THE FEDERAL RESERVE IN THE 1983 ECONOMY

REMARKS OF

JOHN J. BALLES, PRESIDENT

FEDERAL RESERVE BANK OF SAN FRANCISCO

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I'M DELIGHTED TO JOIN ALL YOU SOUTHERN CALIFORNIA IRISHMEN TO CELEBRATE THE DAY, BEGORRA, WHEN SAINT PATRICK CHASED ALL THE SNAKES OUT OF IRELAND. WE COULD PROBABLY USE SOME HELP FROM SAINT PATRICK IN THIS COUNTRY TODAY. STILL, A REVIEW OF THE RECENT BUSINESS AND FINANCIAL NEWS SUGGESTS THAT WE'VE ACCOMPLISHED A GREAT DEAL OURSELVES LATELY IN CLEARING SOME OF THE SNAKES OUT OF THE ECONOMIC LANDSCAPE--ALTHOUGH OF COURSE THE JOB IS FAR FROM FINISHED. IN A WORD, OUR POLICY ACTIONS HAVE CUT THE SNAKE OF INFLATION IN HALF AND IN THE PROCESS HAVE ESTABLISHED THE BASE FOR A SUBSTANTIAL BUSINESS RECOVERY. YET UNEMPLOYMENT AND FINANCIAL PROBLEMS CONTINUE TO PLAGUE THE U.S. AND WORLD ECONOMIES, WHILE THE FINANCING OF A MASSIVE FEDERAL DEFICIT HAMPERS OUR TWO-FOLD TASK OF FOSTERING THE RECOVERY AND CURBING A RESURGENCE OF INFLATION.

STRENGTHS AND WEAKNESSES

REDUCED INFLATION REPRESENTS OUR STRONGEST RECENT ACHIEVEMENT. INDEED, IT IS A REMARKABLE ACHIEVEMENT IN LIGHT OF WHAT WENT BEFORE--THAT IS, A SEEMINGLY UNSTOPPABLE PRICE SPIRAL THAT BADLY UNDERMINED THE ECONOMY THROUGHOUT THE PAST DECADE. LAST YEAR, FOR EXAMPLE, THE CPI AND PRODUCER PRICES ROSE BY ABOUT 5 PERCENT AND 3 PERCENT RESPECTIVELY, OR ONE-HALF AND ONE-THIRD THE RATE OF INCREASE IN 1979 AND 1980. OF COURSE, MANY PRICES ARE STILL MOVING UPWARD, ALTHOUGH AT A MUCH SLOWER RATE. BUT SOME KEY PRICES HAVE DROPPED DRAMATICALLY, AS WE CAN SEE FROM THE DISARRAY OF THE OPEC OIL CARTEL. THE CARTEL'S PROBLEMS SPELL TROUBLE FOR SOME INDUSTRIES AND SOME COUNTRIES, AS COULD BE EXPECTED. BUT LOWER OIL PRICES GENERALLY MEAN BETTER PROSPECTS FOR THE REST OF US. AFTER ALL, IF THE U.S. ECONOMY SUFFERED SO BADLY WHEN ARAB OIL PRICES SOARED

FROM $3 TO $34 PER BARREL, IT SHOULD BENEFIT SUBSTANTIALLY WHEN THE PRICE TREND REVERSES ITSELF, AT LEAST PARTIALLY.

PERHAPS THE PRIME ECONOMIC GOAL OF THE COMING YEAR, HOWEVER, WILL BE A TRIUMPH OVER THAT SEVERE RECESSION THAT UNFORTUNATELY ACCOMPANIED OUR SUCCESS AGAINST INFLATION. THE INDEX OF LEADING ECONOMIC INDICATORS HAS BEEN MOVING UPWARD SINCE LAST SPRING, AND IN JANUARY SCORED ITS STRONGEST GAIN OF THE PAST GENERATION. BUTTRESSING THAT EVIDENCE, REAL GNP PROBABLY WILL BE STRONGER IN THE QUARTER NOW ENDING THAN AT ANY TIME IN THE PAST SEVERAL YEARS. THE ACTUAL LEVEL OF ACTIVITY REMAINS LOW IN HOMEBUILDING AND OTHER KEY INDUSTRIES, BUT THE TREND OF ACTIVITY IS DEFINITELY UPWARD. MOREOVER, ORDER BOOKS ARE BECOMING THICKER AGAIN, AS FIRMS BEGIN RESTOCKING THE INVENTORIES THAT WERE DEPLETED DURING THE FINAL MONTHS OF 1982.

