

For Release at 9:00 a.m. EDT

Friday, September 18, 1959.

INTEREST RATES AND FINANCIAL MANAGEMENT

by

C. Canby Balderston

Vice Chairman, Board of Governors of the Federal Reserve System

at the Convention of the

National Association of State Auditors, Comptrollers and Treasurers

Philadelphia, Pennsylvania

September 18, 1959

INTEREST RATES AND FINANCIAL MANAGEMENT

Many citizens are only now becoming concerned about inflation, about dealings between management and labor, and about international relationships as if they were brand new problems. They are not. Indeed, the same old problems turn up in new guises. Perhaps these problems will not all be solved to your satisfaction, but it is worth remembering that our country has met tough situations before. Given time and a clarification of the issues, our citizens will, I believe, make the hard decisions that are needed. The good sense of the American people is borne out by their constructive attitude toward balancing the Federal budget. The reduced deficit helps to ease inflationary pressures. Cynicism or pessimism with respect to the restraint of price-level inflation represents defeatism that should be abhorred. Certainly this country can so manage its financial affairs as to achieve growth and economic well-being without being cursed with the burdens and inequities of inflation. If Austria, Italy and West Germany, after being ravaged by war, can demonstrate good financial management, our country, which was not invaded, should do even better.

Historical Perspective

Where we now stand can be understood best by viewing the present against the perspective of the past. Chart 1 (see attachments) compares the interest yields on high-grade "municipal" obligations with the rates on high-grade corporate bonds since 1900. Current bond rates, though high in comparison with the recent past, are not as high as in some earlier years.



LIBRARY

This chart presents interest rates for 13 years prior to the birth of Federal income taxes with the passage of the 16th Amendment. During this period, therefore, tax exemption had no appreciable market influence on municipal securities. Even before tax exemption became of value to investors, State and local government credit of high quality commanded a better rate than corporate borrowing. It is still important for financial managers to preserve excellent credit standing resulting from superior financial management. Good management is a prerequisite for a preferred rate in any part of the economy. Chart 2 shows the penalty paid, year after year, by governmental units that allow even modest deterioration in their credit standing.

Experience in Other Countries

The Federal Reserve is urged by some of its critics to abdicate its responsibility over the money supply just to reduce interest rates, or to keep them from rising in the face of borrowing demands that rise more rapidly than saving. The notion that production will stagnate unless credit supplies are both boundless and cheap reminds one of the consequences to countries that have fallen into lax monetary habits. This is a tender subject for those countries that have suffered inflation, and it is not fitting to discuss specific countries that are still in difficulty, except to make the generalization that practically no country in the world that is suffering from inflation, either creeping or galloping, has truly low interest rates. In the few instances that might appear to be exceptions to this rule, closer scrutiny reveals that either there are other controls that frustrate the use of the funds seemingly available at low rates of

interest, or quite clearly the rates in effect are strongly aggravating the inflationary forces to a point so high that interest rates will be pushed upward eventually. In short, experience shows that inflation-ridden countries tend to have interest rates that are unusually high.

Since the Republic of France has now achieved some success in its stabilization efforts, its experience can be used as an example. At the end of 1955, France began to exhibit evidence of how over-expansion of economic activity tends to increase inflationary pressure. To the world-wide surge in demand at that time was added the inflationary financing of a large government deficit, amounting in both 1956 and 1957 to about 20 per cent of government expenditures. Moreover, the amount of bank credit extended to the private economy in each of those years proved excessive. The resulting inflationary pressure was first revealed by the balance of payments; between January 1956 and July 1957, France lost over half of her official reserves of gold and dollars. Ultimately, however, these inflationary pressures were reflected in sharply rising internal prices, and in the space of little more than a year the French franc was devalued twice by a total of about 30 per cent. The French stabilization program, developed in late 1957, was endorsed and tightened by General de Gaulle at the end of 1958. It was made up of the time-honored remedies: reduction of government expenditures; increased taxes; restriction of credit to private industry. These were accompanied by devaluation of the currency.

