

THE FEDERAL RESERVE AND THE PROBLEMS OF 1975

REMARKS BY

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I take special pleasure in talking to our widely diverse group of guests today, which includes representatives from the business, financial, agricultural, and academic worlds. This morning we held the annual joint meeting of the Board of Directors of the Federal Reserve Bank of San Francisco with the directors of our four branches at Los Angeles, Portland, Salt Lake City and Seattle. Thus, included in this luncheon session are those who are currently serving on the boards of directors of our several offices, along with some of our Bank's former directors. And, since Federal Reserve directorships are not lifetime or hereditary positions, I expect that there may be some future directors present in this meeting.

Our reliance upon directors from the entire Western region reflects the unique regional organization of the Federal

Reserve System. In the beginning of our central bank over sixty years ago, this type of organization was largely a matter of political necessity. So great was the popular prejudice against Wall Street and the Eastern banks that there was little chance for the establishment of a completely centralized institution, on the order of the First and Second Banks of the United States. But in addition, significant benefits for the national economy have flowed from our decentralized System, involving twelve semi-autonomous Federal Reserve Banks, operating under the general supervision of the Board of Governors, a seven-man body appointed by the President of the United States. In a pluralistic nation such as ours, there can be highly diverse trends among various industries or sections of the country, and consideration needs to be given to these factors in the formulation of national monetary policy. Thus, the organization of the Fed provides an important grass-roots ingredient.

Within our System, however, there are certain Districts whose size gives them special importance. This is especially true of the Twelfth District headquartered here in San Francisco, which covers the nine states west of the Rockies, including Alaska and Hawaii. This District stands second only to the New York Federal Reserve District in terms of most major financial magnitudes, such as member-bank reserves and member-bank deposits. I need not dwell upon the economic importance of the District, since most of you know much more about it than does a relative newcomer to the West such as myself. There is, however, one statistic that never fails to impress me. Measured in terms of gross product, the San Francisco Federal Reserve District would rank seventh

among all the nations of the world, standing in the same league with Great Britain and France.

Role of Federal Reserve Directors

In the Federal Reserve Act, the Congress specifically required that the nation's varied regional and industrial interests be represented in the decision-making functions of the System. Although the Federal Reserve is by nature a "bankers' bank," great care was taken that it should not be dominated by the banking sector of the economy. The directors of the Reserve banks serve as a bridge between the System and their individual regions and industries, providing first-hand information on business and credit conditions, and in doing so they often have knowledge of trends in the economy before they are observable in economic statistics.

Six of the nine directors on each Reserve Bank's board are elected in the usual manner by the commercial banks which are members of the Federal Reserve System. Three of these elected directors must be bankers. The other three directors elected by the member banks must be actively engaged in commerce, industry, or agriculture, and they may not be officers, employees, or directors of banks. The remaining three directors are appointed by the Federal Reserve Board of Governors, and they may not even own bank stock. These public members, who may be selected from industry, the professions, or academia, are considered to be representatives of the general public interest; the Chairman and the Deputy Chairman of the Board are always chosen from the public members. Thus, a Federal Reserve Bank, although its stock is owned by member banks, is an institution with a public purpose.

The directors of the Federal Reserve Bank have somewhat different duties from those of a director of a commercial bank or manufacturing corporation. They are not part of an organization which attempts to maximize its profits, although our earnings are very large. In a sense the Federal Reserve is the nation's largest single taxpayer, since the vast bulk of our earnings are turned over to the Federal Treasury—technically, as interest on Federal Reserve Notes. Thus, in 1974 for example, the Federal Reserve Bank of San Francisco paid \$786 million to the U.S. Treasury, and for the Federal Reserve System as a whole the figure was \$5.5 billion. Directors need not concern themselves with dividend policy, since the return to the member banks—who hold all outstanding Reserve Bank stock—is set by law at 6 percent.

The major duties of Reserve Bank directors include the supervision of Bank operations and participation in the formulation of public policy. More specifically, our directors perform an advisory and monitoring role in three major areas of Federal Reserve activity:

1. The regulation of the flow of money and credit in such a fashion as to promote economic growth without inflation; their advice is sought on monetary policy generally, and in addition they initiate changes in the discount rate, subject to review and determination by the Board of Governors;

2. The supervision and examination of member commercial banks, the regulation of bank holding companies, and the oversight of American banks' activities overseas;

3. The provision of basic wholesale bank services, such as issuance of

currency and coin, operation of a check-collection system, and services as fiscal agent for the Treasury.

