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# INFLATION AND LIQUIDITY

Remarks by

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

at the

Symposium on Liquidity

of the

National Association of Accountants

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New York City

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My topic today is inflation and liquidity. In dealing with this subject before a group of accountants, whose work calls for a higher degree of precision than usually is required or expected of economists, it seems appropriate that I address myself first to the liquidity problems of the individual firm, which can be examined in full detail. I shall turn later to the macroeconomic relationships that are the stock-in-trade of monetary economists like myself.

My specific concern will be with the impact of inflation upon liquidity. Inflation has been defined as too much money chasing too few goods. That would suggest that inflation is a condition of excessive liquidity. At the corporate level, as we all know, that is far from the truth. We have all observed how the inflation of recent years has in fact severely drained corporate liquidity. It has done so through a variety of channels.

Inflation has caused corporate profits to be overstated, through inventory profits (except for firms on LIFO) and through underdepreciation. Neither form of pseudo-profits generates cash flow. Inventory profits must be reinvested in inventory if the firm is to maintain its scale of operations. Underdepreciation yields no cash because depreciation charges only affect the allocation of the current gross cash flow without affecting the flow itself.

The pseudo-profits thus created by inflation nevertheless have consequences that indeed influence liquidity. Most obvious among them is the reduction in liquidity through added taxes except, as noted, in the case of LIFO inventory. Beyond that, however, there are more subtle effects such as the temptation for unwary directors to pay out some part of these supposed profits in higher dividends. Such "profit illusion" may also induce labor and management to reach higher wage agreements, and may predispose management to price unrealistically, that is, to allow true profit margins to shrink, as has happened in recent years.

When inflation is accompanied by price controls, as it has been temporarily in the United States, it may drain liquidity away from business if the controls do not allow a full pass through of mounting costs. This seems to have been a more important factor in British inflation than in American.

At the present time, we have two major accounting devices that tend to compensate for the dehydrative effects of inflation: LIFO for inventories, and accelerated depreciation for fixed assets. Both help economize taxes and, by presenting a more realistic picture of profits, tend to encourage conservation of liquidity through more realistic dividend, wage, and price policies. With respect to taxes, however, both entail deferral only, not forgiveness. Taxes on appreciated inventories become due when a company has to reduce its inventory (or some pooled part of it), while taxes postponed owing to accelerated depreciation become due if the firm reduces its scale of annual investment.

This arrangement, awkward as it is, nevertheless seems to me to contain an element of essential tax justice. Inventory profits and profits from rising replacement cost and hence rising current value of fixed assets represent, after all, an increase in the net worth of the firm and should be taxed. Of course this is true only to the extent that the growth in net worth exceeds the rate of inflation -- up to that point there is no gain in real terms. At the same time, these gains on inventory and fixed assets represent not ordinary income, but a capital gain. Even though technically realized when inventory is turned over or fixed assets are used up, the gain remains unrealized economically so long as the firm needs the inventory or the annual investment in order to maintain its scale of operations. It has been a rule in our tax system that capital gains are taxed only when realized.

The principal drawback of using accelerated depreciation as a substitute for replacement cost depreciation is that, at high rates of inflation, depreciation must be accelerated very sharply indeed in order to hold taxes down to the level corresponding to true replacement cost depreciation. This makes accelerated methods look like a major concession to business when they may barely enable business to maintain its equipment. The investment tax credit, to the extent that it merely offsets underdepreciation , creates an even more exaggerated picture of favors to business.

The accounting profession is now coming forward with various techniques designed to overcome the distorting effects of inflation on corporate balance sheets and income statements. In the United States, the Financial Accounting Standards Board (FASB) has published its exposure draft, Financial Reporting in Units of General Purchasing Power, for comment. If the FASB proceeds with its proposal, every enterprise will have to file supplementary information on this basis in its annual report. In England, the Sandilands Committee has published a report, Inflation Accounting, recommending another and quite different set of adjustments which would require major British corporations to publish their regular corporate reports in accordance with the principles of current cost accounting. In Australia, the Mathews Committee (Committee of Inquiry into Inflation and Taxation) has published a report. Meanwhile, the U.S. Securities and Exchange Commission (SEC) seems to favor replacement cost accounting in the footnotes to financial statements. The Cost Accounting Standards Board also has put out tentative proposals on depreciation.

