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THE FEDERAL RESERVE LOOKS AT THE SECURITIES MARKETS

Remarks by

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

to the

New York Society of Security Analysts

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It is a pleasure to address the New York Society of Security Analysts on the subject "The Federal Reserve Looks at the Securities Markets." The stock market is a vital part of our economy. It also plays an important role, I might say in passing, in the Federal Reserve's model of the economy. In a period when the need for capital will be great, the Federal Reserve looks to the stock market as an essential source of financing.

This interest, I am sure, is reciprocal. The stock market looks to the Federal Reserve for indications of the shape which our expected recovery will take. Most of the straws now visible in the wind indicate that the beginning of recovery is not far off. There are crosscurrents, as always at lower turning points of the business cycle. We may have to live with these for a little while longer. But the foundations of a good recovery, I believe, are in place. The next job will be to keep this recovery on track to reduce our high rate of unemployment while simultaneously bringing down inflation.

The plans that the Federal Reserve has for the 12-month period that began last March have recently been laid before the Congress. They involve a growth rate of M_1 (currency plus demand deposits) in the range of 5 - 7-1/2 per cent, a growth rate of M_2 (M_1 plus time deposits in commercial banks) of 8-1/2 - 10-1/2 per cent, and a growth rate of M_3 (M_2 plus savings deposits in thrift institutions) of 10-12 per cent. These magnitudes, I might add, are not directly translatable into increases in GNP, because during a recovery some increase in the velocity of circulation of money must be expected.

Presentation of these targets to the Congress has served two useful purposes. In the first place, it has revealed a degree of consensus greater than might have been expected. Witnesses other than those from the Federal Reserve have, of course, ranged much more widely in their recommendations. Some were below, some above, the Federal Reserve ranges. But even among those who argued for high rates of money growth, the typical range was something of the order of 8-10 per cent. Common ground then seems to be only one-half of one per cent away.

I would advise you not to regard the present Federal Reserve targets as invariant. As the Concurrent Resolution under which they were stated indicates, they will be adapted to changing circumstances if that should seem advisable. They are, thus, not an iron-clad rule. If attainment of a target should require some kind of policy action the purpose of which would be only to meet the target, rather than to meet the needs of the economy, the economy's needs clearly must come first. This is not a question of credibility. It is a question of maintaining flexibility in the face of unforeseeable events and of our own very imperfect understanding of the subtle relationships between financial factors and the real sector of the economy where employment and production are determined.

What these targets do for the Federal Reserve, for the economy, and for the financial markets in particular is to convey a broad idea of the thrust of policy. The ranges indicates are consistent with a policy that seeks to ensure recovery, reduction of unemployment, and a return to the kind of price stability that we have known in the past.

In order to ensure that the policy thus defined remains on track, it is important to arrive at a sustainable balance between flexibility and steadiness. Flexibility means to adjust targets when they no longer seem appropriate in the light of circumstances. Steadiness means not to allow temporary deviations, such as market forces may produce over short periods, to push policy off the path leading to its long-term target. Overshooting and undershooting is bound to occur from time to time. How far it should be corrected subsequently and how far the levels of the aggregates that have been attained should be taken as a basis for their further growth path will always remain a difficult decision.

Experienced observers of the aggregates will also be aware that the short-run ranges set by the Federal Open Market Committee -- now being published with a lag of only 45 days -- need not, month-by-month, equal the long-term growth rate. Even though the data on which targets and ranges rest are seasonally adjusted, special developments over short periods may often make for a stronger or less strong rate of growth of particular aggregates. Nor is it to be expected that all the aggregates will always grow in line with each other. The components of M_1, M_2, and M_3 sometimes lead lives of their own, responding differently to various interest rate developments and to the behavior of institutions, of consumers and of savers, all of which may move them apart or may push them closer together. This in turn serves as a warning that no single aggregate possesses any absolute validity or magic power over the economy.

Those who follow monetary developments it will find it useful to study the short-run ranges set by the Federal Open Market Committee as they are published. You will observe that over the past year, they have varied quite a bit from month to month. M_1 target ranges as high as 6-1/2 - 9-1/2 and as low as 2-6 were reported for February-March 1974, and July-August 1974, respectively. You will also notice that the growth rates actually achieved occasionally fall outside the intended range. But if you look at the behavior of the aggregates over a period of six months or even a year, you will observe that the rather diverse results for particular months or quarters average out to reasonably smooth numbers. This is particularly true of M_2 and M_3, because these aggregates are unaffected by decisions people have to make from time to time whether to keep their liquid funds in the form of checking deposits or of interest-bearing deposits. But even though monthly variations do tend to average out to middle-of-the-road figures, this, of course, does not mean that the middle-of-the-road figures always have been what we would have liked them to be.