Dilemmas of Monetary Policy

The first of these three basic functions, the formulation and implementation of monetary policy, is clearly the most crucial one. Monetary policy may be mobilized to fight either inflation or recession. Of course, the current situation embodies the worst of all possible worlds, since we must combat a very serious recession while still facing a high rate of price inflation.

In the abstract, monetary policy would fight inflation by moderating the rate of increase of the money supply, in an attempt to scale down the effective demand for resources. In actuality, excess demand has now been wrung out of the economy, and price increases have come down out of the double-digit range, but a worrisome amount of inflation still remains. As in past recessions, catch-up wage and cost increases continue to push prices up, long after the initial demand stimulus has passed its peak.

A complicating factor is the failure of the Treasury's credit needs to decline during the prolonged period of inflation. Indeed, the Treasury has recorded deficits in all but one year of the past decade and a half, and its borrowing needs have grown immensely in the current inflation. A worrisome byproduct of these large Treasury incursions into the credit markets has been a rise in interest rates. The public and its representatives in Congress are very critical of the sharp increases in rates on mortgages and municipal securities that have developed in times of monetary restraint. But the Treasury's heavy demands upon the

credit markets literally crowd out other borrowers who also want funds. The high or rising level of interest rates that the public associates with tight money is thus exacerbated by Treasury financing needs.

Needless to say, rates have fallen sharply since last summer in the wake of an easier monetary policy. The Fed has used all the monetary weapons in its arsenal to combat recession and to improve the liquidity of the banking system. The discount rate has been cut three times, falling from 8 percent to 6 3/4 percent. Member-bank reserve requirements have been cut, and ample reserves have been provided through open-market operations. Thus, banks have been able to restore their liquidity positions, reducing their borrowings at the discount window almost to zero from last summer's peak of over \$3 billion. The more comfortable liquidity position has been reflected in a drop in the prime business-loan rate from 12 percent last summer to 8 1/4 percent today.

Again in the abstract, Treasury deficits should offer few problems in dealing with a recession, since enlarged borrowings by the Government would replace reduced private credit demands. A complementary monetary policy would ease credit and encourage lower interest rates. Inflation would not be a problem in this situation, because of the weakness of aggregate demand. Unfortunately, our recent experience does not correspond to this textbook description. Because of the continued rise in prices of materials and services, private credit demands have not diminished as would be expected in a period of recession. As Grover Cleveland once said, "We are faced with a situation, not a theory." After contending with one difficult situation—large Treasury deficits

in a time of inflation—the Federal Reserve now must attempt to spark a recovery from recession against a backdrop of inflation. As I just said, the Fed has eased policy considerably to combat recession, but it has not been able to move as aggressively as it would have in a less inflationary situation.

Lagged Effects of Monetary Policy

Central banking and monetary policy have always been surrounded by a certain air of mystery and I'm not sure that we have been completely successful in dispelling this mystique. For one reason, monetary policy acts with a lag, and the full effects of today's actions may not be felt until several years later, when one's attention has turned to other matters.

Our knowledge is still imperfect in this area, but we are able to distinguish between two sets of effects. A change in monetary policy normally is reflected in the "real" sector of the economy within six to twelve months. Thus, an easy-money policy should be followed by increased employment, output and profits within a year's time, and perhaps one to three years' later, by a rise in prices and interest rates. (I should emphasize here that when I say easy money, I mean continued increases in the money supply in excess of productivity gains.) Now, when monetary policy turns tight, the initial results are declining employment and output, followed only after a considerable lag by a decline in the rate of inflation and in interest rates.

This asymmetrical situation creates obvious problems for the implementation of public policy. In the eyes of the public, an easy-money policy is highly desirable because of its role in fostering the growth of employment and output, but tight

money is looked at askance, because of the immediacy of its depressing effect on business activity and the long-delayed nature of its remedial effect on inflation and high interest rates. This tendency should be kept in mind as we assess the current economic outlook and appropriate monetary policy.

Economic Prospects

In the past four months, the state of the economy has deteriorated much faster than most observers had thought possible. It is now quite clear that the present recession ranks as the longest and deepest since the 1930's. Two sectors of the economy, residential construction and autos, have been severely distressed. However, it might be noted that both of these industries earlier enjoyed three years of record growth, so if they have fallen far, they have also fallen from a very high peak. Further weakness is developing in the economy as businesses liquidate the speculative inventories built up over the past year.

