CONFESSIONS OF A NEW CENTRAL BANKER

REMARKS BY

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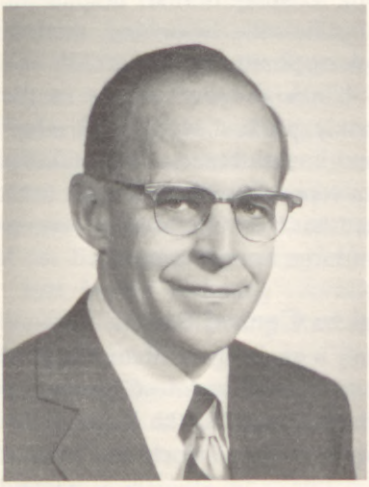

John J. Balles

It is a real pleasure to be here this evening with the Directors of the Federal Reserve Bank of San Francisco and its branches and with a group of leading bankers from the Los Angeles area. It is certainly an honor to serve in my new job as the ninth chief executive of the Federal Reserve Bank of San Francisco, which I have always regarded as one of the leading Reserve Banks.

To be sure, I came here from the East, and most of us recognize that there are some differences between eastern and western banks and bankers. Nevertheless, the similarities are also important. Thus, I don't feel like a total stranger in this environment—especially since I have been closely acquainted with some of you for years. I am looking forward to getting better acquainted with the rest of you.

I view my new position as an opportunity to become a part of the dynamic and innovative financial community of the West. Having come from an area of the country characterized by limited-area branch banking, one of the major differences I already have noted in this part of the country is that, despite the prevalence of state-wide branching, there is obviously an opportunity for small and medium-size banks to play a role in the regional economy, particularly in quick adaptations to local circumstances. The number of such banks represented here tonight testifies to the fact that they can prosper even in the shadow of large branch systems.

Commercial to Central Banker

It is certainly a challenge to share the platform tonight with the illustrious Chairman of the Board of Governors of the Federal Reserve System. This is particularly true in view of the fact that I have not attended a meeting of the Federal Open Market Committee since 1959 and am now about to begin a refresher course in central banking. Perhaps I could rise to the challenge and do something spectacular for the Federal Reserve System if I could get the cooperation of an old friend who is here tonight. He is Lee Atwood, a former director of the Los Angeles Branch of our Bank and the retired President of North American Rockwell Corporation, on whose Board of Directors I was privileged to serve until I accepted my present position. When Rockwell-Standard was merged with North American Aviation to form North American Rockwell, a technology-transfer committee was established, whose main purpose was to explore ways of applying spage-age technology to commercial products. Now that Lee is retired and has a lot of time to think about such matters, I may ask him to consider ways of applying space-age technology to the administration of a Federal Reserve Bank and to the formulation of monetary policy!

Having so recently come from commercial banking, where I was privileged to serve for the last thirteen years with Mellon Bank, I would have to admit that I haven't yet fully shifted back to the point of view of a central banker. In recent years, I have spent considerable time on the affairs of the American Bankers Association, including service last year as Chairman of the Special ABA Committee on the Presidential Commission on Financial Structure and Regulation, and also including service until recently as a member of the Administrative Committee of the Government Relations Council and as a member of the Economic Advisory Committee.

Just before resigning recently from the Trustees of the Banking Research Fund of the Association of Reserve City Bankers, I was managing trustee for a study, which I had proposed, of loan commitments by banks. This study is still in preparation and is being done by a well-qualified professor at Harvard, who was formerly on my staff at Mellon Bank. It was aimed at answering the general questions of what constitutes a prudent upper limit to loan commitments and how such commitments can be better managed. Among other things, we were attempting to test the feasibility of a suggestion made by Arthur F. Burns, in an April 1970 address to the Association of Reserve City Bankers, that banks should limit their loan commitments to amounts they reasonably believe can be financed in periods of tight money and that banks should charge at least as much for take-downs under commitments as they are paying for additional funds at that time. Needless to say, I will be very interested in seeing the study when it is finally published.