Short-run variability of monetary growth rates poses problems both for the Federal Reserve and for the financial markets. Technically it would not be impossible to keep monthly growth rates more precisely on track, even though total precision probably would still elude us. But more rigid targeting of the aggregates would have side effects, and I very much doubt that the benefits from pinpointing and achieving precise targets would be worth the cost of these side effects.

One of these side effects, of course, would be greater instability of interest rates. These are of particular concern for the financial markets. Their effects, however, reach beyond to the thrift institutions and the housing industry, to the foreign exchange markets and the cost of our imports, and to the ability of business to count on assured financing. The functioning of financial markets might be impaired, the cost of financing surely would rise if interest rates were severely destabilized.

There is no easy escape from the difficult choice between more stable growth of the monetary aggregates and more stable interest rates. In the long run, obviously, the level of interest rates is determined primarily by the state of the economy and in particular by the rate of inflation. An effort to smooth out interest rates, if it leads to excessive growth of the aggregates, is bound to be self-defeating within a short time. Moderation in the aggregates is an essential condition of moderate interest rates.

Nor does allocation of credit hold out a hope of escape from reality for the financial markets. Personally I doubt that allocation would work. Money is fungible. If it finds the direct and efficient way somehow blocked, it will find an indirect, less efficient and more costly way, but find it it will. In any event, in any credit allocation scheme, the stock market investors whom you advise would scarcely be at the head of the queue of preferred credit seekers, and neither would large firms seeking to float securities. I see no better solution to the problem of how to maintain an adequate and inexpensive flow of credit through the capital markets than to keep the monetary aggregates growing moderately on average so as to bring down inflation and interest rates, and meanwhile to seek a compromise between stability of the growth of the aggregates and stability of the financial markets.

This conclusion concerning the aggregates and interest rates brings me to my second topic here today, the ability of financial markets to keep financing our economy. Our chances of enjoying a plentiful supply of credit at moderate cost would be better if the fundamental sources from which our capital markets are fed flowed more freely. These sources, which have given the American economy its enormous capital base, are the saving of households, businesses, and on occasion, of governments. Today we confront the fact that government, far from being a source of saving, promises to be a heavy user. Businesses in the past have been important generators of net savings. It has by now become common knowledge that, if economically sound accounting methods are employed, the net savings of nonfinancial domestic corporations are negative. As a group it is only households, or so it would seem, who in the face of all inflationary adversity persist in trying to save. We have every reason to be grateful to them.

The inadequacy of corporate savings is mirrored, naturally, by a rising proportion of external to internal corporate financing. Within the framework of external corporate financing, in turn, debt financing has risen relative to equity, and within debt financing short-term has risen relative to long-term debt. Business is now engaged in a process of unwinding some of these imbalances.

Debt-heavy corporate finance poses a problem not only for business, but also for the freedom and maneuverability of monetary policy. By far the best form of restructuring corporate finance would be a greater generation of internal funds. Unfortunately, any suggestion that this is objectively desirable and not just a self-seeking demand for higher profits, runs into oppostion. A best approach then might be to operate on the assumption of a constant overall tax burden for corporate business, and to try to structure the impact of this burden less unfavorably as between debt and equity.

The present tax law, as everybody knows, makes debt financing preferable to equity financing so long as the credit rating of the firm will stand it. The financial consequences of the capital structure of corporate business that this tax situation has allowed to be built up over the years are also well known. It might be possible to move back toward a more balanced capital structure if the relative tax treatment of interest and of dividends could be moved in a direction of somewhat greater equality. Purely for illustrative purposes I have calculated using 1974 data on all manufacturing firms not including the petroleum industry that the same amount of corporate tax revenue could be raised if interest, instead of being wholly tax deductible, were treated as dividends and the average tax rate reduced to 33.4 per cent. Alternatively, dividends, instead of being wholly nontaxable, could be treated like interest expenses if the average tax rate were raised to 51 per cent.

Obviously, such a restructuring of taxation would not be practical with respect to existing debt and equity. The capital structure of corporations is much too diverse, the impact of such a tax change much too uneven. But perhaps thought should be given to the principle I have suggested on an incremental basis, i.e., with respect to future financing. Under appropriate safeguards, the applying of a revised corporate tax to all income before interest, or to interest plus dividends, would make for a better pattern of financing. Equity financing would become cheaper relative to debt. The structure of business capitalization would become more robust.

Meanwhile I observe massive efforts on the part of corporate business to improve capital structure within the existing framework of taxes and other considerations. This is an important step forward. I hope and believe that corporate financial strength will not in the foreseeable future be tested as it has been in the recent past. But it has been one of the defects of corporate financial practice that, when no severe tests of liquidity and solvency were encountered, the degree of leverage and the risks of short-term borrowing were continuously increased. This progressive exploration of the extreme margin of safety was bound to create difficulties sooner or later, without inflation or with inflation, without a restraining monetary policy or in the face of one. Monetary policy will be more successful in its effort to practice moderation if corporate finance does likewise.