

POLICY PROBLEMS IN 1980

Remarks of  
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As I look around the room, I'm reminded of what the Duke of Wellington supposedly said when reviewing the troops before the battle of Waterloo. "They may not frighten the enemy, Sire, but by Gad they frighten me." I hope that you people are as zealous in your supervisory and examination activities as you appear to be when lined up on review.

In my remarks today, I'd like to cover some of the major policy problems that will affect your operations during 1980. Jack Beebe has already given you a flavor of what to expect on the economic scene -- a rather somber picture, I'm afraid. I'd like to follow-up and discuss the monetary policy implications of Jack's economic forecast. But first, let's stand back and review for a moment what happened in the decade just past, to see how we got into the mess we're in today.

### Cause of Today's Problems

Actually, the 1970's were not all bad. On the positive side, the national economy grew 32 percent (in real terms) between 1969 and 1979 -- a substantial gain, even though it failed to match the 50-percent gain of the preceding decade. Again, real disposable per capita income -- a key measure of individual well-being -- increased 28 percent in the 1970's, or almost as much as it did in the 1960's. But the nation ate up much of its seed corn in reaching its higher standard of living. Real business investment increased only one-third as fast, and worker productivity less than half as fast, as in the preceding decade. Worse still, the nation became increasingly dependent for its raw materials on unstable and expensive sources of supply, as evidenced by a 15-fold rise in the price of Middle Eastern oil over the decade.

Moreover, we're suffering today from the fact that economic growth in the 1970's depended so heavily on public-sector spending. In particular, massive Federal spending increases outpaced tax revenues and created red ink on the books for every single year of the decade. Indeed, the combined Federal deficit for the decade, \$315 billion, matched the combined total for the entire history of the Republic. Inflation became an ever-worsening problem, reflecting this prolonged series of deficits, the stimulative monetary expansion that sometimes accommodated them, and a series of supply-related shocks. Consumer prices practically doubled over the course of the decade, in the worst peacetime inflation in the nation's history.

The impact of accelerating inflation has been felt everywhere. In our international dealings, the inflationary surge has led to a decline in the power of the once-mighty dollar in the world's financial markets. Here at home, it has undermined the strength of the economy and made the task of monetary policy at times almost insuperable. In addition, it has undermined the strength of the Federal Reserve System itself by leading to a massive withdrawal of member banks, which now seems to have reached flood proportions. Other factors, of course, help explain why membership has become such a heavy burden -- financial innovations, shifting competitive patterns, and so on. But the major cause has been the upsurge of inflationary pressures, with their related high interest rates. It has become progressively more costly and more difficult for banks to justify continuing their membership, especially to their stockholders, when as non-members they can earn such high returns on their reserves.

#### Scope of Membership Problem

The numbers recently have been fairly sobering. In the fourth quarter of 1979 and the first few weeks of 1980, 69 banks with about \$7 billion in

deposits gave notice of withdrawal from System membership. The loss of deposits in this short period exceeded that recorded in any previous full year. Moreover, a recent survey by Reserve Banks indicated that many more banks are considering withdrawal -- altogether, some 670 banks, which represent more than 10 percent of the System's membership and hold more than \$71 billion in deposits. If these banks in fact withdraw from the System, deposits of banks holding reserves with the Federal Reserve will decline to 64 percent of banking-system deposits, compared with a 73-percent share just three years ago.

What can be done to stem the membership decline? The fight against inflation is crucial, to help reduce the financial incentives which lead banks to withdraw. But new legislation is also essential in this regard. Let's consider some of the basic principles which the System believes should be achieved by such legislation.

First, reserves should be applied to all transactions accounts, with perhaps some relatively low exemption level or a system of graduated requirements for the smallest institutions. Second, any reserve requirements imposed on time deposits should be confined to short-term non-personal accounts, and should be relatively low. Third, reserve requirements should be equal for all depository-institutions offering comparable accounts, in order to create a "level playing field." Fourth, the System's reserve base should be large enough to implement monetary policy efficiently and effectively. Fifth, all depository institutions holding transactions accounts should have access to Federal Reserve services, with the Federal Reserve recovering the full cost of those services from pricing. Finally, institutions should remain free to choose a state or Federal charter, so that System membership remains voluntary.

### Implementing Membership Principles

Translating these principles into reality can be quite time-consuming and difficult. What banks should be covered under the proposed legislation? What proportion of deposits should be held by those banks? How large should the reserve base be in relation to deposit totals? We have no formula for deciding precisely how large reserve balances need be, or how they should be distributed to insure effective monetary control and a well-functioning banking system. But as Chairman Volcker told the Senate Banking Committee several weeks ago, reserve requirements must be more equitably distributed among the nation's banks, even though the Federal Reserve can meet its responsibilities with a smaller reserve base than it now has.