This is, in brief, the history of France's recent economic crisis and the way it was solved. But note the behavior of interest rates

during and since the period of inflation. Until the early part of 1958, when the first serious stabilization effort began to take effect, French interest rates were not only high, but rising. Because of price advances, the French Government was unable to finance itself except by the sale of indexed bonds, usually tied to the general level of prices or to the price of gold. After the French economy became stabilized and the price level brought under control, interest rates declined steadily. The decline was particularly sharp in the months immediately following the closing week of 1958 when the French franc--along with many other European currencies--was made largely convertible. Now while it is true that the movements in French interest rates have been in part a function of movements in economic activity, informed observers are agreed that restoration of confidence in the currency was one of the main reasons for the decline in French interest rates since the latter part of 1957.

In other words, the path to lower interest rates is not easier money, but appropriate monetary and fiscal policies. If low interest rates are desired (and I favor rates as low as compatible with the savings we need) there is no prescription to equal that of continued fiscal and monetary discipline. Interest rates are high under inflationary circumstances because inflation affects adversely both the habit of saving and the allocation of funds to the capital markets. When they expect price-level advances, people have relatively little incentive to put funds away in savings, and almost none to retain them in any type of fixed-money obligation. Speculation distorts and inhibits the country's rate of

growth, and upsets the financing programs of all borrowers, including governments.

Perspective on Governmental Cost

Preoccupation with interest rates as a cost of government misses two major points. First, while interest cost is of consequence to all levels of government--Federal, State, and local--increases in this form of cost are very much less than the potential increase in the cost of conducting government that is caused by price-level advances. A small variation in the cost of the services and goods that governments buy may more than offset even a wide movement in interest rates.

In fiscal 1958 the gross interest costs of State (as distinct from local) governments, were \$396 million or 1.4 per cent of their total outlays of about \$28 billion. Simultaneously, however, they received \$267 million in interest, largely on their pension and sinking funds. For local governments, however, the invested funds are relatively smaller than those of State governments. Their gross interest paid was \$1.1 billion out of a total expenditure of about \$34 billion or about 3.3 per cent. Since \$200 million of interest was received the net interest cost was only 2.7 per cent of expenditures.

Second, the basic problem of State and local governmental financing is one of sheer magnitude. In recent years, many governmental functions have expanded enormously. The rate of expansion has frequently outrun tax receipts and forced the meeting of their capital expenditures by borrowing instead of paying for them out of current tax revenues as in earlier years. Chart 3 throws light upon the purposes of such borrowing.

Taken together these factors have led to a scale of borrowing that has outrun the natural market for tax-exempt securities. The number of very wealthy investors and the amount of free investment funds available in fully taxed investment institutions have failed to keep pace with the mounting supplies of tax-exempt securities. Chart 4 shows the vastly increased scale of new-money financing by State and local governments in the past few years. At the same time, other borrowers have been making increasingly heavy demands upon the capital markets. These factors, not Federal Reserve policy, have raised interest costs. Federal Reserve policy has been directed toward maintaining growth in the availability of bank credit and in the money supply at a rate appropriate to the economy as a whole. The Federal Reserve cannot provide long-term credit when savings are inadequate to meet all demands; all a central bank can ever do is determine the part of saving that is permitted to take place in money form. The Federal Reserve cannot create saving; it can only create money.

The level of interest rates is determined by the balance between the rate of saving and the demand for capital. The primary influence on interest rates of the Federal Reserve is through the release of reserves to commercial banks to allow them to expand the money supply. Because of arbitrage within the money and capital markets, the rate at which reserves are released influences long-term interest rates as well as short-term ones. Nevertheless, Federal Reserve policy is only one of the economic factors; in the long run, the level of long-term interest rates is determined by the relation of saving to investment. Recently the effects of the

expectation of inflation on both the demand for borrowed funds and the supply of savings has been more powerful than the Federal Reserve.