The only purpose in mentioning my background in such an immodest fashion is to make the point, for those of you who don't yet know me, that if I don't understand the problems of commercial banks, it has not been for lack of opportunity. There is the

further point that your views and problems will always receive a sympathetic hearing at the Federal Reserve Bank of San Francisco —whether or not we end up agreeing with you about any proposed course of action or remedies. In the same breath, I should also mention—as Chairman Burns reminded me during a visit in Washington before I assumed office—that I am now working for all the people, and should solicit views and opinions not only from the banking and business communities, but from other segments of society as well. I am certain that you will appreciate the desirability of doing this.

Role of Federal Reserve Bank of San Francisco

In this age of specialization, I certainly don't pretend to be knowledgeable on all phases of banking—far from it. But I believe that we have in the combined staff of this Bank such knowledge and expertise as is necessary to carry out our functions. I know that if I can't answer your questions on some bank operating matters, such as check collections or cash operations, we have people who can—a group headed by our very able First Vice President, A. B. Merritt, and including Paul W. Cavan, Senior Vice President and Manager of our Los Angeles Branch, who is one of our hosts tonight.

With the team we now have and will develop, it is my hope to make the Federal Reserve Bank of San Francisco an active partner with the banking and business communities in improving the financial and economic climate of the Twelfth District. I don't yet have a blueprint on how to do this, and it would be premature to even mention some possibilities I have in mind until they have been studied more thoroughly. Pending completion of such studies, however, we would welcome now or at any time any suggestions or proposals which you might have along these lines.

Federal Reserve System—Key Problems

Let me now turn to several other matters having to do with the Federal Reserve System. In so doing, I propose to dig back into past history, feeling that this offers valuable perspective on the present. It is especially appropriate to do this in view of the fact that the Chairman of our Board of Directors, Dr. O. Meredith Wilson, was a distinguished historian before he became President of the University of Oregon and later the University of Minnesota. Incidentally, he informs me (presumably with tongue in cheek) that in his current position as President and Director of the Center for Advanced Studies in the Behavioral Sciences at Stanford, he is running a monastery for scholars—but without celibacy!

There are two general points I want to make. First, to the extent that there have been "mistakes" in past monetary policy, as viewed by impartial observers, the most frequent cause has been deficit financing by the U. S. Government. The second point has to do with the vital necessity of maintaining an independent central bank.

First, as to monetary policy, second-guessing the Fed is a popular pastime. Some people have even made a career of it. And I would have to admit that I have done my share over the years, starting with a doctoral dissertation in 1950 on the subject of monetary policy during World War II and the immediate postwar years.

If there was one lesson that was indelibly impressed upon me in preparing that dissertation and in subsequent studies, it was that efforts to maintain a predetermined and relatively low level of interest rates necessarily immobilize monetary policy as an instrument of economic stabilization—and indeed make the central bank an "engine of inflation." Further, the use of fiscal policy as an instrument of restraint also becomes unworkable

under such conditions. It now seems so clear in retrospect. Yet, it was not so clear at the time, as I was reminded recently when reminiscing with Cecil Earhart, my predecessor twice removed, who served as President of the Federal Reserve Bank in those years. We recalled the agonizing debates which took place on the subject in the postwar years—i.e., could the level of interest rates be allowed to rise from the artificially low levels maintained during the war without serious risk of a financial and economic collapse? Along with many others at that time, I urged the necessity of restoring timely and flexible monetary policy, in conjunction with fiscal and debt-management policies, as indispensable in a broad program of vigorous economic growth without inflation. When the Government securities market was finally unpegged in March, 1951, in the now famous Treasury-Federal Reserve Accord, the economy and the financial markets did not collapse, and monetary policy was restored to a viable role in combatting the inflationary pressures that arose with the Korean War.

It was true then, and is true today, that if monetary, credit, and fiscal policies are used in a coordinated manner, they are capable of exerting a powerful influence on income, production, and prices. Moreover, since these instruments of policy operate to influence the general economic environment in an indirect fashion, they are more compatible with a private enterprise economy than the main alternative approach—namely, a system of direct economic controls involving detailed regulation of markets and prices.