THUS, IT SEEMS CLEAR THAT AN ECONOMIC UPTURN IS UNDERWAY. THE MORE IMPORTANT QUESTIONS ARE HOW LONG IT WILL LAST AND HOW STRONG IT WILL BE. IN THESE REGARDS, THERE ARE SOME THREATS ON THE HORIZON, WHICH I WILL MENTION LATER.

ALTOGETHER, REAL GNP COULD GROW CLOSE TO 5 PERCENT OVER THE COURSE OF THIS YEAR, OR ABOUT TWO PERCENT FASTER THAN PREDICTED BY THE ADMINISTRATION'S BUDGET DOCUMENT. SOME SECTORS, ESPECIALLY BUSINESS FIXED-INVESTMENT SPENDING, WILL CONTRIBUTE LITTLE TO THE UPTURN. IN CONTRAST, CONSUMER SPENDING IS LIKELY TO MAKE A STRONG CONTRIBUTION AFTER ITS DISAPPOINTING SHOWING LAST YEAR. REAL CONSUMER INCOMES LOOK MUCH STRONGER THAN BEFORE, REFLECTING SUCH FACTORS AS A SUBSTANTIAL SLOWING OF THE RISE IN CONSUMER PRICES, A MODEST IMPROVEMENT IN EMPLOYMENT, AND SOME EXPECTED AS WELL AS UNEXPECTED GAINS IN AFTER-TAX INCOMES. (HOUSEHOLDS CAN LOOK FORWARD NOT ONLY TO THE MUCH-HERALDED $35 BILLION MIDYEAR TAX CUT, BUT ALSO

TO AN UNEXPECTEDLY LARGE $26 BILLION PACKAGE OF REFUND CHECKS THIS SPRING, MOSTLY REPRESENTING OVERLY LARGE WITHHOLDINGS LAST YEAR.) MOREOVER, THE DECLINE IN OIL PRICES COULD ADD AS MUCH AS ONE PERCENT TO CONSUMERS REAL PURCHASING POWER IN 1983. HOUSEHOLD WEALTH HAS ALSO JUMPED BY PERHAPS $500 BILLION AS A RESULT OF THE SPARKLING RALLY OF THE PAST HALF-YEAR IN THE STOCK AND BOND MARKETS. AND WITH INTEREST RATES DECLINING AND THE CONSUMER-DEBT BURDEN AT THE LOWEST LEVEL OF THE PAST DECADE, HOUSEHOLDS HAVE EVEN MORE INCENTIVES TO START SPENDING AGAIN.

ALL IN ALL, WE CAN EXPECT A SOLID RECOVERY THIS YEAR, BUT CERTAINLY NO BOOM--AND IF WE NEED A REMINDER, I SUGGEST A LOOK AT THE DISTRESSINGLY HIGH UNEMPLOYMENT FIGURES. WITH RECOVERY, THE JOBLESS RATE SHOULD COME DOWN OUT OF DOUBLE-DIGIT TERRITORY, BUT WE'LL STILL BE LEFT WITH A VERY HIGH LEVEL OF "STRUCTURAL" UNEMPLOYMENT IN THOSE INDUSTRIES AND REGIONS THAT HAVE LOST THEIR COMPETITIVE EDGE IN WORLD MARKETS. ROUGHLY 2½ MILLION PEOPLE HAVE BEEN ON THE JOBLESS ROLLS FOR SIX MONTHS OR MORE--THREE TO FOUR TIMES THE NORMAL NUMBER OF LONG-TERM UNEMPLOYED. BUT THEIR PROBLEMS WON'T BE SOLVED BY BROAD-SCALE STIMULATIVE MEASURES OR A NORMAL CYCLICAL RECOVERY; INSTEAD, THEY'LL NEED RETRAINING AND OTHER SPECIFIC PROGRAMS DESIGNED TO GET THEM BACK ON THE PRODUCTION LINE.

