

# HEADLINE STORIES OF 1976

REMARKS BY

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Luncheon Meeting  
Portland Branch Board  
of Directors and Guests

Medford, Oregon  
April 8, 1976





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I'm very happy to visit again the beautiful state of Oregon, where Nature and Man have collaborated so well to create the perfect living and working environment. While I'm about it, I should congratulate you also for Oregon's superb soft-sell industrial-development program. One might think that people would actually stay away from this state because of the activities of the James G. Blaine Society and the solemn pronouncements from Salem—but no, these things only whet the interest of outsiders and make them more determined to come here. There's just no other way to account for the growth in Oregon's population, which in the first half of this decade jumped almost 10 percent—twice the national rate—or for the continued strong expansion of the

state's \$13-billion economy in the face of the troubles of its all-important customer, the national housing industry.

This morning, the Board of Directors of our Portland Branch met here in Medford to discuss current economic developments and various Federal Reserve operating topics. The Board, which consists of Medford's own Frank Servoss and four other distinguished Oregonians, helped bring me up-to-date on the regional economy—and in this way provided a crucial input into my preparation for future meetings of the Federal Open Market Committee, which plays such a vital role in setting the nation's monetary policy. This grass-roots participation in the policymaking process, to my mind, is one of the best features of the System which the founders of the Federal Reserve developed more than 60 years ago, since it guarantees that regional leaders will have some say about national policy decisions.

### **Crucial News Story**

Most of my remarks today will center on the headline stories—some real, some phony, and some quite scary—that have appeared in the newspapers the last several months. To begin with, no one can possibly downplay the importance of that crucial news story, the year-long recovery of the national economy. Real GNP, the measure of the nation's total physical production, rose at an 8-percent annual rate in the second half of last year, and it continued to advance strongly in the quarter just completed. The business recovery since last spring has generated more than 2 million new jobs, has extended the length of the average work-week, and has reduced the unemployment rate from about 9 to 7½ percent. Moreover, the rate of rise in consumer

prices currently, at 6 percent, is only half as high as the 12-percent rate of late 1974.

However, there's a time bomb inside the economy which could erupt into scare headlines at some later date. I refer to the potential impact on prices of a Federal budget which is still not under control. Now, people have suggested a number of reasons for the terrible inflation that we've experienced over the past decade, but the underlying cause of this problem has been the tendency of Federal deficits to expand in good times as well as bad, pulling monetary policy off course in the process. After all, the Treasury has to be financed, and yet there is strong resistance in Congress to high and rising interest rates. In view of such pressures for low rates and associated rapid money growth, deficit financing usually results in excessive monetary expansion.

Huge deficit financing apparently was needed last year to offset the effects of the worst recession of the past generation, but substantial deficits have troubled us not just for a year but for an entire decade. Indeed, for that period as a whole, the Federal government and its agencies went into debt to the tune of almost \$300 billion. The deficit is estimated at \$74 billion for the current fiscal year alone, and on top of that, the congressional Budget Committees now project a \$50-billion deficit for fiscal 1977, despite the lack of need for further stimulus for the strengthening economy. Unless Congress makes a better effort to bring the budget under control, we are likely to be faced with a persistent inflationary problem for the rest of the 1970's. And sooner or later, inflation leads to an unsustainable boom—which then collapses, resulting in recession and rising unemployment.

## Money in the Headlines

In contrast to the scare headlines that may yet haunt us in this regard, let's consider the scare headlines that we've been reading for at least a year about the Federal Reserve's supposed failure to expand the money supply fast enough to support the business recovery. A look at the numbers is instructive. A year ago, the Fed adopted a growth range of 5 to 7½ percent for  $M_1$ —that is, currency plus bank demand deposits—and a growth rate of 8½ to 10½ percent for  $M_2$ —which consists of  $M_1$  plus bank time-and-savings deposits other than large certificates of deposit. Over the past year,  $M_1$  increased about 5 percent and  $M_2$  by more than 9 percent—both within the target ranges, although with significant month-to-month fluctuations. But more to the point, their growth during the past year was roughly in line with the average money-supply growth rate of the preceding five-year period—and yet throughout most of that earlier period, the Fed was sharply criticized not for going too slowly but rather for stoking the fires of inflation with an over-rapid growth of the money supply. This comparison, I think, illustrates the tightrope-walking skills required of the monetary authorities.

Money growth over the past year obviously has been adequate to finance a vigorous recovery, a drop in the unemployment rate, and a slowing in the rate of inflation. In addition, we have seen some decline in interest rates. But where would we have been if we had followed the advice of our critics a year ago and increased the money supply at an annual rate of 10 percent or more? Among other things, it is likely that the rate of inflation would now be increasing, and the stage would have been set for another boom-bust cycle.

## **Banking in the Headlines**

Next, let's consider the scare headlines we've been reading the last several months about the health of the banking system. It seemed to me in this case that some of the most prestigious papers in the country were acting like first-year journalism students, belying that motto about all the news that's fit to print. Their problem seemed to be that the so-called news was a) out-of-date and b) misleading. The gist of these stories seemed to be that the Fed and other agencies permitted the era of go-go banking to get out of hand, and then locked up all the evidence of poor lending practices.

Published lists of year-old problem-bank situations were misleading at least partly because of confusion about the meaning of the term "problem bank." The institutions appearing on the regulators' lists were identified because of certain problems—many of them minor problems—as being in need of extra supervisory monitoring. But most have now made substantial progress in solving their problems, and thus are in no danger at all of imminent failure—if indeed they ever were. But then why didn't the regulatory agencies release all this problem-bank information themselves? Simply because it would be counterproductive to include examination reports with all the wealth of other material that is routinely made available to the public. Since it is confidential, an examination report contains candid and confidential remarks about the most intimate details of bank's customers and its performance, on the part of both the examiner and the banker he is dealing with. Disclosure of examiners' reports would destroy this confidential relationship, making the reports much less meaningful—and in many cases, hamper-

ing the effort to bring problem situations under control.