It seems that we have to keep re-learning the lesson that the principal obstacle to successful use of monetary, credit and fiscal policies has been the failure to use them in a coordinated fashion. In that case, they are likely to offset and defeat each other. Indeed, much of our economic history is marked by inappropriate budget deficits defeating

efforts to combat inflation through credit restraint. The problem that we are faced with at present—namely, a huge Federal deficit in a period of strong economic expansion, is in fact new wine in an old bottle—and there have been many such "old bottles" over the years.

Monetary-Fiscal Mismatch, 1965

By way of illustration, in the latter part of 1965, when the "new economics" was still calling for expansive policies on aggregate demand, with a view to pushing the unemployment rate below 4%, there were some observers who recognized the emerging inflationary threat. One of these was Arthur F. Burns, then President of the National Bureau of Economic Research and John Bates Clark Professor of Economics at Columbia University. In his Benjamin Fairless Memorial Lectures in Pittsburgh at Carnegie Institute of Technology (now Carnegie Mellon University), Dr. Burns recognized the contributions made by the "new economists." But he observed that their favorite instruments of policy, if pushed beyond a point, may bring on inflation and undermine prosperity. Specifically, he observed that such a point was close at hand, if not already reached, and he called for less liberal monetary and fiscal policies, in the interests of both the domestic economy and our international balance of payments. Following a luncheon that Mellon Bank gave for Dr. Burns, I recall a discussion I had with some "new economists" who believed that it was too early to start fighting inflation. That view proved clearly wrong, as illustrated by subsequent developments.

Meanwhile, the Federal Reserve System had also correctly diagnosed the emerging inflationary pressures stemming from the escalation of the Viet Nam War in mid-1965 and from the concurrent expansion in "Great Society" welfare expenditures. By Decem-

ber 1965, the System increased the discount rate as a public signal. Prior to the increase, strong public statements were made by various high-ranking members of the Administration, including the Secretary of the Treasury, warning against such action. After the increase, there was strong denunciation of the move, including a statement by the Chairman of the Council of Economic Advisers to the effect that it represented a serious breach in coordination of monetary and fiscal policy.

However, by the spring of 1966, it was clear that the Council of Economic Advisers had seriously underestimated the strength of the inflationary boom that was developing. Not only did the Administration fail to revise its fiscal stance at the time, but it attempted to dissuade the Federal Reserve from meeting the threat through a modest measure of credit restraint. With the benefit of hindsight, it appears that the December 1965 increase in the discount rate and the associated move toward credit restraint was not only appropriate but overdue.

Lessons from Abroad. At this point, I would like to digress for a moment. In 1959, I happened to be in London on Mellon Bank business at the time when the Report of the Committee on the Workings of the Monetary System—better known as the Radcliffe Report—was scheduled for debate in the House of Commons. In the course of that debate, I heard the Chancellor of the Exchequer announce that one of the principal recommendations of the Radcliffe Report had been implemented — namely, that henceforth any proposed change in Bank rate by the Bank of England would have to be submitted in writing by the Governor to the Chancellor and approved by the Chancellor before becoming effective. Actually, of course, this new procedure simply formalized a practice which had been followed since 1946 when the Bank of England was nationalized.

Can there be any doubt of the outcome

had such a system prevailed in the United States in 1965—i.e., any doubt that the Secretary of the Treasury would have refused to ratify the proposed increase in the discount rate by the Federal Reserve? Can there be any doubt that our economic situation would have ended up even more unbalanced than it did, in the "credit crunch" in the summer and fall of 1966?

Perhaps this one illustration will serve to buttress the case of those of us who believe that the independence of the central bank within government—but certainly not from the government — is a vital protection to sound economic policy in a free society. The world's largest debtor—i.e., the U.S. Treasury—at times has not taken an unbiased and objective view on measures affecting the cost and availability of money.

Independence of the Federal Reserve System. This point has special relevance in view of repeated efforts in certain quarters in the Congress to undermine the independence of the Federal Reserve within government. Most recently, this effort has taken the form of an amendment to an omnibus housing bill (H.R. 16704) which calls for an annual audit by the General Accounting Office of the Board of Governors and the Federal Reserve Banks. It would give the G.A.O. access to all books and records of the Federal Reserve System. At first blush, this appears to be something that is hard to argue about—who can be against audits? In point of fact, it happens that the Board of Governors of the Federal Reserve is already audited by a reputable private firm (Lybrand, Ross Bros. & Montgomery); in turn, the Board's staff thoroughly audits the Reserve Banks.