The deposits that commercial banks create with the reserves allotted to them do have profound effects on prices. With larger reserves, banks can make more loans or investments and create more deposits. Thus a larger supply of funds becomes available to borrowers and through them to other spenders. This added money does not always have an immediate effect on price levels. During war periods, for example, additional money has been generated that did not raise prices at once because they were restrained by direct controls. Also, during depressions, borrowing demands may be inadequate to employ all the reserves available. Sooner or later, however, if unsatisfied credit demands exist, price levels respond to the creation of money. When price levels do move, interest rates are likely to move with them; this has been true in almost all periods of time and in all parts of the world. It may be said, therefore, that the Federal Reserve, by keeping the rate of commercial bank credit expansion and of money creation in line with the needs of the economy, probably tends to stabilize interest rates.

The aggravated problems of State and local government finance cannot be explained by higher interest costs, or, more surprisingly, by increased capital expenditures. The most important factor is past inflation. Chart 5 shows State and local government purchases (services and goods) in current and in constant dollars. It focuses attention upon the central problem--the steady creep of prices in one direction alone. The lower curve of constant dollar amounts may be viewed as a measure of the

increase in real outlays. But higher prices have caused the actual number of dollars spent to increase even more rapidly. You can look upon the area that lies between the two curves as being a measure of what inflation has cost you. The area between the lower curve and the base line (100 per cent) is a measure of what increased real government activities have cost you.

The costs of State and local government have, in fact, gone up considerably faster than the over-all price averages that apply to our gross national product. Chart 6 shows how much faster this increase has been. The divergence of these curves is not only impressive; at the moment no force in sight seems strong enough to halt further divergence. At the same time there is, unquestionably, widespread public revulsion against further increases in taxes and tax rates.

The financial problems faced by State and local governments enlist one's heartfelt sympathy. They are not dissimilar to those faced by the Federal Government. In a world in which industrial efficiency is increasing, and economic activity is high, the costs of human services tend upward. Since governmental activities are so largely human services, there is necessarily a strong tendency for governmental costs to increase even faster than the general price level.

The most helpful answer to these problems would be a sufficiently rapid general increase in productivity and efficiency so that increases in the cost of human services would not have to be carried over into an increase in the cost of final goods and services. This would mean that the cost of what state and local governments bought from private business

would not have to increase. But this increase in productivity and efficiency should also embrace the activities of government as well as of the private sectors. What is needed is more mechanization and methods research. Citizens have a right to expect government to show the same progressive attitude toward cost-cutting methods and improved technology as is evidenced by private industry. It is in this direction that solutions for the problems that confront government at all levels must be sought. Chart 7 furnishes an interesting illustration of the potential influence of improved technology and productivity. It shows that highway construction cost has been almost stable for six years. Here is one type of governmental expense where inflation has been offset by better and cheaper methods of earth moving and by other advances in technology.

Federal Reserve Objectives

Having sketched a background to provide perspective, I now turn to Federal Reserve objectives and policies. The Federal Reserve does not have a high interest rate objective. It does not desire rates higher than are consistent with the state of prosperity. Since interest rates are the result of the impact of investment demand upon the supply of saving, the only way to achieve both lower interest rates and prosperity is through price stability. It is only such a climate that encourages saving and the orderly use of capital. The Federal Reserve also believes that our economy must grow and be dynamic. This growth will be damaged if we should lapse into monetary slackness. As Dr. Winfield Riefler recently said: "Inflation is the enemy of growth, particularly when there is public expectation that the purchasing power of money will continue to decline because it increases instability because it fosters the

misallocation of capital and impairs the quality of the managerial and investment decisions on which growth is based because it distorts the saving-investment process and encourages overspeculation; and because it undermines the country's position in international trade."

I believe we are going to win this battle. Our citizens are not going to be deluded by illusory hopes. Difficult problems are on the immediate horizon because of congestion in the capital markets, but we have faced such problems before and solved them. This country can provide a rising scale of living for an expanding population if its resources, human and material, are not misused. It can afford adequate schools and other public services. But, our nation's future could be spoiled by imprudence and financial mismanagement. As Chairman Martin has said: "We are a rich country Whatever is required we can afford to spend, but we cannot afford to spend it if we are unable to find the means of paying for these expenditures in any other way than by printing money."