<u>CALIFORNIA SCENE</u>

HOW, DOES OUR STATE FIT INTO THIS RECOVERY PICTURE? ON BALANCE, CALIFORNIA SHOULD CONTINUE TO OPERATE AS A HIGH-EMPLOYMENT, HIGH-UNEMPLOYMENT ECONOMY. BECAUSE OF THE TRADITIONALLY FASTER PACE OF ACTIVITY IN THIS STATE, BUTTRESSED THIS YEAR BY A DEFENSE-SPENDING BOOM, REAL INCOMES SHOULD CONTINUE TO GROW ABOUT ONE PERCENT FASTER HERE THAN NATIONALLY. BUT AT THE SAME TIME, THE UMEMPLOYMENT RATE MAY HOVER ABOUT

ONE PERCENTAGE POINT ABOVE THE NATIONAL RATE--AS IT HAS IN MOST RECENT YEARS EXCEPT 1980-81--BECAUSE OF SUCH FACTORS AS THE CONTINUED HEAVY FLOW OF JOB-SEEKING MIGRANTS INTO THE STATE.

CALIFORNIA WILL BENEFIT FROM THE UPSURGE IN ORDERS FOR AT LEAST SOME PRODUCTS OF THE HIGH-TECHNOLOGY SECTOR OF THE ECONOMY. THAT FAMILY OF INDUSTRIES RUNS THE GAMUT FROM CIVILIAN-AIRCRAFT PRODUCTION (OUTLOOK: DEPRESSED) TO MISSILES AND SPACE VEHICLES (OUTLOOK: VERY STRONG). CALIFORNIA NORMALLY TAKES MORE THAN ONE-FIFTH OF ALL PENTAGON CONTRACTS, SO IT SHOULD CONTINUE TO BENEFIT FROM THE MASSIVE DEFENSE BUILD-UP. AND AS A GROUP, HIGH TECHNOLOGY ACCOUNTS FOR 33 PERCENT OF THE STATE'S MANUFACTURING EMPLOYMENT, COMPARED WITH ONLY 7½ PERCENT NATIONALLY. THUS THE STRENGTHENING OUTLOOK FOR MOST ELEMENTS OF THE HIGH-TECHNOLOGY SECTOR SHOULD HELP GUARANTEE A FASTER-THAN-NATIONAL GROWTH RATE FOR THE REGIONAL ECONOMY.

HIGH INTEREST RATE SYNDROME

DESPITE ALL THE PLUS SIGNS IN THE OUTLOOK, RECOVERY IN THE NATIONAL AND REGIONAL ECONOMIES CANNOT BE GUARANTEED, BECAUSE OF THE OVERLY HIGH LEVEL OF REAL OR INFLATION ADJUSTED INTEREST RATES. AS YOU'VE NOTICED, MARKET INTEREST RATES HAVE DECLINED SHARPLY; THE PRIME BUSINESS-LOAN RATE, AT 10½ PERCENT, IS ONLY HALF WHAT IT WAS AT ITS 1981 PEAK. BUT INFLATION HAS DECLINED AS RAPIDLY AS MOST LOAN RATES, AND THAT MEANS THAT REAL INTEREST COSTS FOR HOUSEHOLDS AND BUSINESSES HAVE NOT COME DOWN SUBSTANTIALLY. MOREOVER, THE SITUATION FEEDS UPON ITSELF. HIGH REAL INTEREST RATES ATTRACT MASSIVE FUNDS FROM ABROAD, WHICH MEANS THAT THE DOLLAR REMAINS OVERVALUED AND THUS ENCOURAGES IMPORTS AND DISCOURAGES EXPORTS--WHICH IN TURN MEANS CONTINUED DISTRESS FOR SUCH BASIC INDUSTRIES AS STEEL, AUTOS, AND AGRICULTURE.

