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Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the

meeting of banking chair holders
organized by The American Bankers Association

Watergate Hotel

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The impact of inflation on financial institutions has been so pervasive that I am tempted to respond with a list rather than with a discussion. I shall limit myself to those aspects that are of particular interest to a central banker. The views expressed are my own, but since I find them persuasive, I hope to learn that some of you share them.

Banking textbooks tell us that in inflation, debtors prosper while creditors suffer. Financial institutions in general are net creditors and most of them have indeed suffered from the prevailing inflation. But the ways in which this injury has come about are a good deal more complex than the simple textbook statement seems to imply.

Much of the injury has occurred, not through the net debtor or creditor position of particular intermediaries, but because most financial intermediaries, on balance, borrow short and lend long. This is a useful social function in a world where long-term money typically is scarcer than short-term money and therefore at a premium. Such maturity transformation has also been profitable, for the same reason: short-term rates usually have been below long-term rates.

But inflation has changed this relationship during the recent period when inflation was accelerating and when short-term interest rates were rising. This has meant that in recent times, financial institutions have slipped into a basically losing position, paying more for borrowing short, while making no comparable gains in the yield on their longer term lending. This rests, fundamentally, on a widespread belief, which I share, that inflation is going to be reduced. That belief, in turn, is reflected in a yield structure in which long-term rates will tend to be below short-term rates because they take into account the expected future situation when the rate of inflation and therefore interest rates will be lower.

Such inversion of the usual relationship between short and long rates -- should it be repeated frequently in the future -- raises important questions. These questions go perhaps to the viability of some financial institutions themselves. If the prospect that this type of situation will recur, perhaps frequently, does not cut quite that deep, it seems certain, nevertheless that some of their financial practices must come under serious question. To take some examples:

Fixed interest rates on mortgages, and even fixed monthly payments, may not be possible to sustain for thrift institutions. Financing of medium- or long-term loans from short-term sources would become difficult. The impact on housing finance and nonresidential construction as well as possibly on the savings habits of large numbers of people, would be very adverse.

This possibility, arising from inflation, adds another to the many, and to my mind, compelling, reasons why we should be prepared to make sacrifices to bring inflation to a halt.

My remarks so far have been concerned with the consequences of inflation when it is correctly anticipated and assuming -- as, I repeat, I do -- that the correct anticipation at this time is that it will be reduced. Much of the impact of inflation on financial institutions has come, however, from an incorrect anticipation of past inflation. Long-term loan contracts, especially mortgages, have been written on the assumption of zero or minimal inflation, which meant moderate interest rates. Failure of these expectations to be realized has put lenders on the spot. Thrift institutions and to a lesser extent commercial banks have suffered disintermediation. Pension funds have found their bond portfolios depreciating, while inflation has also hit the equity portion of their portfolios. I shall return to this topic shortly.

The failure of borrowers and lenders alike to anticipate inflation correctly seems to me to contain an important lesson. The lesson says that inflation is very difficult to anticipate. It is altogether impractical to base an economy on the hope that people will guess right on inflation. The nature of inflation is to accelerate, unless it is strongly resisted. Hence people will generally be fooled by inflation.

To argue that in an economy where inflation is correctly anticipated everything would work much as it would in an economy with stable prices, with income, interest rates, and all the rest in real terms being scarcely affected, ignores the realization of experience. And while people undoubtedly would make every effort to guess right the risk of error for everybody would be so enormous that high risk premia would have to be built into every contract. The resulting uncertainty and disarray would be a severe drag on our standard of living.

Inflation hits financial institutions partly through the damage it does to nonfinancial units. Pension funds, as I noted, suffer when inflation collapses the stocks in which they have invested. Banks suffer when inflation undermines the credit of their borrowers. I would like you to observe these processes.

Since corporations are in the aggregate net borrowers, one would expect them -- on the theory that debtors benefit from inflation -- to be beneficiaries. On this theory, even a corporation with a net debtor-creditor balance of zero would not be hurt. Future sales and profits would rise, but so would the interest rate at which future profits would be discounted, leaving the discounted present value unchanged.

But the stock market tells us otherwise. A principal impact of inflation on corporate fortunes is via the tax system. Inventory profits are taxed as ordinary income. So is that part of profits that really represents depreciation, given skyrocketing replacement costs. These taxes eat into cash flow and require the firm to step up its borrowings even faster than prices are rising. Higher leverage increases the risk and depresses the equity. A lower market value for the equity in turn makes equity financing more costly and often less feasible, which leads to a further build-up of debt. The firm's weakened financial position works against long-term borrowing and pushes it into short-term debt. Meanwhile interest charges mount and cut further into profits.

Through vicious cycles of this kind, inflation undermines first the liquidity and eventually the solvency of firms. The news from abroad teaches us how quickly, at high rates of inflation, this can lead to threats of bankruptcy and to large transfers of assets from the private sector to the government.

If we continue along this route, we shall not long have to look abroad for examples of the consequences -- we shall be seeing them at home.