Economists disagree about the turning point and the strength of the expected recovery, but they all agree that the 1975 statistics will make disappointing reading. My research staff expects a 7-to-8 percent increase in current-dollar GNP, to almost \$1.5 trillion for the year as a whole. But net of price effects, this will amount to a decline of 3 percent or more in physical output. This will be so, even though the rate of inflation is expected to drop from 12 percent to 6 percent or less over the course of the year.

The more interesting question concerns what forces will turn the economy around, and when. Most observers are looking first of all to the consumer sector, which has been particularly weak in the

early part of this recession, largely reflecting the effects of inflation. Personal consumption in real terms dropped significantly over the past year, as an 8-percent increase in average hourly earnings was simply overwhelmed by a 12-percent rise in consumer prices. But this erosion of consumer purchasing power should be reversed as the rate of inflation recedes and tax reductions and rebates occur, thereby setting the stage for increased purchases of consumer goods and a turnaround in business activity sometime this spring or summer. By that time also, the necessary inventory correction should be completed, and the stage could be set for a modest rebuilding of stocks. Similarly, a quickening of consumer demand could encourage businessmen to expand their outlays for plant and equipment, after a period of weakness in most fields except the energy industry. If the economy follows this script, we could achieve a healthy 4-to-5 percent rate of growth in late 1975 and 1976.

In the meantime, however, we are left with a serious unemployment problem, with the jobless rate already above 8 percent and perhaps reaching 9 percent before the year is out. Of course, there have been structural changes in the civilian labor force in the past two decades that have raised the level of the unemployment rate associated with full utilization of economic resources. Adult women and teenagers have increased their representation in the labor force relative to adult males. Because of limited work experience or lack of marketable skills, the jobless rate for these two groups is higher than for adult males, and their increasing numbers in the labor force have boosted the overall unemployment rate. Nonetheless, the

1975 recession problem centers in the heart of the labor force, since 43 percent of the 3 million people added to the jobless rolls in the past year have been heads of households. Well over half of the increase in unemployment represented actual job losses, rather than new entrants or re-entrants into the labor force.

We must rely heavily on demand-stimulating measures to cure our present recession, but I believe we should place equal importance on supply-enhancing measures that would help cure our long-range problems of price stability and job creation. Long-run price stability depends on the provision of increased amounts of goods and services as well as the elimination of bottlenecks which impede their production and distribution. This goal depends on rising productivity, which depends in turn on increased capital formation. Thus, incentives to capital formation must be generated, for example through a higher investment-tax credit, which in itself is a strong reason for supporting the current tax-reduction proposals. In addition, we must strive harder to get rid of the host of laws and regulations which tend to limit employment and productivity gains and our general standard of living—such as minimum-wage laws, fair-trade laws, and the like.

Fiscal Policy and Deficits

Congress is responding to the recession and to this jobless situation with larger tax cuts and spending increases than the Administration had proposed. As a result, the economy now faces even more massive Federal deficits than the \$87-billion total previously expected for the fiscal 1975-76 period. But the Federal

Reserve has special problems with respect to these deficits—problems that are not new, but that are increasingly severe. The Treasury-Federal Reserve Accord was reached in 1951, freeing the Fed of direct responsibility for supporting the Treasury bond market, but its task still has been complicated by the fact that surpluses have arisen in only 5 of the ensuing 25 years. The cumulative deficit over that quarter-century, 1951-76, will be at least \$225 billion, largely built up during the 1970's.

A major source of the deficit-financing problem has been the separation of the appropriation of funds and the provision of revenues in the Congressional budgetary process. Funds for specific programs have been authorized and appropriated without regard to how they might be funded. Because of this lack of coordination, deficits have been a residual of the budgetary process rather than a deliberate tool of fiscal policy.

By its very nature, fiscal policy is highly politicized—as it should be, since the public's duly-elected representatives presumably reflect in some degree the social priorities of the public. But because of the separation of functions—and because it is more pleasant to spend than to tax—there tends to be a bias in favor of increased appropriations relative to increased revenues. Congress has added new programs without either supplanting outmoded programs or raising taxes to fund the new programs. And when new expenditures are financed by deficits rather than by increased revenues, the ball is knocked into the Federal Reserve's court. The financing of new Federal expenditures, which is a legitimate responsibility of fiscal policy, thus is delegated *de facto* if not *de jure* to the

Federal Reserve. As Lord Keynes once remarked, "The long arm of the Treasury reaches into the central bank."