THE FINANCIAL MARKETS ARE TRYING TO TELL US SOMETHING, AND AS USUAL, SOME POLITICAL FIGURES ARE TRYING TO SHOOT THE MESSENGER. THE MESSAGE IS QUITE SIMPLE: UNDERLYING CREDIT DEMANDS ARE SO STRONG TODAY THAT ONLY A RELATIVELY HIGH LEVEL OF INTEREST RATES WILL ALLOCATE THE AVAILABLE FUNDS AND SCREEN OUT LESS CREDITWORTHY BORROWERS. TEMPORARILY, MORE CREDIT DEMANDS COULD BE SATISFIED AT LOWER SHORT-TERM RATES IF THE FEDERAL RESERVE FLOODED THE MARKET WITH LIQUIDITY, BUT SUCH AN AGGRESSIVELY EASY POLICY WOULD NOT ONLY LEAD TO A RESURGENCE OF INFLATION DOWN THE ROAD BUT ALSO TO HIGH INFLATION EXPECTATIONS AND HIGHER LONG-TERM INTEREST RATES WITHIN A VERY SHORT TIME.

THE SOURCE OF THE PROBLEM IS THE FEDERAL GOVERNMENTS' MASSIVE CREDIT DEMANDS, AS IS NOW ALMOST UNIVERSALLY RECOGNIZED, INCLUDING RECOGNITION BY CONGRESSIONAL LEADERS AND ADMINISTRATION OFFICIALS. THE TREASURY WAS IN THE MARKET FOR ABOUT $60 BILLION IN BOTH THE LAST QUARTER AND THE QUARTER NOW ENDING, AND NEXT QUARTER IT WILL PROBABLY NEED $35 BILLION MORE, WHEREAS IT NORMALLY RUNS A SUBSTANTIAL SURPLUS DURING THE APRIL-JUNE TAX PAYING PERIOD. INDEED, THE FEDERAL GOVERNMENT SHOULD BE MOVING TOWARD A SURPLUS IN ITS ACCOUNTS AS THE RECOVERY PROCEEDS, TO MAKE ROOM FOR INCREASED PRIVATE CREDIT DEMANDS IN FINANCIAL MARKETS--BUT INSTEAD IT WILL BE POSTING A SERIES OF RECORD DEFICITS. THE PROJECTED DEFICITS--$208 BILLION IN FISCAL 1983 AND $189 BILLION IN FISCAL 1984 WILL BE ENORMOUS - EQUAL TO ABOUT 80 PERCENT OF NET SAVINGS. THIS WILL LEAVE LITTLE ROOM FOR NET INVESTMENT, WHICH IS THE KEY TO GROWTH IN NEW HOUSING AND BUSINESS CAPITAL. THESE DEFICITS OF COURSE <u>WILL</u> BE FINANCED. THE FEDERAL GOVERNMENT, WHICH IS NOT SUBJECT TO THE CONSTRAINTS OF A PROFIT/LOSS STATEMENT, WILL GET WHATEVER IS NEEDED SIMPLY BY OUTBIDDING PRIVATE

BORROWERS FOR THE AVAILABLE SUPPLY OF FUNDS. THIS OUTBIDDING, OF COURSE, WILL BE ACCOMPLISHED BY HIGH INTEREST RATES WHICH IS THE MARKET'S WAY OF CROWDING OUT OR REDUCING NET INVESTMENT.

FEDERAL RESERVE'S QUANDARY

IN THIS SITUATION, THE FEDERAL RESERVE HAS BEEN HANDED THE UNENVIABLE TASK OF SQUARING THE CIRCLE. MANY CONGRESSMEN AND SOME BANKERS HAVE DEMANDED THAT THE FED IGNORE MONEY-GROWTH CONSIDERATIONS - ALTHOUGH THAT COULD MEAN A LATER UPSURGE IN INFLATION AND DO WHATEVER IS NECESSARY TO BRING INTEREST RATES DOWN TO LOWER LEVELS IMMEDIATELY. IN FACT, SOME MEMBERS HAVE INTRODUCED SPECIFIC LEGISLATION TO THAT EFFECT. IN CONTRAST, MANY MONETARIST ECONOMISTS HAVE DEMANDED THAT THE CENTRAL BANK IGNORE INTEREST-RATE CONSIDERATIONS - ALTHOUGH THAT MIGHT MEAN A WEAK OR ABORTED RECOVERY - AND ADHERE TO STRICT MONEY-GROWTH TARGETS IN THE PERIOD AHEAD. SOME INDEED BELIEVE THAT THE FED HAS ALREADY LET THE INFLATIONARY CAT OUT OF THE BAG IN ITS ATTEMPT TO SUPPORT THE ECONOMIC RECOVERY, BECAUSE THE MONEY SUPPLY HAS GROWN RAPIDLY AT A 14 PERCENT ANNUAL RATE SINCE LAST SUMMER.

