

## THE NEW QUEST FOR SECURITY\*

Nothing is changeless but change; and the nature of change is frequently unpredictable.

People, by consequence, must live with a sizable amount of uncertainty. Over the years, people have been uncertain in greater or less degree as to where their next meal is coming from, whether or not they will have a job tomorrow, whether they will be able to afford a vacation, how they will be able to pay their medical bills, and what they will live on after they retire. People spend a good part of their lives trying to answer these questions; these and a host of other doubts and speculations color their actions.

Faced with the uncertainties of economic change, people have understandably tried to protect themselves. There has been a never-ending quest for economic security. This quest, as this group knows, has taken the form of trying to eliminate or avoid or dissipate the risks of loss that arise from unpredictable change.

Inflation since World War II introduced a persistent uncertainty into our economic lives - uncertainty as to the future value of the dollar. This uncertainty has generated a new quest for security. Unfortunately, many of the measures developed to protect against inflation are economically and socially destructive; moreover, they are likely to be self-defeating.

Before I explain why this is so, permit me to review with you the general ways by which we protect ourselves from possible economic loss. These are methods that have evolved and survived over the years.

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\*An address by Karl R. Bopp before the First National Seminar of the Association of Chartered Life Underwriters, University of Pennsylvania, Philadelphia, Pa., on September 21, 1959. (The paper was read by David P. Eastburn. Mr. Bopp was called to Washington.)

Frequently we prepare for potential adversity simply by setting aside something from our weekly pay checks - by saving. Saving has traditionally been a method of preparing for the proverbial rainy day which our pessimistic souls advise us is inevitable.

Sometimes we can shift a risk to another individual. Our market economy has given rise to the professional speculator who will assume risks on the belief that over a period of time his gains will exceed his losses by a significant amount. Dealers in commodity futures are frequently speculators of this kind. These professionals often relieve businessmen of heavy and undesired risk burdens associated with market fluctuations.

Often we can dissipate risks of loss and thereby reduce them by shifting them to a group. Private insurance is a prime example. It is part of our institutional technology and enables the more efficient operation of business.

There are, of course, many risks that are not insurable by private companies. Perhaps the odds cannot be determined; or perhaps when losses come about, they are incurred by large numbers of people simultaneously. The losses of income and jobs during a depression are not insurable by private companies. But to a large extent the Federal Government, by its constitutional authority to tax and regulate interstate commerce and through methods familiar to all of us, has been able to reduce the risks borne by individuals and to promote economic security for the unemployed, disabled, and the aged.

Finally, I should like to mention one more method of handling risks - that is, minimizing the hazard itself. Speed limits on highways and the guards in the Federal Reserve Bank of Philadelphia serve the same general purpose - that of minimizing risks. Public policies to promote full employment and price stability are controls designed to reduce the risk of loss that otherwise would have to be carried by individuals.

Now, these methods of handling risks and the losses associated with them have, by and large and in moderation, proved to be beneficial. Over the years the quest for security which has generated these methods has benefited, for the most part, not only the individual but society as well.

Risk - as you in the field of insurance have impressed upon all of us - represents a cost of doing business; the elimination or reduction of risk decreases the costs and, in a competitive economic system, the prices of goods and services. Insurance, speculation, and controls to minimize hazards contribute to this end.

Moreover, many of the ways in which risks are handled have themselves contributed significantly to the financing of economic growth. The savings of small savers have been aggregated into large sums by financial institutions and invested in expanding enterprise. The same is true of insurance and pension funds paid for by millions of individuals. Risk avoidance has promoted capital accumulation.

Finally, the quest for security has given impetus to analysis of social and economic conditions that, in turn, has permitted us better to regulate and stabilize the operations of the free enterprise system - without interfering with its essential nature.

Since the end of the war, the American economy has on the whole acquitted itself rather well. Our gross national product in real terms has increased about 40 per cent, or more than 3 per cent a year. Unemployment has been relatively low, averaging about 4 per cent.

We have thus far won at least three battles over mass unemployment and depression. Our economy has shown a remarkable resiliency in adjusting to new conditions. And today we are on the crest of another upswing in business conditions that has already generated record prosperity.

Our chief shortcoming since World War II has been the erosion in the value of money. Our price level today is about 30 per cent higher than it was in 1947.

Experience with a rising price level since World War II has led individuals and groups to adopt certain methods to avoid the inherent risks. Many of these methods, as I have mentioned, are undesirable and I think they will prove to be abortive.