Chart 1

HIGH-GRADE BOND YIELDS

ANNUAL AVERAGES, PER CENT

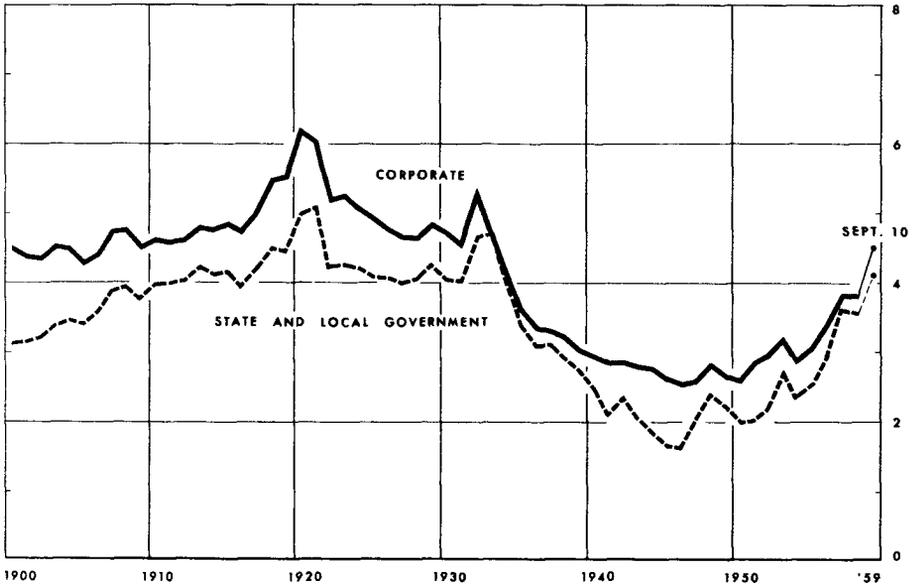


Chart 3

NEW STATE AND LOCAL BOND ISSUES

ANNUAL DATA, BILLIONS OF DOLLARS

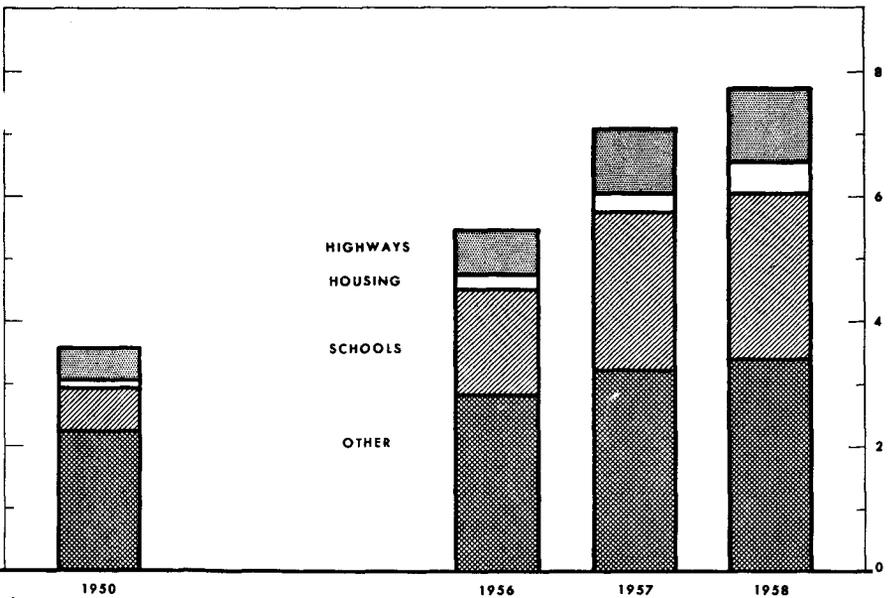


Chart 3

STATE AND LOCAL BOND YIELDS