In the System's view, monetary policy could still be conducted effectively with a reduction in reserve balances held at Federal Reserve banks to as little as \$10-15 billion (expressed in 1977 terms) -- provided the reduction is distributed equitably across depository-institutions having transactions accounts. That level of balances would be about 4 to 6 percent of transactions balances, and less than 1 1/2 percent of total deposits in depository institutions. However, that may be cutting it too thin. For that reason, the System urges at least stand-by capacity to obtain somewhat larger balances, up to \$20 billion or more in 1977 terms. The several pieces of legislation now being considered, either in the House or the Senate, do not meet this type of requirement.

In any event, the System wants to apply reserve requirements to depository institutions on a universal and mandatory basis. This approach is important because it applies reserve requirements equitably to comparable accounts -- thrifts as well as banks, and non-member as well as member

institutions. This is especially important with respect to the rapidly-growing components of the nation's basic money supply -- NOW accounts and ATS accounts, many of which now escape reserve requirements altogether.

It's hard to predict what will happen to membership legislation in the near future, at least partly because of the even-split in the Senate Banking Committee over the best means of solving the problem. We may know more after a scheduled March 4 meeting of House and Senate conferees. Perhaps at that time the log jam will break. But there's no question whatsoever about the need for reform legislation.

Among other reasons, legislation is needed because of the Federal Reserve's decision last October 6 to adopt new operating procedures. These new procedures place much greater emphasis on reserves as the instrument for controlling money growth. Thus far, they have worked reasonably well, but their effectiveness will be undercut with further increases in the share of money not subject to reserve requirements. It is thus essential to obtain legislation to maintain Federal Reserve control over the nation's reserve base, as one essential element in our basic anti-inflation program.

#### Improving Monetary Control

You'll remember that the "Saturday Special" of October 6 came about, in large part, because of the 1979 upsurge of inflation. Contrary to expectations, the U.S. economy heated up during the third quarter, with a buy-now spending boom which reflected an upsurge in inflationary expectations. As consumer prices rose at a 13-percent annual rate, households and businesses boosted their purchases and speculative pressures developed in commodity markets. Despite policy efforts to control the

situation -- measured by steady increases in the Federal-funds rate -- money growth actually accelerated; the annual growth of the  $M_2$  money supply jumped from 8.9 percent to 12.5 percent between the second and third quarters of the year.

The Fed thus had to act decisively on the monetary front to put a brake on inflation expectations. On October 6 the System introduced its three-part policy package, which included a 1-percent increase in the discount rate and an 8-percent marginal reserve requirement on certain managed liabilities. But in addition, it included a greater emphasis on controlling bank-reserve growth, and less emphasis on minimizing short-term fluctuations in the Federal-funds rate. Most important, it was announced that the Fed's intent was to slow the rate of monetary growth, so as to keep within the target ranges originally announced for 1979.

Under the new approach, the Fed attempts to hit certain target growth rates for the quantity of bank reserves. Once this quantity is expanding at a set rate, the rate at which banks can issue deposits (the main element in the money supply) will be largely determined -- at least over the short-term. In contrast, under the previously used funds-rate instrument, the Fed attempted to influence deposit growth not through the quantity of reserves but indirectly through the cost of these reserves.

Economists have argued for some time about which technique does a better job of controlling money. As a technical matter, the race seems to be a draw: using either the funds rate or reserves as the operating instrument could produce equally good results, provided that the funds rate is permitted a wide enough range of movement. However, that is an important qualification. In recent years, the Fed generally moved the

funds rate in the right direction -- raising it in recoveries to restrain monetary accelerations, and reducing it in recessions to hold back monetary decelerations. But these actions were not sufficiently aggressive to keep money growth from moving in tandem with the business cycle. As a result, monetary policy generally added to inflationary pressures during cyclical expansions, and to unemployment during recessions.

This raises an obvious question. Why didn't the Federal Reserve move the funds rate more actively in the past? Partly because of the understandable uncertainty about the exact condition of the economy at any point of time, and about the precise timing and impact of policy actions. In addition, institutional factors contributed to this cautious movement in the funds rate. For one reason, with policy being made by a committee (the FOMC), typical committee compromises frequently led to only modest changes in the level or range of the funds rate. Again, policymakers wanted to avoid changes in policy, which impose costs on the private sector by forcing it constantly to revise its decisions, and so tend to undermine the performance of the economy.

Altogether, our past experience has shown that a cautious funds-rate strategy can lead to swings in money and reserves which accentuate cyclical movements and ultimately lead to undesirable economic results. In contrast, a cautiously-controlled reserves instrument should work in the opposite direction -- it will tend to resist rather than accede to the forces producing procyclical swings in money. With the supply of bank reserves expanding at a relatively stable rate, the maximum rate at which banks can issue deposits will be relatively stable also. The ultimate result thus should be less inflation.



