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**INFLATION, RECESSION, AND STATISTICS**

**Excerpts from remarks by**

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

**at the**

**Tenth Annual Conference on the**  
**Annual Report of the Council of Economic Advisers and the**  
**Budget of the United States for Fiscal 1976**

**of the**

**Federal Statistics Users' Conference**

**in**

**Washington, D.C.**

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Each turn of the economic cycle poses different problems and challenges for different people. The pain that inflation and recession are inflicting upon large numbers of Americans is only too obvious and needs no further comment here. The problems that these conditions leave for the users of statistics are mild by comparison. They are nevertheless not unimportant.

Inflation and recession mean that the data that the economy is now producing are in many respects distorted and at the same time extreme. Real and nominal values differ widely; variances are being expanded. This will have important implications for future statistical analysis and model building.

Econometricians are helped by wide variances, because these make for more clearly defined relationships. But it is not certain that the extreme values that are being generated under present conditions represent meaningful relationships. Values of this kind will tend to dominate in regressions. But what does it mean when unemployment of 8 per cent is associated with inflation of 10 per cent, or when a housing recovery begins with mortgage rates around the 9 per cent level?

It is not clear whether data generated in present conditions can usefully be integrated into the familiar models. Yet the alternative of eliminating them also poses difficulties. Economists are too easily tempted to remove from their data those periods that do not support their hypotheses, such as the depression of the 1930's or the war of the first half of the 1940's. That makes for lively controversy, but not for persuasive findings.

There are possible remedies. Expression of data in real terms, or indexing, may offer a solution. But this seemingly simple prescription often turns out to be remarkably complex.

Take indexing as embodied in the technique of price level accounting which is now being recommended. It is looked to as a means of overcoming the distortions introduced into business balance sheets and profit-and-loss statements by the impact of inflation on inventory profits, depreciation allowances, a firm's net debtor or creditor position, and through other channels. This kind of accounting

certainly is a great deal more meaningful than the use of unadjusted data. But, as its critics point out, it falls far short of conveying a correct picture of the impact of inflation on any particular enterprise, because the prices relevant to the purchases, sales, and assets of any one enterprise probably differ widely from the general price index that must be used for price-level accounting.

Or take indexing for tax purposes, a technique now being examined at a theoretical level. It turns out that the problem goes far beyond applying a price index to the tax brackets of individuals and corporations. The market, moreover, to some extent indexes itself, for instance by charging higher interest rates. There are great perplexities in trying to disentangle these consequences of inflation.

Or consider, as another example, the impact of inflation upon corporate profits. It has often been pointed out that inventory profits are not true profits, because, being embodied in inventory, they provide no cash flow, and cannot be used to pay wages, taxes, and dividends. Yet now that we are entering a period of inventory cutting, it appears that inventory profits do throw off a cash flow and constitute real profits, to the extent that inventory is reduced.

The distortions that inflation introduces into the data through inventory profits reach further. Inventory profits do cause tax liabilities. To the extent that they are not true profits, the

tax on inventory profits simply means that the tax rate on profits after inventory valuation has been raised as far as the tax-paying corporation is concerned. When inventory profits come down, the effect equals that of a cut in the corporate tax rate. In that sense, we have had a very substantial rise in the corporate tax rate which now is beginning to be reversed.

Finally, let me examine some of the problems that inflation creates for the computation as well as the control of the money supply. First, there is the problem of the deflated money supply. Applying the concept of indexing to money, some observers have argued that the money supply should grow at some positive rate in real terms. During an inflation, this might therefore be a very high rate in nominal terms. But the argument overlooks that in an inflation the demand for real balances tends to diminish relative to income or turnover. And it is the public, not the central bank, that decides what the volume of real balances is to be. An effort by the central bank to raise the volume of real balances when the public does not want them would simply lead to ever-higher rates of inflation.

Another problem, the result more of recession than inflation, has to do with the growth of the nominal money supply. At a time like the present it becomes apparent that the causal connection between money and the economy is not all one way. Money influences

the economy, but the economy also influences money. When the economy is weak, its demand for money diminishes. Central bank efforts to increase the money supply under those conditions do not necessarily have their usual effect. The mechanism by which the economy manifests its lack of desire for additional money will be the last of my examples demonstrating the distortions of data and of their meaning under today's conditions.

When the Federal Reserve supplies reserves to the banking system at a time when bank customers are not eager to borrow, the banks first respond by repaying their own borrowings from the Federal Reserve. This means that no additional money is created. When that process is over, the banks, still encountering little loan demand, will use additional reserves to buy liquid securities, such as Treasury bills. This process, however, adds far less liquidity to the economy than does money creation through regular bank loans. A Treasury bill is so liquid that to its holder it is a kind of quasi-money. Converting it into demand deposits adds only a shade to its liquidity and expansionary power.

Moreover, an increase in bank assets under these conditions may not even lead to an increase in the money supply narrowly defined. If people and businesses have no desire for more currency and demand deposits, they will convert these increases into time deposits. This has been happening recently. Time deposits have been growing

rapidly, and the money supply broadly defined, which includes time deposits, has been growing moderately. Meanwhile the money supply narrowly defined has grown considerably less.

These are only a few of the many perplexities that recession and inflation creates for the users of statistics, as well as for everybody else. I have confidence that both of these conditions will mend. Their effect upon the data, in that case, while it cannot be eliminated, will in that case at least remain circumscribed.