The Budget Reform Act of 1974 may point the way out of this financing thicket. Under this legislation, a limit will be set for expenditures and priorities will be established for new or existing programs. A deficit or surplus in the budget will be planned, depending upon the state of the economy, and revenues will be adjusted to meet the desired level of expenditures. Unfortunately, this new budgetary process will not be put in place until fiscal 1977.

Congressional Allocation of Credit

I welcome the Congressional initiative on budget reform, but I have somewhat different views about the wisdom of certain other proposals which, at least in their original form, would set rigid policy guidelines for the Federal Reserve. The enactment of this type of legislation would have far-reaching effects for the Federal Reserve and for the banking community, with respect to both monetary policy and credit allocation.

The most widely-discussed bill, introduced by Chairman Reuss of the House Banking Committee, was later revised and reduced to a resolution indicating the "sense of Congress," which does not convey the force of law. The original bill would have instructed the Federal Reserve to increase the M_1 measure of the money supply (currency plus demand deposits) at a 6-percent annual rate in the first half of 1975—and to report to the Senate and House Banking Committees if the target was not reached for either "technical or substantive reasons." The final House resolution advised the Federal Reserve to "conduct

monetary policy in the first half of 1975 so as to lower long-term interest rates," and to provide monthly progress reports on its actions.

The credit-allocation features of the original bill were also quite restrictive. The bill specified that bank credit be allocated toward "national priority" uses, including small-business loans, farm loans, mortgage loans for low- and middle-income housing, loans to state and local governments, and in addition, loans to business enterprises for expanding productive capacity or ensuring adequate working capital. These priorities generally parallel the set of voluntary guidelines developed by the Federal Reserve's Federal Advisory Council last summer, but they would be rigidly implanted in the statute books. Bank credit would be channelled away from "inflationary" uses, such as loans for purely financial transactions or for speculative purposes, and loans to foreigners also would be discouraged. Committee action on this proposal was postponed after the initial House hearings, but the topic remains very much alive.

Enormous consequences could flow from Congressional intervention in monetary policy and the credit markets, certainly on the scale envisioned in the original Committee bill. First and foremost, monetary policy would become thoroughly politicized. This directly contradicts the original intent of the framers of the Federal Reserve Act, who attempted to insulate the central bank from just such political pressures.

The "softened" requirement that the Federal Reserve merely lower long-term interest rates rather than follow a

prescribed rate of money-supply growth is no less ill-conceived. Long-term interest rates contain an inflation premium which reflects expectations of future price inflation. The House bill would have enjoined the Federal Reserve to treat the symptoms of inflation rather than to strike at its root causes. Indeed, the very act of supplying sufficient funds to lower long-term rates now would guarantee more inflation and therefore higher interest rates in the future.

The allocation of bank credit on the basis of "national priorities" simply grafts a set of social priorities onto a market system which is ill-equipped to handle them. In the housing field, for example, we hear talk of requiring the precise amount of money-supply growth that would achieve a 2-million annual rate of housing starts. But if public policy dictates a high social value for housing, it can best be handled through expenditures, loans or subsidies in the Federal budget.

Credit-allocation schemes are designed to redress the inequities growing out of unequal market power. This is a commendable aim in principle, but it involves serious problems of execution, especially in the areas of leakages and evasion. For example, large corporate borrowers whose needs for funds are not considered "productive" may simply turn to the commercial-paper market for accommodation. Moreover, the enforcement of lending on the basis of priorities would involve a regulatory effort of major dimensions, which of itself could hardly be considered a "productive" effort. The legislation of interest rates and the allocation of credit by fiat have never successfully replaced the market system as a basis for rationing the financial resources of the economy,

and I see no reason to believe they will do so now. Inflation and high interest rates do not come from the use of credit by "speculative borrowers." They result largely from excessive growth of the money supply, necessitated for the most part by large and chronic Treasury deficits.

Concluding Remarks

The Federal Reserve System clearly faces one of the most severe policy crises in its 60-year existence. We must walk a very fine line, providing stimulus to an economy in deep recession without laying the groundwork for a later and perhaps even more destructive bout of inflation. An even more lasting danger lies in the current threats to the independence of the Fed. In the past, monetary policy has on occasion been tighter than would otherwise be desirable, but primarily because of a lack of support from fiscal policy.

If monetary policy is now to be politicized along with fiscal policy, one wonders how we might fight inflation in the future. Moreover, the politicization of the Fed could destroy the System's grass-roots links to various regions and various sectors of the economy, a structure that has served us very well in the past. I sincerely hope that the independence of the Fed and the important role played by its directors are not to be eroded in this fashion.