MONTHLY AVERAGES, PER CENT PER ANNUM

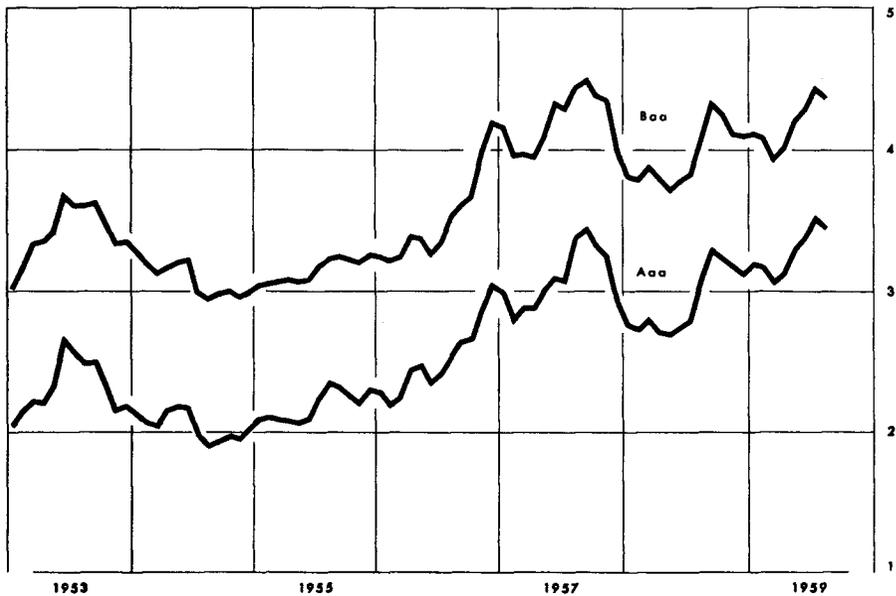


Chart 4

NEW STATE AND LOCAL GOVERNMENT BOND ISSUES

ANNUAL DATA, BILLIONS OF DOLLARS

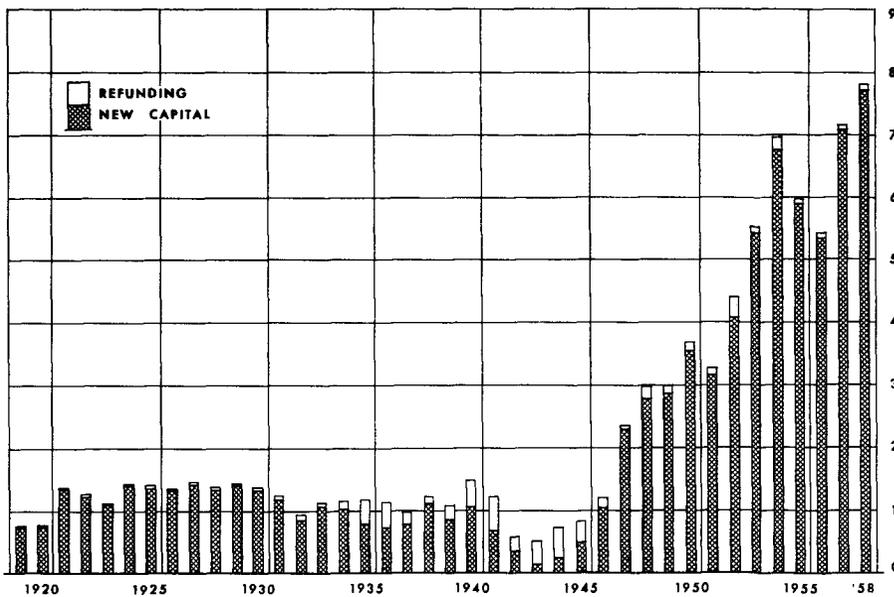


Chart 5
STATE AND LOCAL GOVERNMENT PURCHASES

