THE PROSPECTS FOR ECONOMIC RECOVERY AND INFLATION

Remarks by

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

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The Conference Board's
Conference on the Management of Funds: Strategies for Survival

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I am glad to have this opportunity to address an audience of funds managers on the two principal economic problems that we must resolve: economic recovery and inflation. The Conference Board, to which we are indebted for the opportunity to engage in this discussion, has -- wisely, I think -- put these topics at the beginning of a Conference on "Strategies for Survival." The prospects for survival of a free enterprise economy, such as we have known, lie, I believe, in disciplining our freedoms of economic choice sufficiently to avoid the inflationary excesses that produce recessions, including inflationary actions intended to overcome recession.

My message here today will be that the outlook for recovery is good and that the prospects for further progress against inflation depend very much on how we handle the recovery. If common sense can be made to prevail, you as funds managers should be able to look forward not only to survival, but hopefully to a positive rate of return.
In recent weeks we have listened to an intense debate about how fiscal and monetary policy should be conducted, in hearings before the Joint Economic Committee and the Senate Committee on Banking, Housing and Urban Affairs. The Federal Reserve has responded to a Congressional request to state its plans for monetary expansion. This, I believe, has been a wholesome exercise.

In the first place, the statement that the Federal Reserve plans to expand $M_1$ at a rate of 5 - 7-1/2 per cent, and other aggregates to match, has given the markets a signal of what to expect. The Federal Reserve, to be sure, has not fully followed the example of the German Bundesbank, which laid down a fixed rate of money growth for a full year designed to guide the expectations and the wage and price decisions of the German economy. But valuable guidance nevertheless can be obtained from the magnitudes indicated, including, of course, by funds managers.

Secondly, a useful dialogue has been initiated about the appropriate rate of money growth. Among the academic experts consulted by the committee there was a considerable measure of agreement that money should grow less rapidly in the long run than in the immediate future. That, of course, is also the sense of the Congressional resolution when it speaks of a rate of growth of the monetary aggregates for the first half of 1975 that would facilitate prompt economic recovery and a rate commensurate with the long-term growth potential of the economy thereafter. Moreover, while the witnesses had different views about
the desirable growth of money in the short run, even those leaning toward the high side for the most part did not differ fundamentally with the Federal Reserve. The steady flood of criticism of all the Federal Reserve's works should not be allowed to drown out that fact.

Third, the Congressional Resolution performs a most useful task by specifying stable prices as a goal coordinated with maximum employment. It also calls for lower long-term interest rates, which indeed would be the inevitable consequence of the policy of low money growth and stable prices proposed in the Resolution.

The Aggregates, Interest Rates and the Recovery

The views concerning past Federal Reserve policy expressed by the academic experts at the hearings contrast in an interesting way with what I believe to be the prevailing view among financial market practitioners. The latter, if I am not mistaken, have interpreted the tremendous drop in short-term interest rates as well as the more moderate decline in long-term rates that occurred after mid-1974 as "ease." The academic experts, focusing on the slow growth of the aggregates during that period, often describe it as a period of mounting tightness. This poses the question whether it is the money supply or interest rates that determine the movement of the economy. It is a question worth pausing over.

If one believes that there is some direct connection between money and economic activity -- an increase in money burning holes in peoples' pockets and inducing larger expenditures -- then
the movement of the aggregates would be decisive. I doubt that many people hold this simplistic view. Money works through interest rates. An increase in the aggregates, through many channels, reduces short- and long-term rates, and reduces also rates of return on equities and real estate and even the cost of investment in human beings. Changing interest rates change capital values, especially of equities, of real estate, and of physical assets. The effects of increased or reduced wealth, of capital gains and losses, then influence the behavior of businessmen and consumers.

The proof of the pudding, of course, is in the eating. Over the last year, the direction of the movement of the aggregates and of interest rates have conflicted on two important occasions. In the first half of 1974, the aggregates were strong. Interest rates, however, also rose sharply. If the aggregates were more important than interest rates, there should have been no sharp recession in the second half of 1974. But a sharp recession did occur. Evidently interest rates won out over the aggregates.

Another test occurred during the second half of 1974. The aggregates were weak, but interest rates also came down sharply. If the aggregates were the dominant factor, one would have expected severity of the contraction to increase with a lag of six to nine months. Instead, we seem to be observing a bottoming out of the recession. I hesitate to attribute all of it to the fall in interest rates, since the usual dynamics of an inventory cycle clearly are playing an important role. I do believe that lower interest rates
are contributing to recovery and that for a second time in one year they have demonstrated their ascendancy over the effects of changes in the aggregates. I might add that there have been periods in our historical experience when the test of strength between the aggregates and interest rates went in favor of the aggregates.

