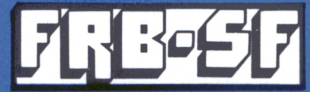

FEDERAL RESERVE BANK OF SAN FRANCISCO
Office of the President

THE DIRECTION OF MONETARY POLICY

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

Finance Industry
Boy Scout Luncheon

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The Direction of Monetary Policy

I'd like to begin by adding a world of praise for Emmett Solomon, today's recipient of the Good Scout Award. His obvious talents and strong personal qualities have fostered a healthy scout movement -- and he's used those same qualities in fostering a healthy California economy. We are all indebted to him for his prolonged efforts in support of our state's strong and vibrant financial community.

Now, at this point of the program, I had half-expected that I myself would be presented with an anti-inflation merit badge. But perhaps some scoutmaster vetoed the idea because I hadn't earned enough brownie points for low interest rates. Well, you know how picky some scoutmasters are.

Inflation and the Young

In that connection, it may be useful for a moment to relate the nation's difficult anti-inflation struggle to the scout movement's goals. The scout movement, in a sense, represents a compact between the younger and the older generations. The movement, through a strict apprenticeship, helps prepare young men and women to become future leaders of business, government, and the professions. But in return for undergoing that apprenticeship, they have the right to expect that we in the older generation will provide them with a viable social and economic environment, within which they can deal effectively with the problems of tomorrow. Yet in recent years we haven't kept up our end of the bargain, but instead have permitted the growth of an inflation which has badly undermined the nation's economic and social stability.

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Let's consider specifically how inflation blatantly discriminates against the younger generation, in the housing market. Inflation has helped many middle-aged people to build up substantial equity values in their homes in recent decades -- by some estimates, this inflation-bloated equity now exceeds one trillion dollars. But first-time homebuyers in the younger generation are not so lucky. Because of high housing prices, which now average $132,000 here in the Bay Area, first-time homebuyers find it all but impossible to accumulate the downpayment for a new home. Because of inflation-bloated mortgage-interest rates, those would-be purchasers can't meet the monthly payments, even if they can somehow scrape together the downpayment. Their elders can move from home to home, utilizing the inflation-boosted equity amassed in earlier decades, but most young people can't clear the first hurdle into the home-buying market.

Problem of Inflation -- and Growth

To restore our compact with the younger generation, we obviously must find ways to overcome inflation -- and to do so in ways that don't bring on a severe recession. The inflation rate declined roughly by half between 1974 and 1976, but at the price of the worst recession since the 1930's -- and that situation led policymakers to adopt stimulative policies which generated a new burst of inflation. This time we must do better, through the type of steady and constant pressure which provides the only real guarantee of a permanent victory over inflation. We must accomplish this at the same time that we are pursuing other difficult economic measures, such as encouraging shifts in consumer budgets from spending to saving, so that more dollars will flow into investment channels to build up the nation's economic and political strength.

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The record of the past two years, while unsatisfactory in many respects, suggests that we may be able to achieve our major policy goal. In particular, we have seen an almost steady deceleration of consumer-price increases ever since last summer, especially after exclusion from the index of its volatile housing component. We've achieved this without a major recession; despite all its monthly and quarterly fluctuations, the economy has shown at least modest growth over a two-year span. And that in itself is an achievement, considering the severe structural problems of major industries such as steel, autos and housing.

I must emphasize, however, that we are just beginning to make inroads on our inflation problem. As measured by the consumer price index, prices doubled within the single decade of the 1970's, and at the 1981 pace, would double again within an even shorter period. The danger comes not just from external price "shocks" from the oil and food sectors, but also from the uptrend in the underlying (or non-shock) rate of inflation. Throughout most of the past decade, this underlying or core rate of inflation, although accelerating, remained below six percent a year. In the last several years, however, the underlying rate has exceeded nine percent.

This upsurge in inflation has gone hand in hand with an upsurge in unit labor costs, because of sharp gains in labor compensation and actual declines in the productivity of the nation's workforce for three successive years, from 1978 through 1980. I should add that the recent uptrend in productivity in the first quarter of 1981 was quite heartening, but we still have lots of ground to make up on that score. One cure for that

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type of cost-push problem is tax cuts, such as those Congress is now considering. Those measures include productivity-enhancing tax cuts for business, such as accelerated depreciation allowances, as well as personal-tax cuts which (it is hoped) will add to the pool of savings to finance a more vigorous pace of outlays on plant and equipment.