Financial institutions would benefit, along with everybody else, from a clearer visibility of the affairs of enterprises to which they lend or in which they invest. We would understand the damage done a great deal better if financial statements of business reflected more correctly the impact of inflation. The shift to LIFO accounting which appears to be taking place, and the use of accelerated depreciation for tax purposes and the investment tax credit are doing some good in holding down the damage from inflation. But they fall far short of what is needed, and they also fail to give a meaningful statement of the affairs of the enterprise. Only so-called price level accounting or some similar device can reveal fully what is happening to assets, liabilities, equity, and rates of return.

That brings me to the problem that commercial banks face in the presence of inflation. Banks clearly are involved with inflation. Without increases in bank deposits there could be no inflation. This does not mean that this increase must be regarded as the cause of inflation. It may be a result that is unavoidable under given economic or political circumstances. Banks also are net creditors, unless they happen to have unduly large real estate or similar assets. In that case they are condemned by the textbook to play the role of a loser from inflation. Here, too, however, the process is a very complex one. The final result, moreover, is to weaken the equity position of banks. This is a matter of great concern to the central banker in his dual role as maker of monetary policy and as regulator and supervisor of the banking system.

On the earnings side, banks have many things going for them in an inflation. Unlike nonfinancial corporations, which simply experience an increase in the dollar value of sales, gross receipts of banks rise both because the level of assets increases and because the interest rate rises. In addition, banks benefit from the greater value, to them, of the prohibition to pay interest on demand deposits and from Regulation Q ceilings on the controlled part of their time deposits. The resultant sharp increase in gross earnings, however, has not been carried down to net. The high marginal cost of money, the continued presence in portfolios of low interest long-term assets, mounting loss experience, and other factors bring about a reduction in the net earnings per dollar of assets even while gross earnings go up sharply.

Because inflation, while it reduced the commercial banks' net return on assets, also reduced the ratio of equity to assets, the return on equity has not greatly changed. For many banks, the return on equity has increased slightly. Since this has happened at a time when the risk factor in the banking business has clearly increased, one is tempted to conclude that the process of competition has worked very well and very quickly in the banking business: the great gain in gross receipts was competed away and the return on equity was held to what, given the increase in risk, might be regarded as the competitive level.

I do not know whether bankers believe that they improved their real rate of return by raising earnings per share slightly. If they did, however, I should be compelled to say that this view involves a serious delusion. The fact is that bank capital has not kept up with the rate of inflation. Being net creditors banks have seen the real value of their stockholders' investment eroded. This poses a problem not only for the stockholder, but for the monetary system which rests upon the banks and for the central banker who seeks to influence it.

The shrinkage of bank capital relative to bank liabilities is evident whether we look at it in terms of book value or of market value. For regulatory purposes, and for the protection of the depositor, it is to book value that we ordinarily look. Market value reflects the market's view of the present value of future earnings. For a bank whose market value has kept pace with inflation one might feel tempted to say that no inflation loss had occurred, even though I would not necessarily advocate the use of market value, reflecting earning power, for regulatory purposes. The fact is, however, that for many banks market value today is below book value.

Book value in a bank is a more meaningful number than in a manufacturing corporation, because a solvent bank owns financial claims that, in the absence of unfaborable circumstances, could be liquidated to pay off liabilities and leave something for stockholders. Unfortunately, an increase in book value is much harder to achieve than an increase in market value, since in the absence of new equity issues it must come out of retained earnings. In an economy in which bank liabilities grow at a rate only slightly in excess of the real rate of growth, and where the rate of return on bank capital is in the proximity of 10 per cent, it is quite possible to keep the ratio of bank capital to deposits or to total assets constant by retaining somewhere near one-half of post-tax profits. Retention equal to 5 per cent of capital would do it when liabilities are also rising at 5 per cent.

But this happy symmetry cannot prevail in an inflationary economy where bank assets and liabilities tend to rise at much higher rates. Thus capital becomes inadequate, and that is what has happened in the American economy. It happened once before, during World War II, when war financing greatly bloated the size of the banking system. Over the following years, most banks greatly improved their capital positions, until the present erosion set in. Largely because of the weakened capital position of some of our large banks, the Federal Reserve Board instituted a go-slow policy with respect to acquisitions of new assets by bank holding companies.

I would like to end with a few necessarily much condensed comments on what might be done about this situation. The present condition of the banking system is not altogether satisfactory. One way in which the banking industry could add to its strength would be to reverse the process through which it has been going, by increasing earnings per dollar of assets. The increase in profits would then be used to build capital from retentions or to sell stock that would have become more attractive thanks to higher earnings. It is not clear whether the competitive process would make this road an easy one. In any event, it would probably involve some shrinkage in the role of bank credit relative to other credit sources, at a time when some of these alternative sources also are not flowing very freely.

Moreover, I do not regard bank capital as the most economical way of protecting the depositor and the monetary system. Bank capital, like money, has no social cost, since both essentially are generated by the same process through the central bank. But bank capital, like money, does have a private cost, since it must compete with alternative uses of capital. This suggests that bank capital is an expensive way of protecting the system. It behooves us to think of more economical ways.

Nevertheless, increases in bank capital, although clearly a second best in terms of cost, still represent the most immediate solution. Inflation has greatly increased the urgency of that solution.

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