The Costs of Forcing the Growth of the Aggregates

If we accept that monetary forces work through interest rates, rates of return, and asset values, what is the meaning of the proposition that at a time such as late 1974 the aggregates ought to have been expanded at a faster rate? Clearly it means that the proponents of such an aggregate policy would have wanted to see interest rates go still lower. I would like to examine the benefits and costs of such a policy. Clearly there would have been some benefits. Very low short-term rates would have pulled long-term rates down somewhat, at least for a while. More long-term bonds might have been issued, although mainly for the purpose of paying off short-term debt. More mortgages might have been written, although the heavy overhang of unsold and unrented housing units would have stood in the way of strong housing recovery. I doubt that consumers would have greatly stepped up their borrowing, or that businessmen would have wanted to forego cutting inventories, or that investors in the stock market would have taken a decisively different view of the outlook. Nor would banks, in all probability, have abandoned their policy of caution in the granting of loans. Therefore, while a further decline in interest
rates would probably have had some expansionary effects, the benefits from such a policy would have been subject to rapidly diminishing returns.

The costs of a policy of inducing wider swings in interest rates, on the other hand, would have been rising rapidly. Clearly, a period of extremely low short-term interest rates would have had to be followed by a period of rising rates sooner than would the more moderate downswing of rates that took place. A rise in rates, even from a low level, at a very early point in the business cycle would have many disadvantages. Wide swings in rates would by themselves be unsettling to financial markets. Recent wide fluctuations in the stock market probably have built a substantial risk premium into equity returns which must find expression in a lower level of the prices. Similar increases in risk premia could occur in other markets. The functioning of the financial markets might be affected if dealers were exposed to greater instability. Reintermediation and disintermediation would plague banks and thrift institutions on a larger scale, with little benefit probably for housing.

The effects of interest rate fluctuations, moreover, are felt with considerable lags even in the financial sector, let alone in the real sector. The demand for money, for instance, responds to changes in interest rates with a lag of one or two quarters. This further complicates the correct evaluation of the behavior of the aggregates.
The balance of payments, finally, and the value of the dollar, would be hurt by the capital outflows that a policy of extremely low interest rates would set in motion. This in turn affects the real sector and the rate of inflation, quite aside from the broad political and economic consequences for the United States that are now implicit in foreign attitudes toward a weakening dollar.

Finally, a policy of forcing the growth of the aggregates at a time when demand for money is falling would probably have quite different effects on different aggregates. Large injections of reserves would tend to be converted mostly into time and saving deposits, if diminishing economic activity reduces the demand for demand deposits. No doubt it would still be possible technically to keep $M_1$ growing at a stable rate if enough reserves are supplied. But this might imply a very great rise in time deposits, i.e., in $M_2$. Moreover, if the banks expand by buying securities rather than by making loans, the expansionary push coming from an increase in bank credit would be blunted.

For all these reasons, I doubt the advantages of a policy of rigorously maintaining a stable growth of $M_1$ at a time when the demand for demand deposits and bank credit is weak. The gains from such a policy diminish rapidly, while its costs increase. If it is argued in its support that historically the economy and the money supply move closely together, I would say that this does not prove that control of the money supply necessarily means control of the economy. The
relationship between money and economic activity runs in both directions. The money supply is influenced by the economy, as well as influencing it. The close statistical relationships observed between money and economic activity is the result of this reciprocal influence. It would be exaggerating the effect of the economy on money, to say that trying to control the economy by controlling money is like trying to control the weather by controlling the barometer. But forcing money down the economy's throat when the economy has no demand for it will have only moderate effect in the short run. It will do not much good and may do considerable harm.

The Recovery Outlook

Let me now turn to the outlook. In the financial area, the most important problem to be faced by the market is the prospect of a "crowding out" of private expenditures by the large Federal deficit. The reason why opinions seem to differ so widely on this matter is in part at least that some observers look at the real sector while others look at the financial markets. In the real sector, there is a great deal of slack, although in particular industries our failure to make needed investments leaves us uncomfortably close to capacity operation. A substantial expansion of economic activity is possible. That expansion would raise savings, and these savings might well be adequate to accommodate a very large Federal deficit without "crowding out" much private investment. But whether or not this could be done without new inflationary pressure depends not only on the amount of slack in the economy. It depends vitally also on the speed with which the economy
returns to full employment. Slack holds down inflation, rapid expansion speeds it up. If the deficit is large enough to make the economy zoom, it will cause inflation whether there is crowding out or not.

In the financial sector, "crowding out" takes on a somewhat different aspect. Here the ceiling for financial expansion is given, not by the capacity of the economy in terms of manpower and industrial plant, but by existing financial resources, including the money supply. The margin for deficit financing before sharp increases in interest rates would threaten to crowd out private borrowers is smaller. This is the implication of proposals frequently made that the money supply should be expanded in one quick jump and then once more be allowed to grow gradually.