The real point of the amendment in question is that it would not be confined to a financial audit. Instead, it would include an appraisal of operations, not only in regards to compliance with law, but also in reference to

recommendations "for attaining a more economical and efficient administration" of the Federal Reserve. The authority is so broadly described that it could include a review of System open-market and foreign operations. In my judgment, this could lead to intimidation of the Federal Reserve and to efforts to influence its policy. Fortunately, it now appears that the amendment is dead for this session of Congress, mostly because of the clogged legislative calendar, but the proposal is almost certain to be raised again. Eternal vigilance is the price necessary to avoid "political money," and I urge that you be alert to such proposals in the future.

Budget Deficits — the Main Barrier to Monetary Policy. To return to the subject of Federal Reserve policy, I recall my participation in President Nixon's pre-inaugural Task Force on Inflation in 1968. On this task force, I associated myself with the criticism of "stop-and-go" monetary policy, as evidenced by the "credit crunch" of 1966 and the unduly rapid monetary expansion in the second half of 1968—which, subsequent to our report, led to the "credit squeeze" of 1969. However, I managed to see that our report recognized the fact that large budget deficits are the most likely factor to pull monetary policy off course toward over-expansion, leading later to the necessity of tromping hard on the credit brakes.

Politically, while it is not too difficult to use fiscal policy for purposes of economic stimulus, it is very difficult to use it on the side of restraint. Recently, we have again heard words of warning on this subject. In view of the huge deficit in the Federal budget, which threatens to get still larger, Chairman Burns has stated before the Joint Economic Committee his fear that the Federal budget is out of control, and has called for support of current Administration and bi-partisan Congressional efforts to secure passage of a $250 billion ceiling on Federal expendi-

tures in the current fiscal year. I was pleased to note that the American Bankers Association also called for such a ceiling in its action of August 22, and proposed other measures to arrest the alarming uptrend in Government expenditures. A vote on the expenditure ceiling is scheduled in the House this week, and a great deal depends on the outcome.

The fundamental problem is to re-establish a sense of fiscal discipline in Congress, and especially to regain control over Federal spending. Otherwise, fiscal policy will not only fail to live up to its potential, but is likely to defeat monetary policy as well. Unfortunately, some of those prominently associated with the "new economics" are calling for a different approach than the one I have outlined. In a recent article in the *Wall Street Journal,* one such representative warned against "prematurely" cutting off the monetary and fiscal lifeblood of the current economic expansion, stating that we need not start throttling down until mid-1973. In my personal judgment, this would be too late to re-establish fiscal discipline for purposes of economic stabilization, given current circumstances.

In Conclusion

In closing, I would like to indicate the challenge I see in my new job which drew me to it, despite the attractiveness of a career in commercial banking. I see an opportunity, which I hope I can fulfill, to serve the community as a whole by accepting a position where I can work closely with bankers and businessmen from a huge and dynamic region—the Twelfth Federal Reserve District—to help solve some of the trying financial and economic problems now besetting society.

The kinds of problems I have in mind include: (1) the world's apparent inability to come to grips with inflation; (2) the acceler-

ating need for capital, based on rising material expectations, especially from those groups in society which have tended to be by-passed by the promise of technology; (3) the exacerbation of the capital shortage by the need to refurbish existing capital facilities and to improve the quality of the environment; and (4) the need to use financial institutions in our society in a way which will benefit all of the people, through increasing opportunities for them to earn their own livelihoods and lead the "good life."

That is a tall order—and is a challenge to all of us. Unless we succeed, the future of private enterprise is in danger. In striving for these goals, let us recall the words of Woodrow Wilson's first inaugural address, which happen to be inscribed on a plaque at the entrance to the Federal Reserve Bank of Cleveland, where I first began my tour of duty in central banking:

> *"We shall deal with our economic system as it is and as it may be modified, not as it might be if we had a clean sheet of paper to write upon, and step by step we shall make it what it should be."*