ANNUAL INDEXES, 1946=100

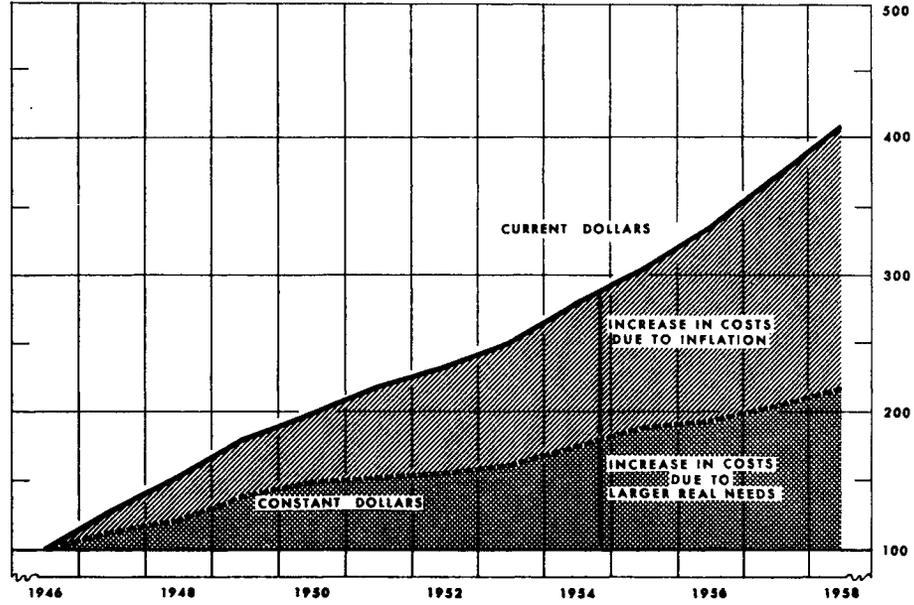


Chart 6
PRICE LEVELS AS MEASURED BY COSTS OF GNP PURCHASES

ANNUAL INDEXES, 1946=100

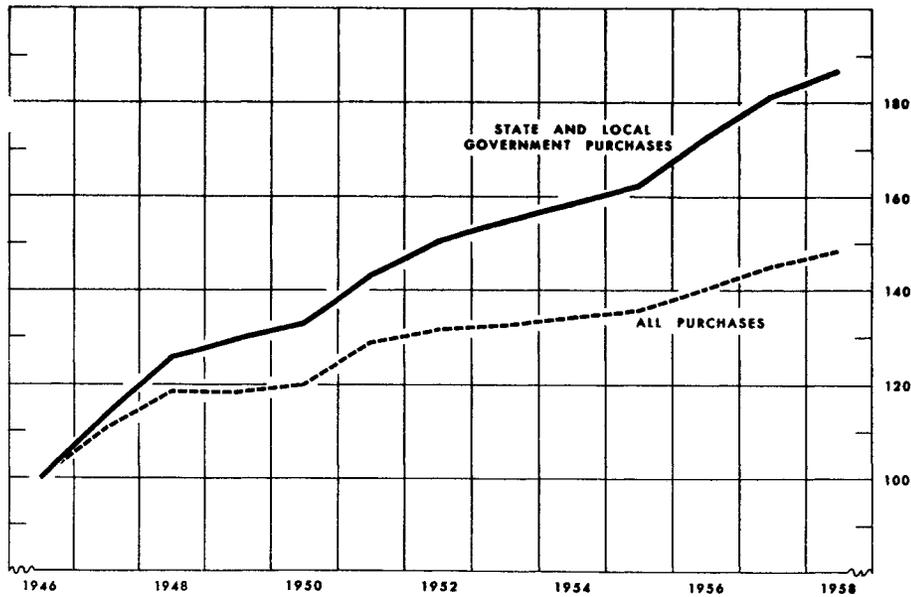
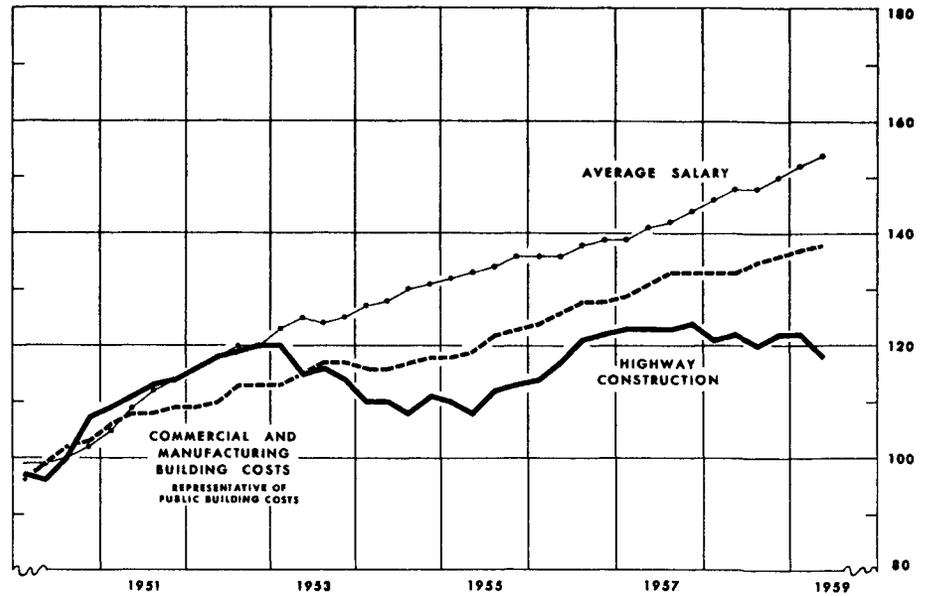