### **Missing News Stories**

Now, the story that should have appeared in the headlines would cover the underlying causes of the banks' difficulties, including the worldwide turmoil of the past decade. That tumultuous period encompassed Vietnam, Watergate, OPEC, the collapse of Bretton Woods, and (almost concurrently) the worst inflation and the worst recession of the past generation. Admittedly, amid this turmoil, several major bank failures occurred here and abroad, but the ensuing forecasts of a replay of the 1930's turned out to be far off the mark. Indeed, by January 1976, only 121 of the nation's 15,000 banks—and none of its large banks—were listed on the FDIC's checklist of serious problem cases. And don't forget the biggest news of all—while shareholders suffered losses, not a single depositor lost any money in the several bank failures of the past few years.

Many banks of course made mistakes during this difficult period. Some forgot that they were supposed to be cautious with other people's money, and instead took unnecessary risks with that money to serve their borrowers. At any rate, there was a swing by many banks away from their cautious behavior of a generation ago toward a stronger risk-taking stance. But now, the pendulum has swung back again. Responding to the riskier atmosphere of the mid-1970's, banks have adopted more cautious credit policies, and have thereby improved their own financial health.

Another important story that failed to make the headlines was the essential role the banking system played in stabilizing

the economy at a critical time, at some cost to itself. At mid-1974, bank funds in many cases were the only funds available to small-and medium-sized firms, as money and capital markets tightened drastically in the face of double-digit inflation. Moreover, public utilities had nowhere else to turn for funds at that time, since they were unable to obtain needed funding through internal sources or through the capital market. The resultant heavy loan demand strained the liquidity of many banks—but it helped to support the economy at the time it was most needed. Later, as the economy recovered, the financial environment did too, so that today the nation's banking system is healthy—and getting even better, despite a few problem cases.

### **Regulators in the Headlines**

Now, because of the public's confusion over what is news and what isn't, we're being treated to headlines today about Congressional reform of the bank-regulatory system—a development we may not otherwise have encountered. Don't get me wrong; I'm not saying that improvements cannot be made in this complex system. At the San Francisco Fed, we have already set up a special financial-monitoring unit to ensure that we don't run across any unwelcome surprises in the banks that we supervise, and at the national level, Chairman Burns has made a number of suggestions to Congress regarding possible regulatory reforms. But that's not the same as a wholesale overhaul of the entire system, as some critics propose. But this passion for reform seems to occur in a number of fields. As a result, a lot of babies have been thrown out with the bathwater in recent years—a useful technique perhaps if you're aiming only at zero population growth, but a technique

which in this case could bring about zero *economic* growth.

As you've probably heard, the shape of the banking legislation has changed considerably as it has worked its way through the halls of Congress. But no matter what the final outcome, I believe it's worthwhile to mention some of the more ominous features of the proposals that have been circulating recently. Indeed, the nation's future financial stability could be endangered by proposals that would introduce political factors into Federal Reserve operations and policy. The proposal for Presidential appointment and Senate confirmation of Reserve Bank presidents—and for rather short terms at that—would mean that political acceptability would replace professionalism as the primary attribute of these officials. The Fed thereafter would have great difficulty in attracting highly professional, career-oriented talent to staff the top executive positions at the various Reserve Banks. Other legislative provisions would deprive these Reserve Bank presidents of their voting rights on the Federal Open Market Committee during their current terms, and would deprive directors of their responsibility for selecting Reserve Bank presidents and holding them accountable during their incumbency. These features, I fear, would weaken that element of direct regional participation in Federal Reserve activities which the founders of the System were so anxious to foster.

I see problems also with legislative proposals which would require the Federal Reserve Chairman, in his quarterly reports to Congress on monetary policy, to specify the intended or expected levels of interest rates over the succeeding twelve months, and to specify also the expected impact of

monetary policy on employment, production and prices. However, interest-rate movements depend on many factors outside the Fed's control, such as expectations of borrowers and lenders about the future course of inflation, so that we could mislead the public if we attempted to make precise forecasts about rates. Again, the looseness of the relationship between monetary policy and economic developments makes it doubtful that we could come up with precise projections of employment, production and prices, and the proposal practically guarantees confusion because of the constant updating of forecasts that would be required.

I could go on at length, but I'll mention just one other proposal that is missing from the legislation now under study, but which could surface at any time to create damage. I refer to the proposal for an audit of monetary-policy operations by the General Accounting Office—an action that would leave the way open for Congress to exercise direct responsibility for the conduct of monetary policy. For the future health of the economy, I think it's essential for us to separate the people who print the nation's money from the people who spend the money. Otherwise, if we limit the central bank's activities to operating a printing press, we'll create the tinder for an inflation that, Latin-American style, could destroy the economic and social fabric of the nation.

### **Concluding Remarks**

To sum up, you should now have a pretty fair idea of what I think should have appeared in the papers these past several months, as opposed to what actually did appear. The real economic news is that the business recovery progressed faster than anyone expected—not that some

vestiges of the recession still remain. The real financial news is that the banks met the economy's basic needs for funds throughout the worst inflation and the worst recession of the past generation—not that some sour loans were incurred in the process. The real regulatory news is that the authorities helped support the financial system through bad times while bringing about a reaffirmation of traditional banking virtues—not the reverse, as has frequently been charged. The task of regulatory authorities is to see that the worst does not happen when the economy becomes badly strained, and I think we successfully performed our job.







