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INVESTMENT, INTEREST RATES AND CENTRAL BANKING

Remarks by

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

at a meeting sponsored by the

Bank of Portugal

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It is a great pleasure to address this distinguished audience on the subject "Investment, Interest Rates and Central Banking." I am deeply grateful to the Bank of Portugal and its governor, Dr. Silva Lopes, for making this visit possible.

In speaking to a Portuguese audience, I am aware of the many interests that link Portugal and the United States. We live in an interdependent world, and no man, and no country, is, in that sense, an island. The turbulent state of economic affairs in recent years has provided our countries with many opportunities to demonstrate this sense of common interest, common purpose, and mutual support.

Common Challenges

But beyond all this, Portugal and the United States have in common a number of challenges that, notwithstanding all the differences between the two economies, exhibit a remarkable parallelism. Inflation, heavy balance-of-payments deficits, large budget deficits, are among them.

Both countries face the need to improve productivity performance, by making more effective use of their labor force, and improving and building up their capital stock. These are the main challenges in the real sector of the economy.

In the financial sector, inflation must be brought down, currency instability reduced, and the credit system must be freed from distortions. In my following remarks, I want to stress particularly issues of investment and interest rates that are of special interest to central and commercial bankers, but first I would like to touch briefly on some broader aspects of economic growth, since growth depends in large measure on factors such as investment and interest rates.

Considerable progress has been made in the last few years in overcoming the economic disturbances that have affected both our countries. Employment and production have advanced, growth has been fairly well sustained. But if these gains are to be extended and consolidated, as they must, more basic approaches than those pursued so far seem necessary to me. Particularly in the United States, we must find our way back to some economic fundamentals which we have allowed to drift out of sight.

Some years ago, it was widely believed that stable economic growth was assured. Productivity would advance steadily, work effort could be relaxed as man increasingly relied upon the machine. Shorter hours, longer vacations, higher wages, less discipline and effort devoted to the chores of production seemed to be the road of the future. Experience since has taught us that hard work is still necessary, that progress comes slowly, and that facile belief in easy solutions brings diminishing productivity, rising inflation, and declining quality of output. These tendencies must be reversed if economic progress is to be achieved.

Stressing the Supply Side

It was widely thought, not so long ago, that the attainment of greater output was simply a question of enlarging demand. But it was found that large deficit spending and easy money did not lead to sustained growth. Such policies ignored the supply side of the economy. It is on the supply side today that major progress, both in government policies and in the thinking of economists, remains to be made. And by this I do not mean, of course, that government should take a hand in production, but that government should pay attention to the needs of producers so that they can expand their output.

Too much attention has been devoted to increasing consumption, too little to building up production. Efforts to redistribute income did indeed succeed in removing many inequities and helped to improve the lot of the elderly, the sick, and the handicapped. But if redistribution of income in the direction of consumption does not leave enough resources for productive investment, its benefits will be very limited.

In the United States, moreover, many of the improvements that the shift in resources from production to consumption has brought about are not even being adequately recognized. Very large resources have been employed to improve or at least maintain our environment. Our air is cleaner, and our water is purer, thanks to the great expenditures imposed on the economy to make them so. Likewise, large resources have been spent to enhance safety of workers on the job and of people moving in traffic. But we do not take into account this collective consumption in evaluating our living standards. Demand for goods that can be bought in stores and wage increases to pay for these goods, continues unabated, ignoring the environmental and health and safety benefits that should to some extent take their place. Cumulation of demands for collective and individual consumption overloads the economy; inflation is the consequence.