Chart 7
STATE AND LOCAL COSTS

QUARTERLY INDEXES, 1950=100



Notes to Charts

High-grade Bond Yields

Annual averages compiled by Standard and Poor's Corporation. Prior to 1929 data are based on averages of monthly high and low quotations. Since 1929 data are based on monthly averages of weekly indexes.

State and Local Bond Yields

Monthly averages of weekly data compiled by Moody's Investors Service. Both the Aaa and Baa indexes are based on quotations for five bonds with an average maturity of about twenty years. Latest data shown, August 1959.

New State and Local Government Bond Issues

Annual totals of the par value of new long-term State and local government bonds sold to obtain new capital classified as to use of proceeds of sale. Data for years prior to 1957 include small issues (those less than \$500,000) sold for highway, housing and school purposes in other purposes.

New State and Local Government Bond Issues

Annual totals of the par value of new long-term bonds sold by State and local governments. Refunding issues are those sold to obtain funds to redeem bonds already outstanding. Investment Bankers Association and Bond Buyer data.

State and Local Government Purchases

Annual indexes based on total expenditures as included in the National Income Accounts. Data in constant dollars have been adjusted to eliminate the effect of price changes. State and local government purchases of goods and services consist of general government compensation of employees and purchases from business, mainly construction outlays. Department of Commerce data.

Price Levels as Measured by Costs of GNP Purchases

Annual indexes based on price deflators used to adjust purchases for the effect of price change. Different types of purchases are adjusted by different deflators that measure price changes for the particular types of purchase. Department of Commerce data.

State and Local Government Costs

Quarterly indexes. Average salary is based on Department of Commerce estimates of State and local government payrolls and Bureau of Labor Statistics estimates of State and local government employment. Commercial and manufacturing building costs are compiled by M. H. Boeckh and Associates and are averages of indexes for 20 major pricing areas. This series is used to represent the probable costs of constructing public buildings. Highway construction costs are based on indexes compiled by the Department of Commerce on the basis of an average unit price for common excavation, concrete pavements, reinforcing steel, structural steel and structural concrete with quantity weights. Latest data shown, second quarter 1959.