FEDERAL RESERVE CHAIRMAN VOLCKER RESPONDED TO THESE CHARGES IN HIS SEMI-ANNUAL REPORT TO CONGRESS LATE LAST MONTH. TO THE INTEREST-RATE WATCHERS, HE SAID THAT THE FED "RECOGNIZED THE DESIRABILITY OF ACHIEVING AND MAINTAINING A LOWER LEVEL OF INTEREST RATES TO ENCOURAGE GROWTH, BUT FELT THAT THIS COULD ONLY BE REALISTIC IN A CONTEXT OF BUILDING ON THE PROGRESS ALREADY MADE AGAINST INFLATION." HE ADDED THAT ANY EFFORT TO FORCE INTEREST RATES DOWN THROUGH EXCESSIVE LIQUIDITY CREATION COULDN'T BE SUCCESSFUL FOR LONG, BECAUSE AGGRESSIVE EFFORTS TO EASE MONETARY POLICY WOULD GENERATE NEW FEARS OF FUTURE INFLATION.

AT THE SAME TIME I WOULD REMIND THE MONEY-GROWTH WATCHERS THAT THERE WERE GOOD REASONS WHY THE NARROW (M-1) MONEY SUPPLY--CURRENCY PLUS CHECK-TYPE DEPOSITS--GREW ABOVE TARGET LAST YEAR. THE FED PERMITTED ABOVE-TARGET GROWTH BECAUSE OF ITS CONVICTION THAT, IN PRACTICAL TERMS, POLICY OTHERWISE WOULD HAVE BEEN APPRECIABLY MORE RESTRICTIVE THAN INTENDED WHEN THE TARGETS WERE SET IN EARLY 1982.

LET ME EXPLAIN THIS IN A LITLE MORE DETAIL BECAUSE IT GOES TO THE HEART OF THE NEED FOR AN INDEPENDENT CENTRAL BANK. IN 1982 THERE WAS AN EXTRAORDINARY INCREASE IN THE PUBLIC'S DESIRE TO HOLD (RATHER THAN TO SPEND) LARGER MONEY BALANCES. THERE IS SOME DEBATE AMONG ECONOMISTS AS TO WHY THIS OCCURRED. SOME WOULD ARGUE THAT THE INCREASED UNCERTAINTIES ASSOCIATED WITH HISTORIC HIGH UNEMPLOYMENT INCREASED THE PRECAUTINARY BALANCES THAT PEOPLE WISH TO HOLD. OTHERS WOULD ARGUE THAT THE DECLINE IN THE INFLATION RATE HAS MADE IT MORE ATTRACTIVE TO HOLD MONEY THAN IN THE PAST. IN ANY EVENT, THE EVIDENCE IS QUITE CLEAR-THE PUBLIC'S DESIRE TO HOLD M-1 INCREASED DRAMATICALLY IN 1982 AND AS A RESULT, THE RELATION BETWEEN MONEY TO INCOME (WHICH IS CALLED VELOCITY) FELL DRAMATICALLY IN 1982. WITH THE SAME AMOUNT OF MONEY TO DOING LESS WORK, THE FEDERAL RESERVE HAD TO SUPPLY A LARGER AMOUNT OF MONEY DURING 1982 THAN IT ORIGINALLY INTENDED IN ORDER TO AVOID FOLLOWING A MORE RESTRICTIVE MONETARY POLICY THAN WAS DESIRABLE OR NECESSARY. RATHER THAN FORCING M-1 TO GROW IN THE RANGE OF 2½ TO 5½ PERCENT, THE FED ALLOWED IT TO GROW 8½ PERCENT. THE DECISION TO DO THIS WAS A JUDGMENT CALL WHICH HAS BEEN RATIFIED BY THE VERY POSITIVE RESPONSE OF THE FINANCIAL MAREKTS AS SHOWN IN A DECLINE IN LONG-TERM INTEREST RATES AND RISE IN STOCK PRICES.

