

INFLATION AND INVESTOR ATTITUDES

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by

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Your program suggests my remarks will be on economic, social, and legislative forces affecting the operations of your business in the future, but listening to some of the splendid speeches yesterday and this morning, I think it appropriate to focus essentially on inflation and investor attitudes.

Perhaps the switch is not so strange. At the Federal Reserve, we spend much of our time thinking about and acting on ways designed to influence credit and inflation. And good information about investor attitudes is immensely helpful in explaining the ups and downs of the economy. These subjects are constantly on our minds and sometimes other subjects of undisputed importance may be temporarily pushed to the back burner.

Inflation and investor attitudes are equally important to the insurance industry, too. Inflation is a particularly serious problem for you. It reduces the return and value of your investments and loans, many of which are to be repaid at some future time.

My own experience is representative of the effects of inflation on your policyholders. In 1945, I bought a \$4,000 policy for my daughter's education, thinking this amount would be fully adequate for the basic expenses. By the time she got to college, the \$4,000 scarcely paid her board and room, much less her tuition. Would you care to estimate the number of policyholders who have suffered and are suffering the same disappointment?

Credit is another subject of mutual interest to the Federal Reserve System and the life insurance business. Historically, life insurance companies have been heavy investors in real estate, large suppliers of business credit, and active purchasers of federal, state, and local government securities. As a whole, the life insurance business is the fifth largest institutional lender. In 1975, it lent and invested at a record \$18 billion clip.

Your credit policies, collectively and individually, contribute substantially to the question of whether this nation's capital needs are met. The new investments you will make during the rest of this year and next; the commitments you will undertake; the balance sheet restructuring you will do-- these actions will play a part in Federal Reserve monetary policy decisions.

If you will consider the problems of inflation and the questions about the supply and cost of credit and then tangle them up with the mystery of investor attitudes, you will have some idea of the complexities faced by economic forecasters. At the Federal Reserve, we know about the defaults, foreclosures, losses, and other painful experiences that life insurance companies have had in the last two years. It is what we don't know that will reflect in the clarity of our predictions for the future. What risks have you decided to assume? Will you assume more than the usual risks? Will you reduce your investments, or will you follow a course of moderation?

Subjective answers to these questions would provide us much more confidence in making predictions about the economic and financial outlook. Believe me, your investment decisions influence the general outlook far more than you realize.

So far, you have the general theme of my remarks today; now, to some specifics.

Inflation is a less serious problem today than it was two years ago. Now, inflation is 6 percent; then, 12 percent. This improvement represents a major accomplishment, much of which reflects reduced price increases for fuels and stable-to-lower food prices. The United States, in fact, is now a comparatively cheap place to live, as has been so quickly discovered by recent travelers to Europe. Aside from Germany, Western Europe's inflation rate remained well above ours, though there, too, it has come down.

From a different perspective, our price performance represents progress, but not unqualified success. Inflation is usually mild after a recession, and we are now only eighteen months into economic recovery. Prices this time rose faster than in comparable recovery periods. We still have a troublesome task to even match the 2 percent inflation rate achieved in the early 1960's.

We cannot afford the luxury of being complacent about the problem of inflation. Suppose the 6 percent inflation rate continues. Our price level would double, and the purchasing power of savings and assets would

shrink by 50 percent in twelve years. None of us want this to happen. And yet, looking toward 1977, the evidence is less than convincing that the inflation rate is likely to come down significantly.

Food is the only major item for which the near-term price outlook is favorable for the consumer. There, we are reasonably optimistic. Crops are expected to break or approach records. Even in the food sector, however, we must not be too confident. Drought in Western Europe, uncertainty about weather, and a history of having the unexpected happen are good reasons to suggest caution.

More predictable, but less optimistic, is the price outlook for industrial products. In recent weeks, higher prices were announced for steel, aluminum, passenger cars, and clothing. This incomplete list covers products in ample supply. If many such price increases remain firm, imagine what could happen if shortages should develop. Keep in mind that the shortages experienced in 1973-74 were an evil gremlin contributing to the double-digit inflation in 1974.

Serious shortages are not likely to develop soon because of slack in product markets generally. But we look for the economy to continue its expansion. That means the productive capacity for many materials and commodities will eventually fail to match demand. As a consequence, precautionary buying, shortages, and bottlenecks can be expected in the long run, thus intensifying price pressures. The chance that these and

other problems will reappear makes me pessimistic about a sharp reduction in the inflation rate.

For example, significant reductions in inflation appear impossible without a substantial drop in labor cost increases. How realistic is this prospect? Can we anticipate smaller wage increases or larger productivity gains, or both?

So far this year, wage increases have moderated to about 7 percent; productivity rose to about 4 percent; labor cost increases went down to about 3 percent. Nevertheless, recent wage contracts and the upward wage pressures usually accompanying later stages of economic expansion make it doubtful that these wage trends will continue indefinitely.

In addition, productivity, though increasing, is still well below postwar rates. For these reasons, I am pessimistic about achieving less inflation from the labor cost side.