### Financial Markets After October 6

How much success have we had with this new policy? In the most important respect, it has worked unequivocally. I've been very encouraged by the post-October 6 slowdown in money growth, which has brought the major monetary aggregates within the boundaries projected by the Fed a year ago. The narrow definition of money,  $M_1$ , slowed to a 5.2-percent rate of gain in the fourth quarter in contrast to 10.0-percent growth in the third quarter. The broader  $M_2$  measure of the money supply also slowed, from a 12.5-percent rate of growth in the third quarter to a 9.2-percent growth in the final quarter of 1979, and it decelerated even further in early 1980. The Fed has delivered on its promises, and it will persist with a gradual orderly diminution of growth in the months ahead.

Nonetheless, the public has not been persuaded of the success of the new policy, somewhat to the surprise of the many proponents of the new look in the academic community. For example, immediately after October 6 the stock market nose-dived, while rates rose steeply in other financial markets. After a period of stability, the sense of turmoil arose again in early 1980, even though not everywhere. The money markets and the foreign-exchange market have remained relatively stable, but the bond market has experienced a blood-bath -- for example, with yields on corporate Aaa bonds increasing by 100-130 basis points in the last several weeks.

How can we explain this big cost increase in long-term credit financing? Obviously, long-run inflation expectations have worsened, with market-makers deciding, on the basis of the Administration's new budget, that we're in for a repetition of Vietnam-style, guns-and-butter financing which laid the basis for our present inflation problem. The problem has been aggravated by some inflation-related structural changes in the bond

market. Life-insurance companies, which typically are big buyers of long-term bonds, have smaller amounts available today because they've been hit by an upsurge in loans against their outstanding insurance policies. Moreover, pension funds and insurance companies, with their large commitments to buy mortgages, are now preempting funds they might have otherwise put into bond purchases. The U.S. government also has become a larger borrower in long-term bond markets. And finally, individual investors have practically withdrawn from the market -- in contrast to their heavy purchases in earlier periods, such as 1970 and 1974-75, when they didn't have the alternative of buying money-market certificates or money-market mutual funds.

Some observers have referred to the "Europeanizing" of the bond market -- that is, a disappearance of long-term debt financing. The market could be restructured to include floating-rate bonds and bonds with shorter maturities and faster repayment schedules. Again, many corporations could turn increasingly to commercial banks for funds. This could reduce the liquidity of the banking system, since part of their liquidity depends on corporations being able to borrow long in the bond market in order to pay off bank debt.

#### Concluding Remarks -- Inflation and Policy Problems

Underlying all the problems that I've mentioned is the severe and continuing problem of inflation. The inflation rate exceeded 10 percent last year, even if we adjust for the fact that the consumer-price index overstates certain factors such as housing costs. At any rate,

the inflation rate will probably be in double-digit territory again this year, with oil-price increases adding perhaps 2 percentage points to the projected increase of 8 percent or so resulting from previous monetary acceleration. And with the declining likelihood of a recession, we are not likely to get enough of reduction in demand to reduce the pressure on prices.

This raises the basic question: what can we do to bring about a deceleration of this price upsurge? Apparently, we will get little help from fiscal policy this year. Already, the forecast for the fiscal 1980 deficit has been raised from \$29 billion to \$40 billion. (The famous spending shortfalls of several earlier years are now only a memory.) More importantly, the projected figures for fiscal 1981 -- that is, a \$16-billion deficit with total spending of \$616 billion -- may also be out-distanced by events. The deficit could balloon under the spur of sharper-than-expected defense spending, higher unemployment benefits, and perhaps also an election-year tax cut.

Once again, as in the past, monetary policy will face a difficult task ahead. Now, monetary policy will not solve all of our problems, but it's indispensable to a solution. Monetary and economic factors can not be forecast precisely -- after all, there are lags and institutional changes to consider. But inflation can be sustained only by an excessive increase in money and credit flows. As I've already indicated, we have seen the beginning of a gradual, orderly reduction in money growth. If we continue along the same lines, we can expect long-term success in containing inflation.

Chairman Volcker said as much when he announced the annual target ranges for the monetary aggregates, in testimony Tuesday before the House Banking Committee. M-1A (currency plus bank demand deposits) is targeted within the range of 3.5 to 6.0 percent for 1980, compared with last year's growth of 5.5 percent. M-1B (currency, demand deposits and other checkable deposits) has a target range of 4.0 to 6.5 percent, compared with last year's growth of 8.0 percent. And the new M-2 (currency, demand and other checkable deposits, small time and savings deposits, money-market fund shares, and overnight repurchase agreements and Eurodollars) has a target range of 6.0 to 9.0 percent, compared with last year's growth of 8.8 percent. As the Chairman noted when he reported these new target ranges, there is "no alternative to a progressive slowing of growth of the monetary aggregates to lay the base for restored stability and growth."

Meanwhile, we must reinforce the signals which the money-growth statistics are now giving the financial markets. We must in some way reinforce the public's perception of the Fed's willingness to fight inflation. One useful way of doing this is just what we did last week -- utilize the discount rate for its announcement effects. We didn't have to raise the discount rate at that time to stem any massive increase in member-bank borrowing. However, we did have to act, as we did, to let the public know of our determination to end inflation once and for all.

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