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INFLATION, MONETARY POLICY

AND BUSINESS INVESTMENT

Summary of Remarks by

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Board of Governors of the Federal Reserve System

before

Directors, Officers and Guests
of the
Federal Reserve Bank of Cleveland

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I am pleased to be with you this evening, and to join in an exchange of views covering business conditions and their prospects.

When a group like this gathers at a time like this, one theme must dominate all others in our discussion. I refer, of course, to inflation. Each of us, in our own way, is wrestling with this fearsome antagonist. The contest is a fierce one, for we are caught in the grasp of one of the most powerful and persistent inflations in our history. It is tearing at the vitals of our economic system--distorting income flows, eroding real standards of living, sapping the value of savings, creating the illusion of progress and profit where none really exists. The blunt fact is that we cannot long tolerate so rapid a pace of price advance without substantial and irreparable damage to our present way of life.

We have tried, of course, in a number of often ingenious ways over the past decade to force this inflationary genie back into its bottle. We have tried talking it into submission; we have tried enmeshing it in an apparatus of direct price and wage controls; we have tired generous doses of wishful thinking; and--intermittently and sometimes only partially--we have turned to the application of the fundamental remedies of fiscal and monetary restraint.

None of these remedial efforts deserves to be judged a real success to date. Fiscal policy clearly has a powerful anti-inflationary potential, but our ineffectuality on this front is indexed by the cumulative mass of our Federal budget deficits--over 100 billion dollars in the last 10 years.

There is, I believe, some hope appearing on the fiscal side. The Administration is attacking the goal of a balanced budget with new vigor, and Congress seems about to impose upon itself the most comprehensive procedure for budgetary control in its history. But real fiscal restraint results from actions, not intentions; I devoutly hope these admirable intentions are fulfilled.

Meanwhile, monetary policy is having to bear a very heavy share of the burden of the current inflationary fight. We at the Federal Reserve are determined that monetary restraint will make its responsible contribution to slowing the rate of increase in prices. For that to happen takes time, however, and in the interim we cannot overlook some of its unhappy side effects. Interest rates are very high, and the fact that other prices are going up does not always make such money rates much easier for the borrower to bear. Housing starts have been reduced, and they may be pared even further as the availability of mortgage money is curtailed. Financial intermediaries who have specialized in borrowing short and lending long are finding themselves increasingly hard pressed to earn enough to keep pace with their high cost of money. Here and there liquidity squeezes are imparting some sobering experience to those who had built up business commitments on the blithe assumption that they could always "buy the money someplace."

For a long time it has been accepted as a fact that business corporations--particularly the larger ones--had no place on the list of victims of monetary restraint. Indeed, the more common impression was that larger businesses did not alter their spending decisions at all because of the changing cost and availability of credit--their business was too attractive for any lender to deny, and rising interest costs were but a trivial increment in their overall income and expense figures.

However true that model once might have been, there are signs that it is out of step with current realities for at least a substantial proportion of American business enterprise. In a world of rapidly rising selling prices and replacement costs, some corporations are perceiving that part of their vaunted imperviousness to tight money grows out of the "inflation-blindness" of conventional double-entry bookkeeping. In a world of high and rapidly fluctuating interest rates, even sophisticated corporate executives may be given pause by the thought that if their borrowing is delayed for a few months the cost of the funds might change by two or three percentage points. In a business environment where leveraging (often by borrowing at short term) has become a more and more common stepping stone to higher per-share earnings, the resultant enhancement of the weight of money cost and availability in corporate calculations is not always appreciated by outsiders. In a corporate investment community where issuance of common stock is not only a source of new equity capital but also a base for further leveraging and a special currency for corporate acquisitions, the extent of the drop in stock prices induced by tight money is an indirect but appreciable dampener of entrepreneurial spirit.

Some of the effects of these influences on corporate spending are too subtle to pin down concretely. Reports reach my ears, however, of a number of inventory decisions tilted toward the conservative side by credit considerations. Occasionally, there are hints of slowdown or restudy of some planned capital expansion programs.

In general, such curtailments are in an anti-inflationary direction, and should be welcomed. Sometimes advocates of economic stabilization go further, and favor direct or indirect measures to curtail business investment to a greater degree, in the interest of balancing the bite of all anti-inflationary measures among the various sectors of the economy. That approach makes the most sense when timed to coincide with one of the short but intense periods of inflationary pressure that have been so characteristic of American business history. In such periods in the past, building a plant meant taking some relatively scarce supplies of steel, concrete, and the like off the current market, but with little or no hope of bringing the new plant into production before the inflation rate subsided.

It is important for business and public policy-makers to recognize how different the current situation is from that illustration. Many economic forecasts presently look forward to an inflation that will at best recede only gradually over the next several years. Given that kind of schedule, there would be time for quite a number of plant and equipment investments to be completed and to begin producing. Such developments would add to available supplies, thereby putting downward pressure on the price of such products. That downward pressure would be greater in the numerous instances in which new plants were more efficient, turning out products at lower unit costs. It would be most welcome in those several sectors currently plagued by out-and-out supply shortages. Continuation of this kind of business capital investment today could produce useful anti-inflationary results in the more distant stages of this tough-to-control inflation. Public policies need to be shaped with some awareness of this potential.

One problem attaching to such business investment prospects deserves special mention tonight. In a number of lines of business, both the inflation of costs and the complexities of the latest technology have combined to make the most efficient plant additions very expensive indeed. As a result, the blocks of long-term funds needed to finance such capital investments appear so large as to place strains both on some borrowing businesses and on the credit and capital markets themselves. As extreme examples of this phenomenon, we need only to look to the public utilities, where the bite of these two facts of economic life is being compounded by bureaucratic delays in approving needed increases in selling prices. In this environment, a special need exists for imaginative thinking as to the design of financial instruments which could best raise these funds. Ideally, such instruments should rest heavily upon the strong final market demands for the products or services in question. Given the size of the needs in question, multi-company guarantees may be advisable in some cases to disperse the burden of risk. Other ideas are undoubtedly occurring to fertile minds in the corporate financing field. Those ideas need to be brought forward promptly and tested against one another in the crucible of the market place, to winnow out those most viable additions to our corporate finance arsenal. A goodly number of our most important industries are going to need all of this kind of help they can get if they are to be of major help in ultimately bringing this current inflation under control.