The upsurge in inflation, however, has also gone hand in hand with the excessive money growth of past years. This situation came about when monetary policy was pushed off course for years by excessive credit demands, generated primarily by Federal deficit financing. The cure for that type of problem is to curb rapid money creation by reducing deficit-financing pressures.

Fed Policy and Its Critics

In an attempt to improve its control over money growth, the Federal Reserve changed its procedures in October 1979 -- in effect, by placing more emphasis on controlling the quantity of bank reserves than on tightly pegging the cost of those reserves (that is, the Federal-funds rate). The most important (M-1B) measure of the money supply -- currency plus transaction, or check-type, accounts -- increased 6 3/4 percent in 1980 (4th quarter - 4th quarter). By that measure, the rate of money growth has declined slightly for two years in a row. In fact, the 1980 figure was the smallest increase of the past four years. Still, it slightly exceeded the upper limit of the Fed's targeted growth range for the year of 4 to 6 1/2 percent. Meanwhile, we've experienced major fluctuations in interest rates during the past year and a half. The prime business-loan rate fell as low as 11 percent and rose as high as 21 1/2 percent

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in late 1980. It then fell to 17 percent early this spring and swung back to a mid-May peak of 20 1/2 percent, before recently declining again.

Amid all this financial turmoil, the nation's central bank has come under heavy attack, usually from two opposite sides of the issue. The controversy, increasing in volume during the past year or so, has centered around two conflicting views of monetary policy. To the average newspaper reader -- and perhaps the average legislator -- easy money means low interest rates, and tight money means high interest rates. To the average economics professor or financial analyst, easy money means rapid money growth, and tight money means slow money growth. Thus, in recent months, the Fed has been criticized by the interest-rate watchers as being too tight, and criticized by the money-supply watchers for being too easy.

Fed Response to Criticisms

The central banker's life is not an easy one in any case, but it becomes even more difficult when he's advised to follow two completely opposite policy courses at the same time. So how should we respond? To the interest-rate watchers, we would suggest that interest rates are determined by many factors -- including but not exclusively the actions of the Federal Reserve, which can control only the supply of money, not the demand. Certainly the Fed has some influence over rates in the short run, as it works to control the amount of reserves in the banking system and money in the hands of the public. By restricting reserves and money, the Federal Reserve can temporarily raise interest rates -- and by easing the supply of reserves and money, it can temporarily lower rates.

However, business-cycle conditions also influence rates, as credit demands rise and fall with the cycle. And above all, price expectations

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heavily influence rates, frequently offsetting other market influences. Today, for example, if people expect prices to rise by (say) 10 percent a year, lenders will demand the "real" underlying rate of interest plus 10 percent, so that they'll be protected against an expected loss in the purchasing power of their money. This suggests, then, that curbing inflation is the only long-run solution to high interest rates.

To the money-supply watchers, we would say that monetary policy in recent years has been directed toward reducing money growth, especially since the October 1979 shift in Fed procedures. History shows that changes in money-supply growth definitely affect the inflation rate over time, generally with about an 18-24 month lag. The Fed thus should continue to follow the path of gradual deceleration adopted several years ago.

We recognize of course that little has been achieved by the large intra-yearly swings in money growth experienced since late 1979. Those swings could be dampened by the adoption of certain technical changes in policy implementation, such as the Fed is now considering. But such variations in money growth probably cannot be completely eliminated, given the existence of major shifts in underlying economic conditions. Again, we have to recognize that the Fed's shift in emphasis away from trying to control interest rates can involve short-term costs. Home builders, farmers, small businesses, and other interest-sensitive borrowers can be badly hurt by high and fluctuating levels of interest rates. The Fed thus must step in at times to dampen excessive rate swings, even at the cost of temporary deviations in the growth path of the money supply.