The danger of overloading the economy has been brought home dramatically, in the United States, by the January 1979 Report of the Council of Economic Advisers. The Council sharply reduced its estimate of the potential growth rate of the American economy, and of the gap between present potential and actual GNP. The Council did this in the light of the very adverse productivity experience of recent years and the prospect that over the next few years productivity performance is likely to remain extraordinarily modest. For the last few years, Americans had been told that a growth rate of 3-1/2 per cent could be expected with some confidence over the years. On that basis, our present GNP of $2.1 trillion could be computed to be 5.6 per cent below its potential. This supposed gap appeared to represent not only a challenge to future achievement, but also a cushion against the dangers of excess demand and inflation. Under the new calculation, the expected growth rate of potential output for the next 5 years is estimated at 3 per cent. The gap between current GNP and potential has been reduced to 2.75 per cent. That is one reason why President Carter, in his Economic Report, proposes to aim at a growth rate for 1979 of 2.25 per cent, somewhat below our long-run potential. The danger of inflationary excess demand has been much closer than would have appeared from the old estimates that now have had to be revised.

The evils of inflation are sufficiently familiar to make prolonged generalizations unnecessary. This could not have been said in the United States some years ago. It is one measure of the progress we have made that the defeat of inflation today is regarded as the number one priority of the economy. Understanding the urgency of this task involves also a clear realization that the task will be difficult, protracted, and costly. There is no easy way of fighting inflation.

I do not believe that it is possible, for a country like the United States, to "live with inflation." Nevertheless, because the job of ending inflation will take time, measures must be taken to mitigate its impact while it lasts. This requires, in particular, measures to correct the many distortions that inflation engenders. Attempts to ignore or surpress these distortions, or attempts to deal with them by seeking to control the price mechanism, can only mask and may seriously aggravate the underlying problem. The United States has learned this from its post-1971 experiences. We have rediscovered the painful truth that short-run effects can be illusory and must be measured against predictable future costs. I would like to examine two key areas of the economy in which these distortions have been particularly serious: business investment and interest rates.

Business Investment

The need for more productive investment is undeniable. Our past experience, as I have described it, makes that clear. Greater emphasis needs to be given to the requirements of production. In the long run, of course, that will mean more consumption rather than less, as economic growth is maintained or accelerates. It is only in the short run that more investment requires more restraint of consumption, through higher saving.

In the United States, one of the most serious handicaps that business investment experiences today is the distortion of values under existing accounting practices that has been brought about by past inflation and threatens to be aggravated by its continuance. The flow of investable funds becomes inadequate to replace worn out plant and equipment because depreciation allowances are based on original cost. That is what the tax law prescribes. Of course, a business can take the higher cost of new plant and equipment into account by setting the price of its product accordingly. But it will find that such realistic depreciation charges are treated as profits by the tax collector and taxed accordingly. Of course, these profits are not real profits, and the tax bites into funds that are needed to replace the depreciated assets. Since firms cannot indefinitely raise new capital in order to replace old assets, this underdepreciation severely discourages investment.

Investment in business fixed assets is held back also by the prevailing climate of uncertainty, of which inflation again is one of the root causes. Calculations of costs and returns become speculative and require provision for a large risk premium. One visible consequence of this enhanced risk is the low price at which stock markets in the United States presently evaluate corporate profits. These profits, to be sure, are in many cases overstated thanks to inclusion of illusory inventory profits and to the inadequacy of depreciation allowances which are based on original instead of replacement cost. For these the market no doubt makes a correction. But the more than doubling of the cost of equity capital since the early 1970's cannot solely be explained on those grounds. Uncertainties on the part of buyers of equities about the future of their corporations must also play a role. Those doubts reflect, in turn, the uncertainties perceived by corporate managers about the feasibility of many investment projects.

In the United States, we have taken a first and important step in dealing with the inadequacy of business investment by realizing that this inadequacy exists. We have, I believe, largely shed the old fallacy that the problems of investment and supply can be ignored as long as demand and consumption receive strong fiscal and monetary stimulation. In the United States, a variety of measures have been taken to encourage business investment -- the investment tax credit, now permanently set at 10 per cent and liberalized in other ways, a reduction in the corporate tax from 48 to 46 per cent, an easing of the individual's capital gains tax from a maximum of 49 to a maximum of 28 per cent, and others. These measures were taken in the belief that they would provide a special stimulus to investment. But because inflation has held back investment so much, it may well be that the intended stimuli at most suffice to offset some of this drag. Conceivably, there may be no net benefit despite the appearance of much having been done for investment.

