

FINANCIAL PROBLEMS IN A TIME OF INFLATION

Remarks by

Henry C. Wallich

Member, Board of Governors of the Federal Reserve System

at the meeting of the

National Association of Real Estate Investment Trusts

Thursday, June 6, 1974, 12:30 P.M.

at the

International Club

Washington, D.C.

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I am glad to have this opportunity to speak to members of the National Association of Real Estate Investment Trusts. Nick Buffington, whom I have known for many years, has pointed out to me the importance of a free flow of communication at a time when financial pressures have mounted. Under such conditions, it is sometimes useful to stand back a little from the problems of the day and to look at the course of events in a broader perspective. That is my intention here today. At the end of my remarks, I shall, of course, be glad to listen to anything you may wish to tell me about the current problems in your industry.

Real estate investment trusts are part of the great wave of financial innovation that has been in evidence since the early 1960's. The design of new technologies is not the exclusive province of scientists and engineers. There are important inventions also in

the field of finance. Properly designed, and managed with care, they add to the economy's productivity and to the general welfare.

Innovation, however, also involves risks. Since risk is not easy to evaluate in advance, we must rely heavily on past experience and on trial and error. Past experience suggests that the willingness to accept risk increases so long as there are no adverse consequences. This process involves the danger that the outer margin of acceptable risk will be approached too closely, leading to difficulties and to losses, and to a subsequent withdrawal from unduly exposed positions. Our financial history records more instances of this process than should have been necessary.

For financial institutions that are new in their basic conception, the problem of judging risk and avoiding excessive degrees of exposure is particularly difficult. For each member of such a group, there may be a temptation to observe what the others are doing, each institution assuming that it is in safe condition so long as it is not out of line. This may be a workable rule of thumb so long as conditions in and outside the industry do not change. But there are two developments with which a new financial industry that cannot rely on experience derived from a long history must reckon.

One is the effect of competition. All bright new innovations attract followers. A rate of return that originally may have been well above average is likely to be worked down over time to no more than what prevails elsewhere. And secondly: financial conditions change with the business cycle, and sometimes with longer term trends. During each cycle, typically, financial pressures tend to rise to some peak and then to subside. Financial institutions must be geared to meet the tests posed by these peaks, whatever their nature may be. The general contours of this testing process are predictable. The particular circumstances and intensity, of course, are not.

These problems become compounded if the economy enters into a stage of severe inflation. Inflation distorts the relationship of costs and prices. Real estate investments are among the most durable of all investments, and also among those where a precise calculation of future costs and returns is of particular importance. Inflation plays havoc with these calculations, insofar as they relate to wages, materials, and expected receipts from an investment. In the longer run, of course, inflation may benefit earlier investments by raising the cost of new ones.

Inflation can become even more disturbing by its impact on interest rates. All interest rates tend to rise during inflation as investors seek to protect themselves against loss of purchasing

power while borrowers, anticipating gains from rising values of assets, feel that they can afford to pay more. In addition, however, inflation tends to twist the relationship between short- and long-term rates. So long as the markets believe that inflation will be brought down, long-term interest rates will not fully reflect the current inflation. They will be held down by the anticipation of lower inflation rates and interest rates in the future. Short-term rates are a different matter. They will tend to reflect principally current conditions of supply and demand in the financial markets. They may reflect the going high level of inflation. Thus they may well reverse the more usual relationship which, at least according to experience since the 1930's, has registered short-term rates below long-term. For institutions whose interest earnings are in some degree inflexible, the implications are obvious.

Inflation, it is sometimes said, favors the debtor and hurts the lender. But financial institutions are both lenders and borrowers. The impact upon them of inflation is unpredictable, depending on the maturity structure of their assets and liabilities.

Once inflation has reached the levels we are now observing, its influence on interest rates begins to outweigh that of other forces, including the central bank. Monetary policy can contribute to halting an inflation. In that way, it can exert a lasting influence on interest rates. Any other influences, exerted through the usual channels of money and credit are likely to be short lived.

Moreover, as I will explain, these short-term influences unfortunately tend to work in the wrong direction in the longer run.

In the face of strong credit demand which tends to drive up interest rates when bank reserves are being expanded at a moderate rate, it is sometimes argued that the resulting market pressures could be eased by supplying reserves in larger volume. For a short period this may indeed have the desired effect. But with some lag, a more rapid rise in money is likely to lead to a more rapid rise in prices. Faster inflation in turn means higher interest rates. In such an inflation there is no way by which a central bank, through what is called an "easing" of credit, can bring rates down lastingly. It can only cause the same problems and pressures to repeat themselves at still higher levels of inflation and interest rates. The way to achieve permanent relief is to bring down inflation. Unfortunately, this means that the economy must pass through a period of possibly intense pressures in financial markets. There is no other way. It is the price we must pay for not having worked as hard as we should have to hold down inflationary pressures in the past, and for yielding to the temptations of large-scale government spending and too ready creation of money and credit. At the same time, we must avoid the risk of excessive restraint that could bring recession and unemployment.