THE FED PLANS TO PLACE MORE WEIGHT ON BROADER MONEY MEASURES IN 1983 BECAUSE OF A BELIEF THAT THEY WILL TRACK ECONOMIC ACTIVITY BETTER THAN M-1. THESE BROADER MEASURES ARE M-2 (WHICH IS CURRENCY, CHECKING AND SAVINGS ACCOUNTS, AS WELL AS MONEY-MARKET FUNDS HELD BY INDIVIDUALS) AND M-3 (WHICH IS M-2 PLUS LARGE TIME DEPOSITS AND BALANCES IN INSTITUTIONAL MONEY-MARKET FUNDS). SPECIFICALLY, THE GROWTH RATES FOR THE MONETARY AGGREGATES IN 1983 ARE: M-1 4-8 PERCENT. THIS IS WELL ABOVE THE TARGET FOR 1982 OF 2½-5½ PERCENT, BUT BELOW THE ACTUAL GROWTH RATE OF 1982 OF 8½ PERCENT. IF THE VELOCITY OF M-1 REVERTS TO ITS HISTORICAL PATTERN OF GROWTH, THEN M-1 WOULD BE EXPECTED TO GROW AT THE BOTTOM OF THE RANGE. HOWEVER, IF VELOCITY DECLINES AS IT DID IN 1982, THEN M-1 WOULD TEND TO GROW AT THE TOP OF THE RANGE. M-2 IS 7-10 PERCENT, WITH A BASE FOR CALCULATING THE RANGE OF FEBRUARY-MARCH 1983 VS. THE OTHER AGGREGATES WHICH HAVE A FOURTH QUARTER 1982 BASE.

THIS SHIFT IN BASE REFLECTS THE FACT THAT THE PERMISSION TO ISSUE MONEY MARKET DEPOSIT ACCOUNTS PAYING COMPETITIVE INTEREST RATES IN MID-DECEMBER HAS GREATLY INCREASED M-2. A SURPRISINGLY LARGE SOURCE OF THE INCREASE IN MMDA'S (WHICH NOW AGGREGATE OVER $250 BILLION) HAS COME FROM OTHER LIQUID ASSETS WHICH ARE NOT INCLUDED IN M-2, SUCH AS LARGE CD'S. AS A RESULT, MOST OF THE M-2 GROWTH DOES NOT REPRESENT OVERALL GROWTH IN TOTAL LIQUID ASSETS. BY SETTING THE M-2 TARGET RANGE ON A FEBRUARY-MARCH BASE, IT IS HOPED THAT DEREGULATION IMPACT WILL BE LARGELY BEHIND US, AND THE TARGET RANGES NEED ONLY BE SLIGHTLY ABOVE THOSE FOR 1982. FOR M-3, A RANGE OF 6½-9½ PERCENT IS EQUAL TO THAT IN 1982 BECAUSE IT IS NOT AFFECTED BY DEREGULATION.

CASE FOR FED INDEPENDENCE

THIS DISCUSSION SUGGESTS THAT A STRONG DOSE OF POLICY PRAGMATISM IS CALLED FOR IN THESE UNCERTAIN TIMES. IN FACT, MONETARY POLICY IS AIMED AT

PROVIDING ENOUGH MONEY AND CREDIT TO FACILITATE RECOVERY. BUT TO ASSURE THAT THE RECOVERY IS SUSTAINABLE, WE ALSO RECOGNIZE THE NECESSITY OF CONTINUING THE PROGRESS AGAINST INFLATION. THIS MEANS WALKING A VERY NARROW LINE, ONE WHICH RECOGNIZES THAT A NONINFLATIONARY RECOVERY COULD BE ENDANGERED BY EITHER RIGID INTEREST-RATE TARGETING OR RIGID MONEY-GROWTH TARGETING.