Real Interest Rates

It is sometimes argued that business investment benefits from inflation because inflation reduces real interest rates and may even turn them negative. This brings me to my next subject -- interest rates. Inflation drives a wedge between nominal and real interest rates. Frequently, interest rates become negative in real terms. It is my view that negative real interest rates do, indeed, have important consequences. For the most part, these consequences are adverse. Such benefits as inflation-induced negative real interest rates may confer on business investment are more than offset by the distortions and inequities that follow in their wake.

Negative real interest rates are a subsidy to borrowing, but they are not likely to act as a strong stimulus to business investment. Only a relatively small part of long-term investment is financed with debt, except perhaps in the case of public utilities. The larger part usually is financed by equity, from retained profits and to a lesser extent from new stock issues. The high cost of equity capital to which I have already alluded implies, therefore, that the combined cost of debt and equity capital remains high.

Furthermore, even though the high nominal interest rates that inflation usually produces may be negative in real terms, they still cause a cash flow problem to the borrower. He must find the money each year to pay amounts equivalent to a significant part of the principal of his debt to the lender. His liquidity situation thus may become difficult. Finally, the long-term borrower must look to the future. He cannot be sure that an interest rate that today is negative in real terms will remain so once inflation is brought under control. All of these factors will reduce his willingness to invest.

Meanwhile, negative real interest rates distort economic relationships in numerous ways. Capital tends to be misallocated. Speculation may occur in inventories, or in whatever "inflation hedges" the economy may offer. The exorbitant rise in the price of individual family homes that has occurred in the United States must in good part be traced to the fact that mortgage interest rates, in real terms, have been positive by only a bare margin, if at all. Allowing for tax deductibility of interest paid, the real cost of mortgage credit clearly has been negative to the homeowner.

Resources are misallocated also by the support that negative real interest rates give to unprofitable enterprises. By enabling such enterprises to charge uneconomically low prices or to maintain an inappropriately large scale of operations, negative real interest rates add to the cost of inflation.

On the side of the lender, meanwhile, the absence of positive real interest rates works genuine hardship and discourages saving. This is particularly true of the small saver, who usually lacks the facilities for protecting himself against this consequence of inflation. The real value of his principal shrinks, and the interest he receives does not make up for that. The tax that he must pay on his interest increases his loss. This condition is not only inequitable, it also threatens the supply of saving without which there cannot be adequate investment.

The United States bears down particularly hard upon the small saver by imposing ceiling rates of interest on time and savings deposits. Savers of more substantial means have been able to protect themselves better by investing in the money market certificates issued by banks and thrift institutions in minimum denominations of $10,000, which are tied to the Treasury bill rate, and in certificates of deposit of $100,000 or more, the rate on which is fully market determined. However, for holders of these instruments who are subject to income tax, the return after taxes frequently still is negative in real terms.

A demonstration of the effectiveness of positive real rates for savers has been supplied by the policies pursued in this regard in Korea, Taiwan, and Indonesia. At various times since 1950, these countries have deliberately raised interest rates on savings deposits to rates that compared favorably with the going rate of inflation, with the results one might expect. Inflows of savings deposits into thrift institutions multiplied, and these institutions were able to grant credit out of genuine savings instead of from newly created money. These measures are believed to have played an important role in improving the allocation of credit and eventually in bringing down the rate of inflation in the respective countries. In Brazil, liberalization of the reward to savers that resulted in a shift in deposits from institutions granting mainly consumer credit to others that contribute to production helped to accelerate capital formation and growth.

I ask your leave to append a personal reminiscence to this historical evidence. In early 1951, I did a study of the Portuguese financial system in which I noted, among other things, that government had been able to borrow domestically at 2-1/2 per cent while the rate for bank lending was 4 per cent. At that time, the long-term interest rate on government bonds in the United States was also 2-1/2 per cent. I suggested then that a higher interest rate would be more in keeping with the capital requirements of the Portuguese economy. Nearly 30 years later, numerous students of Portuguese finances, to whose circle I unfortunately can no longer claim to belong, have been asking whether interest rates are high enough to meet the needs of the economy.

