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# CENTRAL BANK OF THE WEST

REMARKS BY

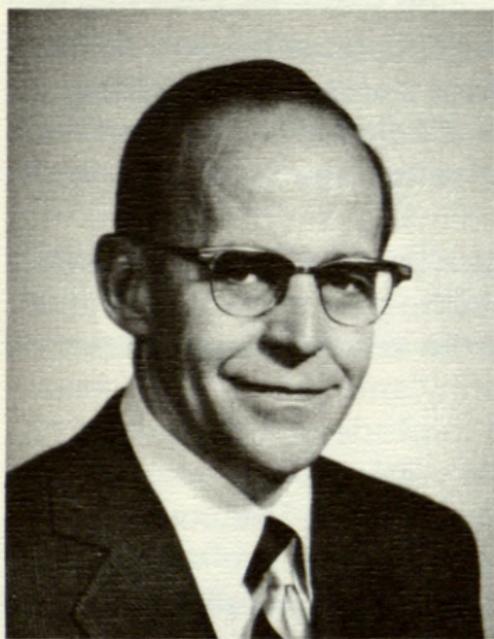
**John J. Balles**

PRESIDENT  
FEDERAL RESERVE BANK  
OF SAN FRANCISCO

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Rotary Club of  
San Francisco  
San Francisco, California  
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*The function of the Federal Reserve is to keep the nation's economic blood pressure under control, says Mr. Balles. Past experience shows that the central bank has a difficult job in achieving the sometimes conflicting goals of economic growth, high employment, and a strong dollar at home and abroad. That task would be made even more difficult if our nation followed the example of others and placed the Fed under direct Executive or Congressional control. It is no accident that the two industrial nations with the strongest central banks—Germany and the United States—are also the two with the strongest records of curbing price inflation.*



John J. Balles

I'm glad to have the opportunity to drop in on the Rotary Club today. It gives me the chance to meet several hundred new faces and (as your chairman requested) to tell you what we've been doing lately at the Fed—and why.

The Federal Reserve was organized over sixty years ago as the nation's central bank. It consists of twelve semi-autonomous Federal Reserve Banks, operating under the general supervision of the Board of Governors, a seven-man body appointed by the President and confirmed by the Senate. The West was the logical area for the location of a new Reserve Bank, and that logic has become more evident over the years with the westward flow of population and trade. When we got started in 1914, our nine-state District accounted for 6½ percent of the nation's commercial-bank deposits, but today it has 14½ percent of the total. In 1914, the San Francisco Reserve Bank opened for business with a staff of just 21 people—officers, tellers, bookkeepers, stenographers,

messengers, one guard and one janitor. Today, our offices here and in four other Western cities, with about 1,900 employees, serve 33 million people and almost 6,500 banking offices in a vast area stretching from the Arctic Circle to the Mexican border and from the Rockies to the mid-Pacific.

Our operations affect the flows of money and credit—which I don't have to remind you, represent the very lifeblood of our business economy. Indeed, you could say that our job in the Federal Reserve is to keep the nation's economic blood pressure constantly under control. This covers a great deal of ground, since we're involved in "wholesale" banking operations, in bank supervision and regulation and, above all, in monetary-policy decisions.

### **Operations and Regulation**

Like every other central bank, the Federal Reserve is in most respects a wholesale bank, dealing largely with the financial community and the U.S. Treasury. Most employees at the twelve Reserve Banks throughout the country work at providing central-banking services for their communities—keeping the wheels of business humming with coin, currency, check-processing services and the like. Last year, the people at our five offices handled 732 million pieces of currency, 351 million food stamps, almost 1½ billion coins, over 1 billion paper checks, and many other chores besides. (The San Francisco office was one of the busiest—for example, handling 290 million checks during the year.) However, our work load would have been much, much heavier had we not benefited from all the internal processing that goes on inside the branch systems of the large Western commercial banks.

Monitoring and supervising financial institutions is another major function. If you

didn't know it before, you've certainly read in the papers recently that different agencies supervise different segments of the nation's banking system. We at the Fed supervise state-chartered banks which are members of the Federal Reserve System, along with bank holding companies and various international activities—and the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the state banking authorities all have different pieces of the pie. Naturally, improvements can 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.

That's not the same, however, as a wholesale overhaul of the entire system, as some critics have proposed. This deadly dull subject of "problem banks" and regulatory reform ordinarily wouldn't be mentioned except in specialized banking journals. But as you'll remember, a lot of stories appeared in the headlines early this year, which seemed to say 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 misled many readers, at least partly because of confusion about the meaning of the term "problem bank." The institutions appearing on the regulators' list were identified because of certain problems—many of them minor—as being in need of extra supervisory monitoring. Most banks have now made substantial progress in solving their problems, and thus are in no danger of imminent failure—if indeed they ever were. In January of this

year, when the newspaper stories broke, less than one percent of the nation's 15,000 banks—and none of its large banks—were listed on the FDIC's checklist of serious problem cases.

Some banks admittedly took too many risks during the boom years of the 1960's and early 1970's, but the pendulum swung back again during the mid-1970's, as banks adopted more cautious credit policies, and thereby improved their own financial health. The banks deserve credit for this performance, and they also deserve credit for what they did earlier in stabilizing the economy during the credit crunch, at some cost to themselves. At mid-1974, bank funds were the only funds available to many 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.