HERE LIES THE CASE FOR A STRONG AND INDEPENDENT CENTRAL BANK WITHIN THE FEDERAL GOVERNMENT. THE TECHNICAL COMPLEXITIES OF ADJUSTING THE NATION'S MONETARY AND CREDIT NEEDS TO A FAST-CHANGING FINANCIAL ENVIRONMENT AND PAYMENTS SYSTEM CANNOT BE HANDLED WELL BY A LARGE DELIBERATIVE BODY SUCH AS CONGRESS. WISELY, THEN, CONGRESS DECIDED 70 YEARS AGO TO DELEGATE AUTHORITY OVER THE DAY-TO-DAY CONDUCT OF MONETARY POLICY TO OUR CENTRAL BANK, WHILE KEEPING ULTIMATE CONTROL OVER THE FED'S ACTIONS.

FED INDEPENDENCE IS NOT AN END IN ITSELF, BUT A MEANS TO AN END. AS A SUBCOMMITTEE OF THE THE HOUSE BANKING COMMITTEE NOTED THIRTY-YEARS AGO, "MANY OF THE POLICIES WHICH THE FEDERAL RESERVE MUST ADVOCATE TO MAINTAIN THE SOUNDNESS OF THE DOLLAR DURING TIMES OF INFLATIONARY PRESSURES ARE UNPOPULAR: YET IT IS NECESSARY THAT THEY HAVE A STRONG ADVOCATE IN ORDER TO AVOID A BUILT-IN INFLATIONARY BIAS IN THE ECONOMY. THIS END IS BEST SERVED BY ENDOWING THE BOARD OF GOVERNORS WITH A CONSIDERABLE DEGREE OF INDEPENDENCE, THEREBY ENHANCING ITS BARGAINING POWER IN THE DETERMINATION OF OVERALL POLICY."

TO THIS END THE CONGRESS RECOGNIZED, ON THE BASIS OF ABUNDANT HISTORICAL EVIDENCE, THAT CONTROL OVER THE POWER TO CREATE MONEY SHOULD BE KEPT OUT OF THE HANDS OF THOSE WITH THE RESPONSIBILITY OF FASHIONING SPENDING PROGRAMS AND PAYING THE GOVERNMENT'S BILLS. IN A WORD IT

RECOGNIZED THE NEED FOR AN INDEPENDENT CENTRAL BANK AS AN INSTITUTION WITH A VESTED INTEREST IN FIGHTING INFLATION. IF ANYTHING, THE NEED FOR SUCH AN INSTITUTION IS GREATER TODAY THAN IT EVER WAS BEFORE.

NEVERTHELESS, I WOULD NOTE THAT THERE CURRENTLY ARE A NUMBER OF PROPOSALS WHICH WOULD VASTLY INCREASE THE POTENTIAL FOR "POLITICIZING" THE FED AND REDUCING ITS INDEPENDENCE. AMONG THESE ARE PROPOSALS WHICH WOULD SUBJECT THE FED TO THE CONGRESSIONAL APPROPRIATIONS PROCESS -- THEREBY REMOVING THE KEY BULWARK OF ITS INSULATION FROM DAY-TO-DAY POLITICAL PRESSURES IN THE CONDUCT OF MONETARY POLICY -- WHILE ALSO EXPANDING THE INFLUENCE OF THE EXECUTIVE BRANCH OVER THE FED BY REDUCING THE TERMS OF GOVERNORS FROM 14 TO 7 YEARS, AND BY PLACING THE TREASURY SECRETARY (WHO REPRESENTS THE WORLD'S LARGEST BORROWER) BACK ON THE BOARD OF GOVERNORS. I SAY "BACK" ON THE BOARD, BECAUSE THIS WAS A POSITION WHICH HE (AND THE CONTROLLER OF THE CURRENCY) HELD UNTIL THEY WERE REMOVED BY THE CONGRESS IN 1935 IN RESPONSE TO CONCERN OVER THE EXCESSIVE INFLUENCE WHICH THE TREASURY SECRETARY, AS BOARD CHAIRMAN, HAD EXERTED.