But, as in the real sector, there is danger in high-speed expansion. A very rapid rate of money growth would fan inflationary expectations. Nobody could be sure whether and how soon it would be terminated. It would be widely viewed as a signal that rapid inflation was about to resume. And indeed, if a rapid spurt in the real sector were to follow, inflation could hardly be far behind. Some researchers have found that money growth affects prices with a two-year lag. Rapid bursts of expansion in the real sector, as well as pressure against the capacity ceiling in that sector, may be the reason.

In summary, it appears that we have to deal with two ceilings, one in the real sector, the other in the financial. The ceiling in the real sector is higher and presents less of a "crowding out" problem.
In the financial sector, the ceiling is lower, the crowding-out danger more imminent. But there is no safe way of taking advantage of the high ceiling in the real sector to expand the economy quickly, and there is no safe way in the financial sector to raise the ceiling by a quick spurt in the money supply.

How Much Help from the Banking System?

The banking system, of course, will play an important role in the financing of the anticipated upswing. But there can be no certainly that this role will be the same that it was in the previous expansion. During the years of exuberance after 1971, the banks used volatile borrowed funds to expand risk assets, and often allowed their capital ratios to decline. The experience of the year 1974 has injected a note of caution. Many banks are working to rebuild their liquidity by increasing the proportion of liquid assets in their portfolio and by reducing their reliance on volatile funds. Many banks may also desire to strengthen their capital ratios. To the extent that the markets for equity and subordinated bank debt permit, this could occur through new financing. Otherwise the remedy would have to take the form of retention of profits and limitation of the growth of risk assets and, in the case of bank holding companies, of limitation also of new acquisitions.

However, banks in general have come a long way in the past year toward correcting the situations -- including over-dependence on highly volatile deposits and over-expansion of bank holding companies -- that gave so much cause for concern last summer. Banks that have brought
themselves into more adequate liquidity positions are now in shape to lend their hand in fulfilling legitimate credit needs of the recovery.

This is equally true, also, of thrift institutions, although as with the banks, many of them will continue to need to make corrections, in their liquidity base. This process, fortunately, has been underway for a number of months now. The enormous inflow of funds registered in recent months has contributed. A good part of these funds, however, have gone into passbook deposits withdrawable at any time. Past experience of periods of rising interest rates suggests that disintermediation, the outflow of funds from thrift institutions into money market instruments, becomes substantial when market rates significantly begin to exceed deposit rates. The repeated experience of wide fluctuations in interest rates no doubt has tended to make depositors more interest-sensitive. This increases the liquidity needs of thrift institutions.

In an environment of heavy Treasury financing, highly liquid assets will not be hard to find. Slower overall growth of bank credit, however, combined with increased acquisition of nonrisk assets, may limit the amount of financing that the private sector can expect to obtain from the banking system. Bank credit, however, is not the only form of credit in our economy. A slowing of bank credit need not mean a corresponding slowing of total credit expansion. A larger part of credit needs would then have to be satisfied through the open market, or through nondepositary financial institutions.
A large borrower, for instance, who cannot obtain credit from a bank may go to the commercial paper market. If commercial paper becomes hard to sell because of reduced willingness of banks to provide backup lines, credit may be obtained from the bond market, or perhaps from foreign sources. Consumers, too, can find sources of credit outside the banking system. So long as the Federal Reserve supplies reserves to the banks, and as long as the banks convert these into deposits, there will be funds available to buy credit instruments sold outside the banking system.

But clearly the matching of supply and demand, with appropriate maturities and acceptable risks, will be more difficult. Intermediation of credit through the banking system offers many advantages that the open market does not. Thus, the prospect that "crowding out" will be avoided will depend in some degree -- but, we should note, by no means entirely -- upon the contribution to financing that the banking system can be expected to make.

As I have indicated, the banking system is approaching the coming period of economic recovery, when the demand for bank loans will swell, in far better position than it was a year ago. The opportunities for credit extension will be there. But the banks undoubtedly will make their decisions with a new awareness of and perhaps attitude toward risk.
Conclusion

My analysis of the outlook suggests that the prospects for both recovery and continued reduction of inflation are good if the excessive rates of money growth that have occurred at some points of the past can be avoided. A combination of substantial progress in absorbing the existing slack with a continued reduction in the rate of inflation, which still is far too high, should be possible in those conditions. A reduction in the rate of new wage settlements, and a resumption of productivity gains that have been absent for 11 quarters, would be necessary to achieve that objective. If the economy, moving along such a path, can return to high employment and reasonable price stability, the great inflation of recent years will have been ended, albeit with considerable pain. Nevertheless, it will have done so with a lower aggregate loss of employment than if the process of disinflation had been spread out over a longer period.

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