and we must strive for greater investment in our private economy, to create the productive jobs which will generate the higher living standards of the 1980's.

# # #