AS SENATOR CARTER GLASS, ONE OF THE AUTHORS OF THE ORIGINAL FEDERAL RESERVE ACT (AND SUBSEQUENTLY A SECRETARY OF THE TREASURY) NOTED, THE TREASURY SECRETARY HAD EXERTED ENORMOUS INFLUENCE ON THE BOARD, OFTENTIMES TREATING IT AS A "BUREAU OF THE TREASURY INSTEAD OF INDEPENDENT BOARD," AND THAT ON OCCASION "THE FEDERAL RESERVE BANKING SYSTEM HAS BEEN MADE A DOORMAT OF THE UNITED STATES TREASURY."

IN SHORT, THE KEY TO THE SYSTEM'S GENERAL SUCCESS OVER THE YEARS IN PROMOTING THE NATION'S ECONOMIC GOALS IS THE SUBSTANTIAL DEGREE OF INDEPENDENCE FROM SHORT-TERM POLITICAL PRESSURES, THAT IS, AN INDEPENDENCE

WITHIN BUT NOT OF THE GOVERNMENT. BY WAY OF CONTRAST, FINANCIAL INSTABILITY AND CHRONIC HAVOC ARE WREAKED BY INFLATION IN MANY COUNTRIES IN WHICH THE CENTRAL BANK DOES NOT ENJOY A SUBSTANTIAL DEGREE OF INDEPENDENCE. IN THOSE COUNTRIES, MONETARY POLICY IS MADE SUBSERVIENT TO FISCAL AND DEBT POLICIES. (IN MOST COUNTRIES OF SOUTH AMERICA, FOR EXAMPLE, ANNUAL RATES OF INFLATION -- AND, NOT COINCIDENTALLY, UNDERLYING GROWTH OF THE MONEY SUPPLY -- TYPICALLY RANGE FROM THIRTY TO OVER ONE-HUNDRED PERCENT A YEAR.) CONVERSELY, THE COUNTRIES WITH THE BEST INFLATION RECORDS GENERALLY ARE THOSE WHOSE CENTRAL BANKS ENJOY A SUBSTANTIAL DEGREE OF INDEPENDENCE WITHIN THEIR GOVERNMENTS, SUCH AS IN WEST GERMANY, SWITZERLAND AND THE UNITED STATES.

CONSEQUENTLY, IT WOULD BE TRAGIC INDEED IF THE FED'S ABILITY TO IMPLEMENT ITS RESPONSIBILITIES, INCLUDING ITS EFFORTS TO PROMOTE A SUSTAINED NON-INFLATIONARY RECOVERY, WERE TO BE COMPROMISED BY THE ADOPTION OF NEAR-SIGHTED PROPOSALS WHICH WOULD REDUCE ITS ABILITY TO CONDUCT MONETARY POLICY FREE FROM DAY-TO-DAY POLITICAL PRESSURES.

CONCLUDING REMARKS

TO SUM, WE CAN CONGRATULATE OURSELVES FOR HAVING BROKEN BOTH THE UPWARD SPIRAL OF INFLATION AND THE DOWNWARD SPIRAL OF RECESSION DURING THE PAST YEAR. MUCH REMAINS TO BE DONE, OF COURSE. WE MUST DEAL WITH THE PROBLEM OF LONG-TERM STRUCTURAL UNEMPLOYMENT IN MANY OF OUR BASIC INDUSTRIES, AS WELL AS THE THREAT OF FINANCIAL COLLAPSE AMONG MANY OF OUR MAJOR TRADING PARTNERS OVERSEAS. MOREOVER, WE CAN'T MAINTAIN A SUSTAINED RECOVERY IN THE U.S. ECONOMY WITHOUT A SUBSTANTIAL DECLINE IN REAL INTEREST RATES. THE FEDERAL RESERVE, WITH A POLICY GEARED TOWARD NONINFLATIONARY

GROWTH, CAN CONTRIBUTE TO THE SOLUTION OF ALL THESE PROBLEMS. BUT SUCCESS WILL BE DIFFICULT--IN FACT, WILL BE ALMOST IMPOSSIBLE--IF CONGRESS AND THE ADMINISTRATION FAIL TO CURB THE ENORMOUS BUDGET DEFICITS WHICH THREATEN EITHER TO SHORT-CIRCUIT THE RECOVERY OR TO UNLEASH A NEW ROUND OF INFLATION.