Those needs today, of course, must place priority on a reduction of inflation and an efficient allocation of capital.

Having commented on real versus nominal interest rates, it may be appropriate for a central banker to say something about the power of a central bank to influence either. That power is far more circumscribed than often seems to be believed. The fact is that the central bank can influence real interest rates hardly at all, at least not with any degree of permanence. Its influence over nominal rates, in a meaningful sense, likewise is very limited. The central bank's main influence, and one that it may not at all desire to exert, derives from the fact that the central bank, by creating money, can change the rate of inflation which, in turn, tends to raise or lower nominal interest rates.

Let me be more explicit. When a central bank seeks to lower nominal interest rates, it does so by increasing the supply of money and credit. This will bring down short-term interest rates for a while. Whether it would also lower long-term rates has become very doubtful as far as American experience is concerned. But the increase in money and credit, with some lag, also raises prices. This leads to a rise in the demand for money and, therefore, a tendency for interest rates to rise again, unless the central bank meets the demand by further expansion. Long-term lenders and borrowers, noting the threat and soon thereafter the actuality of accelerating prices, will mark up their rates eventually or perhaps immediately in anticipation. On the other hand, when a central bank holds down money and credit, it will at first raise interest rates at least in the short-term area. But as inflation diminishes in consequence, short-term interest rates will come down. Long-term rates meanwhile may begin to drop as soon as the new central bank policy is perceived and before inflation actually begins to slow.

What this means is that a central bank attempting to control interest rates arbitrarily will find that it is ultimately pushing rates in the opposite direction. If it tries to hold interest rates down, it will raise them with a lag. If it raises them, it will find that eventually they come down as inflation recedes. That is why I believe that the power of central banks over interest rates tends to be much exaggerated.

The International Side

I would like to close my remarks with a few comments on the international monetary system. Portugal and the United States have a strong common interest in that system. More than that, however, the entire world community has a strong interest in that system. We all are its beneficiaries when it functions well, and we would all suffer jointly if it fails to do so.

The system of fixed rates came to an end in 1973 and we have since lived in a world of floating exchange rates. Wide fluctuations in rates that have occurred have been troublesome. Little good is achieved, however, by attempts to prevent fluctuations that are an expression of changes in underlying conditions. Exchange rates in the long run are bound to be governed by fundamentals. Efforts to avoid the working of these fundamental factors are destined to be defeated and may create serious distortions so long as they remain effective.

In the new system, the old rules of the Bretton Woods system no longer apply. But the new system is not without its guideposts. To replace the discipline of fixed but adjustable rates, the second amendment to the Articles of the International Monetary Fund provides for a regime of firm surveillance of the exchange rate policies of member countries, both those in deficit and those in surplus, and surveillance also of their domestic policies affecting exchange rates. The United States has indicated that, as Under Secretary of the Treasury Anthony Solomon said on January 12 in speaking of IMF surveillance,

> "We believe the time has come for the IMF to move more vigorously to fulfill its potential in this area, and we intend to support it in that effort."

We believe that U.S. national interests as well as those of the world and of the international monetary system will best be served if all countries accept the surveillance of the International Monetary Fund and cooperate with the Fund, as the United States is prepared to do. A world without some common ground in the handling of national exchange rate policies, and without some agreement on the proper policies to pursue on the part of deficit and of surplus countries, is not a world safe for free movements of goods and capital. Without mutually consistent policies under the surveillance practiced by the Fund, we run a serious risk of relapsing into protectionism and exchange controls. The private international credit system, which is carrying so large a burden in financing payments deficits, cannot function without free movements of capital. Portugal and the United States, together with all other countries, have a tremendous interest in making sure that the international monetary system works efficiently.

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