### **Scope of Policy**

This brings up the Fed's major task, which is to help keep the economy healthy, or as I said at the outset, to keep the nation's blood pressure under control. We get our marching orders from the Federal Reserve Act of 1913 as modified by additional legislation in 1933 and 1935. As far as economic policy is concerned, our basic goals are defined by the Employment Act of 1946, with its commitment to "maximum employment, production and purchasing power." Those are all laudable objectives, and I would add one more that should have been made explicit in the Employment Act—namely, price stability.

The Federal Reserve helps the nation attain these economic goals through its ability to influence the availability and the cost of money and credit. As the nation's central bank, it tries to ensure that money and credit growth is sufficient over the long run to provide a rising standard of living for our growing population. In addition, it works in the short run to counteract recessionary and inflationary influences as they arise. Moreover, as lender of last resort, it utilizes all available policy instruments when necessary in an attempt to forestall national liquidity crises and financial panics. The Fed achieves its ends by influencing the reserves held against bank deposits, utilizing such tools as purchases and sales of Government securities in the open market, as well as changes in reserve requirements and discount rates.

But of course, monetary policy is only one of the many factors affecting the health of the economy. Government tax and expenditure policies bear critically on the economy's performance, and so too does the government's international economic policy. Government credit policies that affect housing, small business and agriculture also influence the broader economy. The wage and price policies of business firms have very important effects. And finally, there are innumerable other private and public decisions, many of which are independent of monetary and fiscal policies, but related rather to such crucial noneconomic factors as technological innovations, international crises, population shifts and public confidence.

### **Need for Independent Policy**

Monetary policy, nonetheless, plays a crucial role in helping the nation achieve its goals of economic growth, high employment and relatively stable prices. In many respects, it is far more effective than fiscal

policy, which has several important drawbacks. For one reason, manipulating government spending tends to be a rather clumsy way of dealing with rapidly changing economic developments. Secondly, the process of reaching a consensus on needed tax changes usually turns out to be complex and time consuming. Indeed, history teaches us that alterations of fiscal policy, once undertaken, usually affect the economy too late to be of much value in moderating fluctuations in business activity.

Fortunately, monetary policy is relatively free of these shortcomings, because of its great virtue of flexibility. Changes in the course of monetary policy can be made promptly and—if need be—frequently. Under our scheme of things, the Federal Reserve can make the hard decisions that might be avoided by decision-makers subject to the day-to-day pressures of political life. And experience shows us that the effects of substantial changes in the supply of money and credit are rather speedily transmitted through financial markets to the nation's factories, farms and commercial enterprises.

The founders of the Federal Reserve System were well aware of the dangers that could arise from the creation of a monetary authority subservient to the Executive branch of government, and thus subject to political manipulation. Consequently, they took several steps to ensure the independence of the central bank within the structure of our Federal Government. First, the term of office of Board members was made long enough to minimize the threat of covert political pressure, and appointees were given staggered terms in order to avoid Presidential "packing" of the Board. Second, the Federal Reserve was required to account for its actions to Congress and not to the Executive branch of government.

Third, the Fed's operations were to be financed from its own internal sources, and thus protected from the political pressures that may be exercised through the Congressional appropriations process. Fourth, power was to be diffused within the Federal Reserve System, so that the interests of borrowers, lenders, and the general public could all be recognized in the activities of the regional Reserve Banks.

Our system of monetary management, I believe, has been working just the way the founders of the Federal Reserve intended. Certainly, policymakers have stumbled on some occasions, but it's hard to imagine that our problems would have been solved if we'd followed the suggestion of the Fed's critics and turned control of the monetary authority over to the Executive branch or to Congress. Specifically, if the spending propensities of Federal officials had been given freer rein through easier access to the "printing press," the inflationary tendency that has weakened our economy over much of the past decade probably would have been aggravated even more.

Every nation in the world has suffered severely from inflation in recent years. But as Chairman Arthur Burns recently noted, the two industrial nations with the strongest central banks—Germany and the United States—are also the two with the strongest records of curbing inflation. Great Britain, whose central bank was taken over by the Government several decades ago, has recently been experiencing a chronic case of double-digit inflation, rising at times last year to an annual rate of 30 percent or more. And in some other countries, in Latin America and elsewhere, where the monetary authority has always been dominated by the executive or the legislature, triple-digit inflation holds sway, bringing economic and political chaos in its wake.

In our democratic society, of course, the independence of a governmental agency can never be absolute. The Federal Reserve System is thus subject not only to the provisions of the Federal Reserve Act, but also to the Employment Act and numerous other statutes. The founders of the System recognized this duty by requiring the Fed to account for its stewardship to the Congress. This responsibility has recently been formalized in a new reporting system, with Chairman Burns traveling up to Capitol Hill every quarter to discuss the course of monetary policy, and to provide growth projections for the major monetary and credit aggregates for the year ahead. The present system is effective because it provides ample scope for the exercise of Congressional oversight, yet keeps political pressures away from day-to-day involvement in the details of monetary policy.

### **Concluding Remarks**

I hope that, from all I've said, you now have a better feel for the scope of the Fed's activities, ranging from the intricacies of monetary policy to the mundane handling of checks, coin and currency. As we've seen in the past several years, the central bank has a difficult job in achieving the sometimes conflicting goals of economic growth, high employment, and a strong dollar at home and abroad. That task would be made even more difficult if our nation followed the example of others and placed the Fed under direct Executive or Congressional control. Thus, I hope that you will agree with me that the nation needs an independent monetary authority free of short-term partisan political pressures, because if such pressures should succeed, we would have few defenses left against the type of destructive inflation that is now ravaging so much of the rest of the world.