When people try to protect themselves against the risk of loss they, understandably, take what they believe the best course available. In the case of inflation, there are some severe limitations on what people can do.

It is not really possible for the individual to save enough to compensate for inflationary losses. Nor does he have any real incentive to save. The value of his savings declines as inflation proceeds. There is, as we all know, an incentive not to save.

Nor is the risk involved in inflation privately insurable - no more so than the risk involved in depression.

Nor can all the potential victims of inflation look with much hope to the Government for benefit payments.

The individual cannot protect himself against the economic devastation of a rising price level in any of the above ways. The only method the individual has to fall back upon - since he cannot exert significant control over the inflationary process - is to try to shift the risk to someone else.

Shifting the inflationary risk in our economy can take several forms. Let's examine them carefully.

The classical way to shift the risk of loss associated with inflation is to shift out of that asset which threatens to decline in value into assets that don't. Individuals tend, under inflationary pressures, to shift out of money into goods, common stock, and any other asset they feel will maintain or increase its value.

If I am afraid that the dollar I possess will be worth less next month than it is today, I have a real incentive to make next month's purchases this month. If the rest of you feel and act the same way I do, prices are certain to rise - not next month but this month, and by more than you and I originally expected.

Such a flight from money to goods has not yet occurred in the United States. But it is, nevertheless, a distinct possibility. Other countries have had inflationary responses of this sort. And such a response may well come about in the United States if we permit our inflationary record to accumulate depth.

There has developed in recent years a rather popular notion as to "how to beat the inflation." Individuals and organizations seem to have increasingly come to the conclusion that investment in common stocks represents a good inflation hedge. Organizations and individuals with large amounts of investable funds have been tempted to purchase equities by the prospects of inflation on the one hand and the rapid increase in stock values on the other.

As I have mentioned elsewhere, it is primarily the earnings of corporations that give value to their stock. Of course it is not past but prospective earnings that the investor is concerned with. Now, the earnings of corporations have been increasing over the past 15 years, but it is interesting to note that corporate profits after taxes are today a smaller fraction of gross national product than they were 30 years ago. How can we be sure what their relative importance will be 30 years from now? How can we be sure that they will keep pace with increases in the general price level, and thereby provide a sound basis for rising stock values that preserve real incomes?

Even if earnings do expand rapidly, demand for equities may still force up the so-called price-earnings ratio, or the number of dollars an investor pays for one dollar of earnings. As more and more investors attempt to hedge against inflation by purchasing equities - as fewer people are willing to hold money or fixed-income obligations for any length of time - the price-earnings ratio will rise still more. If this persists, is it not likely that a stage will come when neither actual nor hoped-for returns on the investment will be sufficient to offset the decline in the value of the

dollar that they anticipate? When this stage is reached the only reason people have to invest in equities is the hope that stock prices will rise still further. For a time they may. Eventually, however, the idea that speculators are merely fooling one another is likely to take hold. In other words, there will be few people left willing to assume the risk that stock prices will continue to rise. When this occurs, at the very least we can expect a significant downward readjustment in stock values.

Investment in equities has much to commend it. It has made possible much of our phenomenal industrial and commercial growth. Equities have a place in the portfolios of the individuals and organizations.

But we mustn't close our eyes to the danger. The stock market is not a hedge of which all can avail themselves. Some must accept the risk of holding money, and bonds, and of real income deterioration if others are to benefit by stock market investment.

Some, of course, may accept the risk. What about the group of savers who "suffer from inertia or ignorance"? "Must all skilled artisans and theoretical physicists," Robert C. Sprague, Chairman of the Board of the Federal Reserve Bank of Boston, has asked, "be forced to hire investment advisers or stock market operators (in an effort) to maintain their incomes?" Can we, in good faith, permit such a condition, or must all these people be advised that bond, life insurance, and other fixed-income investments are of limited value when prices are rising?

Nor can we close our eyes to the implications of acting as if the stock market were a perfect hedge. We have lived in a world in which

fixed-income obligations have been considered relatively safe and equities relatively uncertain. Savings invested in the fixed-income obligations have brought relatively low but regular returns. Savings invested in equities have had the opportunity to enjoy the profits of enterprise.

As the well-known English economist, Dennis H. Robertson, has stated: "What a perversion of true principle, what a 'worst corruption of the best' when gilt-edged and equities change hats. . . ."

Yet this is the inevitable result - in the United States, England, and other western countries - when colleges, churches, and a host of others climb on the equity band wagon to hedge against inflation.