I shall make a few brief comments on some of the general principles involved in various adjustment techniques, so far as they affect liquidity. I must note right at the outset, however, that this may not be their most significant aspect. A more fundamental question, it would seem to me, is whether the adjusted statements are to serve for the assessment of corporate taxes, in lieu of statements derived by conventional accounting principles. So far as I know, neither the FASB nor the Sandilands Committee propose such a drastic change, which of course would require massive changes in the tax laws.

Absent such use for tax purposes, the adjusted accounts would principally serve to enhance the understanding of corporate management, directors, labor, and the public concerning the true, or at least more nearly true, state of corporate profits. With the tax law remaining unchanged, the principal effect of such enlightment should be more realistic policies with respect to dividends, prices, and wages, as well as with respect to investment in inventory and fixed assets.

The restatement of "nonmonetary" assets and liabilities in terms of constant dollars, which is the first major step in the adjustment proposed by the FASB, typically -- though not necessarily -- leads to a reduction in stated profits. The second major step -- adjustment of the profits figure so derived by the net gain or loss from the firm's net debtor or creditor position -- produces an inflation profit for firms that are net debtors, i.e., whose monetary liabilities exceed their monetary assets. Nonfinancial corporations usually, though not necessarily, are net debtors. This gain, of course, rises in step with the net debtor position, which in turn tends to rise with the degree of leverage in the firm's capital structure.

As an example, application of the technique by Davidson and Weil to the thirty Dow-Jones Industrials had the effect, in the first step -- constant dollar adjustment -- of reducing the reported profits of the median firm to 64 per cent of reported profits. The second step -- involving the net debtor position -- brought adjusted profits back to about 88 per cent of reported profits, with wide variations among companies. For a sample of 44 other major corporations studied by Davidson and Weil the corresponding figures were 72 per cent and 93 per cent, again with a wide range.

It is particularly noteworthy to see, from the work of Davidson and Weil, that the profits of utilities after the two adjustment steps, thanks to their heavy leverage, often far exceed reported profits. Since the verdict of the stock market clearly has been that utilities have not fared well in inflation, the FASB approach seems to be somewhat at odds with the views of the market.

My purpose here is not, however, to comment on the FASB's approach and its usefulness in general. It is to examine its impact upon liquidity. Clearly, since monetary items, which represent the main elements of liquidity, are not adjusted for balance sheet purposes, and since taxes paid are not affected, there is no direct liquidity effect. The impact is indirect, via the effect of restated profits on corporate policies with respect to dividends, prices, wages, and on the scale of corporate operations that flow from the perception of these profits.

The perception encouraged by the FASB technique is that unrealized capital gains are profits just like other profits. But while the firm indeed is richer, it is not richer in cash, and it generally cannot convert any of its unrealized gains into cash if it wants to continue its scale of operations. As far as liquidity is concerned, therefore, restated profits are likely to be almost as misleading as the profits that are actually being reported.

A realistic statement of profits, from the point of view of liquidity, in my opinion, would be to keep the gain from the net debtor position out of the profits account and to carry it to a reserve account. This broadly is the approach of the Sandilands Committee, which, moreover, bases its adjustments not on the general rate of inflation, but on a revaluation related to current cost. In addition, the Sandilands Committee recommends a sources and uses of funds statement, to alert readers to the liquidity needs of the firm. The approach reflects the principle that the enterprise should be protected as an operating entity. The restatement of profits should not require or encourage payment of taxes or dividends that, for reasons of price movements alone, would interfere with the continued operation of the business. I find this basic philosophy persuasive.

Let me briefly apply the principles of the FASB to the banking industry. It is here that, in my view, the approach has a good deal of validity because it reveals that inflation has affected the profits of banks in a way that is not shown up by conventional accounting. In the case of banks, whose principal assets and liabilities are monetary, there is little scope for the various adjustments relating to nonmonetary assets and liabilities. Instead, there is one major fact: most banks are in a net creditor position, in contrast to the typical nonfinancial corporation which is a net debtor. The reason, of course, is that banks' monetary assets exceed their monetary liabilities, capital being treated as a nonmonetary "liability." The capital of banks, being invested in monetary form (except perhaps for the banks' own building and the like) suffers from inflation. Some banks' profits, which have seemed to increase in recent years, are found to look a good deal less favorable. It will take substantial current earnings to make up for the injury that inflation has been inflicting upon bank capital. The liquidity of the banking system, however, is not affected by these considerations.