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On balance, the Federal Reserve has no choice except to continue with its policy of reducing money-supply growth over time, to help the national economy return to a non-inflationary growth path. Thus, the Fed has reduced its projected growth range for the M-1B monetary aggregate by a half-percentage-point in 1981, to between 3 1/2 and 6 percent. (That calculation abstracts from the impact of shifts into NOW accounts and other interest-bearing transaction accounts.) The new target range thus implies a significant reduction in the monetary growth rate, in comparison with last year's 6 3/4-percent growth. The latest (April) figures show that the level of the money supply (M-1B), after adjusting for shifts of savings into NOW accounts, was about at the midpoint of the 3 1/2-6 percent growth path set for the year. Thus far in 1981, therefore, we have carried out our "game plan", which should add credibility to the nation's anti-inflation program, and help to reverse long-standing expectations of continued high inflation.

The Fed's target is frankly designed to be restrictive -- as Chairman Volcker (with strong Administration support) has emphasized in recent Congressional appearances. The target implies restraint on the potential growth of nominal GNP, which represents real growth plus inflation. If inflation continues unabated or increases, real activity is likely to be squeezed. But as inflation begins to abate, the stage will be set for stronger real growth. The Fed's policy is based on a simple premise -- the inflation process cannot persist very long without monetary accommodation. However, the Fed's policy can be successful, without massive financial-market distortions, only if Federal government policymakers reduce their credit demands.

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Credit-Market Pressures

According to our Bank's research staff, net borrowing by the Federal government and Federally-assisted agencies totalled nearly $120 billion in fiscal 1980. This amount represented one-third of all funds raised in credit markets by non-financial sectors, up sharply from the one-fifth share of the previous year. The 1980 total included borrowings to finance the unified budget deficit and the deficits of off-budget agencies, plus borrowings to finance the activities of Federally-sponsored enterprises and Federally-guaranteed mortgage pools.

In part, such borrowing represented a reallocation of credit, but we have strong reason to believe that much of it represented "crowding out" of other borrowers -- households, businesses, and state and local governments, who couldn't afford to pay the interest rates that the Federal government is willing and able to pay. Federal and Federally-assisted borrowing may diminish somewhat (in dollar terms) in fiscal 1981, but may still account for over one-fourth of all credit demands. Surely, this massive Federal presence in credit markets must be considered a major cause, along with high inflation, of the high level of interest rates.

As I've suggested, a balanced anti-inflation program would include measures to improve the nation's productivity and international competitive position, along with measures to reduce deficit-financing pressures on monetary policy. The President's new fiscal program represents a major step in the right direction. Still, various observers of financial markets note that these budget proposals result in large fiscal deficits for the next several years -- perhaps exceeding $60 billion in fiscal 1981, and perhaps reaching $50 billion or more in fiscal 1982.

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The necessity for substantial Federal spending cutbacks is obvious, given the Administration's commitment to significant tax reductions coupled with a major defense build-up. Understandably, then, Congress is beginning to turn its attention to some politically sensitive entitlement programs -- "payments for individuals" -- simply because that's where the money is. Aside from defense and interest costs, such payments amounted to 70 percent of total outlays in the last fiscal year, after an eight-fold increase over the past decade and a half. Most of the increase in benefit payments can be traced to inflation indexing -- indeed, indexing might account for three-fourths of the increase expected in the cost of these programs over the next half-decade. And the basis of the indexing is the consumer price index -- which is now recognized as overstating the "true" rate of inflation because of the excessive weight it gives to sharply rising home-purchase and mortgage-interest costs. Thus, indexing represents a useful subject for Congressional review.

Concluding Remarks

In sum, I believe that monetary policy definitely is headed in the right direction. Despite all the structural problems of the nation's basic industries, despite all the difficulties of curbing the Federal government's financing demands, and despite all the Fed's difficulties in developing new operating techniques -- despite all these things, we now seem to be attaining real growth in an atmosphere of decelerating inflation. The contrast is striking with the 1974-76 period, when we temporarily halted inflation, but at the cost of a severe recession and a later rekindling of even worse inflationary pressures. Only by gradual and continued pressure can we return to a non-inflationary growth path -- and only in that way can we restore our broken compact with the younger generation.

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