Let's look at equity purchases from another point of view - that of the demand for funds. Many important institutions, such as governments, schools, etc., cannot issue equities, and yet these institutions must be financed. The Federal Government has already run into problems in financing its huge debt and has found it necessary to pay more and more interest to sell its obligations. This is, of course, in part due to the general shortage of capital we find in any period of prosperity. Yet we may well ask how much of it is due to the pressures exerted by the fear of price inflation. We argue about paying higher interest rates today; but if we do not, and inflation is not halted, will we not have to pay even higher interest rates tomorrow, if Government obligations are to be sold.

Finally, some have tried to prepare for inflation by devising schemes designed to protect their real incomes. Devices to protect the purchasing power of groups injured by inflation - workers, public utility stock holders, Government bond holders, and others - have been adopted and proposed here and in foreign countries.

I approach these schemes without enthusiasm. I recognize the unfair impact of inflation on certain groups. But exemptions based upon superior bargaining power or political influence are not the answer to inflation. Perhaps small groups of people can be protected in this way. But it is the public in general that needs protection. If large numbers of people are protected by such means, the result once an inflation gets started is to push up costs of production and prices substantially - the result, in other words, is an upward spiral of prices in which cost-of-living adjustments become merely a temporary palliative for a condition they themselves tend to aggravate.

From an ethical point of view, I believe all groups should be protected. From an economic point of view, this type of defense against inflation can only be effective so long as most groups are not.

I think it is clear from what I have said that all individuals cannot protect themselves individually from inflation. To the extent that they can shift the risk and the losses to others because of the inferior bargaining power, political influence, ignorance and inertia of others, the others of course bear the burden. To the extent shifting cannot take place, because all can shift equally well, there is no protection. But the mere attempt to shift promotes inflation, and this is likely to result in economic hardships for all.

The error here is one that the individual is not likely to see, but one which we who deal in public policy are likely to see - it is an error of composition. In the case of inflation, when each individual tries to obtain security for himself, the entire society turns its fears into reality and defeats its own ends.

The individual, then, cannot satisfactorily protect himself against inflation. There remains, by elimination, only one way to handle the problem effectively - by reducing or eliminating the hazard itself.

Looking back on the price inflation of the postwar period, I get the feeling that we have been rather inflexible in our demands. As consumers, we have demanded more and better consumer goods and thereby encouraged higher levels of expenditures by producers; as citizens we have required our state and local governments persistently to increase their expenditures to accommodate our expanding populations and our improving tastes. As citizens we have also sanctioned our Federal Government continually to increase expenditures to meet the ever-growing demands of national security and other seemingly vital programs.

Because our economy has been operating at levels approximating full capacity since the end of World War II, overly rapid expansion of our demands has resulted in increases in prices as well as output.

The key to preventing inflation is to prevent demand from exceeding our capacity to produce. We can do this by keeping demand in check and also by encouraging the expansion of capacity.

The Federal Government should not contribute to excessive demand by incurring deficits during periods of prosperity. We in the United States have the highest standard of living in the world. It stands to reason that if we want our Government to produce more goods and services, we should be willing to give up some goods and services produced by others.

Monetary restraint is never popular; but during periods of economic expansion it is a necessity. Some borrowing must be restrained if we are to keep demand in bounds and the price level stable.

Let me emphasize that it is not demand we wish to keep stable, but the price level. One of our basic goals is to promote the economic expansion of production, capacity, and demand.

I do not believe, however, that we can achieve this goal by permitting the price level to rise. Inflationary excesses in the past have typically resulted in economic crises that have created unemployment, and other severe hardships and which have checked economic development. Moreover, I do not believe there can be moderate inflation over a period of years - the devices and schemes people invent to shift the costs of creeping inflation, inevitably spur inflation on to a trot and a gallop.

Inflation interferes with the accomplishment of fundamental economic objectives - growth and full employment. In this sense, preventing inflation is a means to an end.

Preventing inflation is also an end in itself. I do not believe that a majority of us wish to live in the kind of society where everyone is continually trying to shift the risk and the loss burden of rising prices to everyone else - where, through force and by evasion, the strongest are successful in shifting the burden and the weakest members of society are compelled to carry the load.

The alternative is a society of restraint - restraint by the monetary authority, by our Government, and above all, by all of us as individual citizens, for the Government and the monetary authority are ultimately responsive to the citizenry. I do not believe that restraint is too high a price to pay, in the richest country in the world, for reducing the hazard of inflation.