I now would like to turn to some broader aspects of liquidity. You often hear it said that it is the central bank's function to supply liquidity to the economy. If this statement is interpreted to mean that the central bank, by increasing the money supply, thereby increases liquidity, it becomes very misleading. Except for short periods, money and inflation go hand in hand. In an inflationary environment, and especially one where inflation unfortunately is deeply embedded in peoples' expectations, an increase in the money supply, or in its rate of growth, increases liquidity only until prices begin to respond. Inflation, as we have seen, reduces liquidity. The ultimate effect -- and not so very ultimate -- of more money, therefore, paradoxical though it may seem, is less liquidity rather than more.

Lasting liquidity can be achieved only through appropriate policies and conduct of individual decision makers -- business firms, financial intermediaries, and households. Ever since World War II, business firms have allowed their liquidity to decline. That is true whether we measure liquidity as the ratio of liquid assets to short-term liabilities, or to corporate gross product. The ratio of liquid assets to short-term liabilities has declined from 59.4 per cent in 1950 to 23.6 per cent at the end of 1974. Relative to corporate gross product, liquid assets equaled 15.2 per cent last year as contrasted with 26.6 per cent in 1950.

For a long period, this reduction in liquidity probably reflected a deliberate policy, aimed at profit maximization and encouraged by the tax law. Finally, in the late 60's and early 70's, many business firms found their liquidity inadequate and struggled to rebuild it. But by then they were caught in the throes of inflation which tended to drain away liquidity.

In addition to the deliquifying mechanisms I have already mentioned, corporations found themselves in the last few years pushed increasingly toward short-term debt by growing difficulties in floating long-term debt. Inflation, with the very high interest rates that it engenders, tended to sap firms' credit standings as the traditional multiple coverage of interest by earnings became harder to achieve. The rise in debt/equity ratios which went on with only a few brief interruptions, while essentially a solvency factor, also gives evidence of diminishing liquidity.

With regard to this particular ratio, it can be said that the high book profits of the inflation period, overstated as they were, nevertheless helped to convey a somewhat more positive and, with respect to solvency, not entirely misleading impression. This relatively better picture on the books of corporations unfortunately is contradicted by the frequently low valuation of corporate equity in the market, which lenders presumably take into account in evaluating a firm's credit standing.

In recent months there has been some improvement in a number of the measures of business liquidity. Liquid assets to short-term liabilities have climbed from a low of 23.6 per cent in the fourth quarter of 1974 to 25.9 per cent at mid-1975. Similarly, liquid assets are now 15.8 per cent of corporate gross product compared to 15.2 per cent late last year. Corporations have issued bonds and paid off short-term bank debt. Cash flow has improved materially. The growing proportion of firms using LIFO accounting implies that a growing proportion of inventories is being carried at a very conservative valuation and that simultaneously the quality of reported profits is improving.

Banks' liquidity likewise has improved. Holdings of short-term Treasury securities have increased, reliance on purchased funds has diminished. A heavy inflow of time and savings deposits has aided the liquidity both of banks and thrift institutions.

Finally, consumers have improved their liquidity by increasing their savings. Since 1972, the savings ratio has risen from 6.6 per cent to 10.6 per cent at mid-1975. Consumer credit extensions have falled from a peak of 117.3 per cent of repayments to a current 104.4 per cent. Total liquid assets of consumers have risen from 1.45 times total consumer liabilities in 1972 to 1.57 times liabilities in the second quarter of 1975.

All this adds up to a significant improvement in the structural liquidity of the economy. In 1974 and 1975, the liquidity of the economy has been tested as it had not been since the depression in the 1930's. Some of the consequences of inadequate concern with liquidity remain to be worked off. But the overall picture unquestionably has shown improvement.