It should come as no surprise that in a period when the money supply and credit have been rising at higher rates than in past periods of relative stability, the need for credit should be greater than ever. Inflation itself creates the demand. Corporate profits have increased statistically, and the cash flow from them might be expected to take care of good part of financial needs. But the underlying facts are otherwise. Profits in good part consist of inventory profits. These are not available to meet financial demands, because they are already embodied in inventory. To the extent that they generate tax liabilities, they have a negative influence on liquidity. Part of the recent rise in profits is being earned abroad and is not necessarily available for the domestic needs of American business. Thus it is not surprising that the demand for credit has been strong. The banking system has met it, at rising interest rates.

Liquidity problems, fortunately, by their nature tend to be temporary. Restraint on liquidity restrains inflation, and diminishing inflation in turn reduces the demand for liquidity. In a more enduring sense, it is solvency that matters. Our present experience, to be sure, suggests that there may be exceptions to the familiar view that solvency also guarantees liquidity, on the grounds that a solvent institution can always find money. Inflation, moreover, can convert what started out as a liquidity problem into a solvency problem. The lesson for the future is plain: it is not sufficient to seek to assure solvency by observing appropriate ratios

of equity and subordinated capital to liabilities. Assured methods of financing will have to be secured if solvency is to be translated permanently and reliably into liquidity.

The degree to which financing can be assured depends on a variety of factors, among them the proportion in which short-term borrowing takes the form of borrowing from the money market and from commercial banks or other institutional lenders, respectively, and the extent to which borrowings from the money market are back-stopped reliably by credit lines extended by which lenders. The open money market knows no close or permanent relationship between borrowers and lenders. It can function efficiently only if punctual payment is assured beyond the shadow of a doubt. That is why this type of financing often is cheaper than borrowing from an institutional lender.

A borrower's relationship with an institution is different. The lender has, or should have, in depth information about the borrower. The expectation of a continued relationship justifies an effort on the part of the lender to accommodate the borrower and, within the limits of prudence, the acceptance of some degree of risk.

The responsibility of lending institutions, such as commercial banks, can be envisaged as going beyond those arising from the lender's relationship to any one particular borrower.

The lender has an interest in the proper functioning of the credit system as a whole. No man is an island, and neither is any single institution. What happens to one affects and matters to all. Troubles developing in any individual credit relationship affect, however remotely, other similar relationships. To realize this and to act upon it, prudently but with an understanding of this enlightened self interest, is what has sometimes been called financial statesmanship.

Large and small lenders may well have different responses to the call for statesmanship. A small institution rarely can, by its own individual action, influence significantly the general course of events, the state of the markets, the preservation of confidence. Large lenders have greater scope. Their decisions may at times significantly influence the tone of the market and the state of confidence. The example of one large lender may set a pattern for other institutions. In our financial framework, in which bigness is sometimes viewed with misgivings, one of the possible compensations for the concern it arouses, as I see it, is the ability to demonstrate financial statesmanship. As our banks continue to grow, and as their activities expand into wider areas, they are, in my view, also incurring greater responsibilities. I find it difficult to see a justification for increasing command over resources unmatched by acceptance of a greater obligation for financial statesmanship.

The institutions of the private sector are not alone in carrying a responsibility. In every mature financial system, the central bank traditionally has accepted the role of a lender of last resort. This role, of course, describes a responsibility for the functioning of the financial system as a whole, not for the welfare of particular institutions. Moreover, in its role as a lender of last resort, the central bank deals with problems of liquidity, not of solvency. And its ability to provide liquidity must remain circumscribed by the need to avoid inflationary consequences. A central bank has responsibility for preserving the strength of the currency, domestically as well as internationally.

Neither private nor public financial arrangements and policies can guarantee success if the economy which they seek to serve is lacking in fundamental strength. I have great confidence in the strength of the American economy, and I believe that events so far have given evidence of this strength. The economy has been subjected to shocks of an unprecedented kind and severity. The energy shortage, our food situation, the international value of the dollar, our domestic price level all have subjected us to severe shocks. Yet the economy appears to be absorbing these shocks and, after retreating for a few months, appears to be ready to resume its earlier pattern of progress and advance.

There has been a questioning of the prospects for future growth. It has been argued that we are approaching limitations of supplies of all kinds, constraints imposed by the environment, impediments to the continuation of trends that have been going forward for centuries. I see very little evidence of any such changes. There are some changes ahead that do seem plausible. They are imposed by responses to the rising cost of energy, possibly changing supplies of raw materials, changes in population trends. But as I look at these prospective changes, they do not seem to dim the outlook for future growth. They do point to the need for massive investments in productive capacity, in equipment of all kinds, and particularly in construction. Carrying out these investments will make great demands upon the willingness of the American people to save and thereby to supply investable resources. They will also make great demands on, and provide great opportunities to, our financial system. The economy's need for the kind of investments that your industry helps to finance will continue to grow. Growth will generate demand of consumers for goods and services of all kinds, with a rising emphasis, very probably, on durable goods such as housing and consumer goods made with the help of large capital installations. Some investments no doubt will turn out to have been ill advised in the future, as has sometimes happened in the past. But in a broad view, I believe that confidence in the American economy, and investments made that rest on this confidence, will prove justified.