The federal budget, which has been in deficit in nine of the last ten years, gives further encouragement for reflection. These deficits have not only been common and huge, but they have been part of the inflation problem. Federal spending in fiscal year 1976 exceeded revenues by \$65 billion. Considerable red ink is again expected in fiscal 1977--probably close to \$58 billion.

Deficits may be regarded as only mildly inflationary as long as our capacity to produce remains large and the economy hums along, as in our present situation. But in a more ebullient economy, deficits can cripple

progress against inflation. How we'll even approach price stability unless we keep more restraint on federal spending or increase taxes is difficult to foresee.

Huge federal deficits, moreover, have a way of derailing monetary policy. The U. S. Treasury, of course, covers its deficits by borrowing in credit markets. If massive deficits accompany large business and consumer credit demands, private credit gets squeezed and interest rates escalate.

Admittedly, the Federal Reserve is not powerless in such a situation. We can counterattack by taking actions directed toward lifting the rate of monetary expansion. But a dilemma is presented by such action. The long-range effects of a high monetary expansion rate are inconsistent with subsequent price stability. Therefore, Federal Reserve policy during the past year has been to lower gradually its long-run monetary growth targets, hoping that this will help reduce the inflation.

While keeping a wary eye on prices, we are not unmindful of the need to encourage business expansion. We have sought a pace of monetary growth that was adequate to facilitate a sustainable economic recovery without aggravating inflation. During the past year, the narrowly defined money supply (M_1) grew about 5 percent. The broader measure (M_2) rose by about 10 percent. In general, liquidity in the economy is ample.

I feel comfortable with these money growth rates. They fit the goal of moderate monetary stimulus, serving both short- and long-term

objectives. A lesson we have learned, and in which we had a refresher course in the early Seventies, is that a sustainable recovery is far better than a quick recovery. If recovery can't be sustained, inflation is aggravated rather than eased and the next recession is pushed forward. Like a change in musical tempo, the rhythm is quickened.

Unemployment remains intolerably high. About 4 million persons have been added to payrolls since the end of the recession. Nevertheless, the economy did not expand fast enough to absorb the extra large number of women and teenagers looking for jobs. So, the unemployment rate dropped more slowly than we would have liked and over the last three months even rose somewhat.

At times, debates over unemployment and inflation have become so emotionally charged that the Federal Reserve's independent status has been questioned. Proposals have been made to bring monetary policy under closer control of either the Congress or the Executive Branch.

There are those today who advocate reducing the protection of the Federal Reserve from political pressures. The Federal Reserve Act established an independent status for the country's central bank within a governmental framework. This concept fits the basic principles of our Constitution, and it has kept the System free of the political arena with its constant pressures. It gave the System strength to fight inflation and gives us now the opportunity for lasting success.

Effectively reducing inflation is a long-term process, and, at times, unpopular policies are necessary. Under persistent political pressures making the same decisions would be extremely difficult if not impossible. It is not surprising to find countries with weak central banks have the most debilitating inflation, and countries with independent central banks have the best anti-inflation records. This strikes us as convincing evidence that the independence originally granted the Federal Reserve continues to augur well for the best economic environment for our country.

Today, credit is certainly not in short supply. If anything, there is an abundance of credit. Borrowing costs have not increased in this economic recovery phase, despite massive Treasury financing. This is remarkable--interest rates usually rise in the second year of economic recovery.

There are at least three major explanations for the recent relative interest rate stability. Corporations have enjoyed a large cash flow, thus holding down credit demands. The cash flow of life insurance companies, pension funds, and savings intermediaries has been enormous. Large sums became available. All this together with an accommodative monetary policy, reluctance to lend, and relatively slack credit demands (except for short-term refinancing) produced an unusual interest rate phenomenon. Lower inflation rates and reduced inflationary expectations helped. So we enjoy a bright spot in the economy: no credit squeeze and something of an interest rate plateau.

Probably that statement should be qualified slightly. Borrowers can take advantage of interest rates that are not double-digit. Lenders, on the other hand, had to accept a lower nominal return than in some time and, if they wanted to extend credit, more often had to go out looking for opportunities. The adjustment has been difficult because earlier losses instilled a conservative lending mood. This was a natural reaction.

It follows that a look at investor attitude is appropriate. Lenders and investors have experienced a trauma, and this is easily understood. The widespread emphasis on caution, the necessity of reflecting on our exposures, and on getting our own shop in order, including the restructuring of balance sheets, was not misplaced advice. But now that corporations have significantly rebuilt their liquidity, the time for reassessment has come.

Lenders should not neglect their vital role in financing the economic recovery now in progress. To fail would hamper the recovery as well as retard the long-term growth of the country.

Will there be enough funds available to meet the large capital needs? The question has been and will be debated in financial circles. There is no ready answer, but on one point we can be certain: If life insurance companies and other institutional investors fail to meet the public's expectations, the federal government is sure to step into the breach and assume the responsibility. History has shown all too clearly that the federal government seems willing and ready to fill any existing vacuum in lending. Even

if the government does not become a direct lender, it has stern alternatives: it could legislate controls or allocate credit among competing demands. Obviously, these are not palatable to anticipate.

What does all this mean to you? Well, traditionally, life insurance companies have provided commendable economic leadership and promoted practices contributing to success. International inflation, domestic unemployment, and shifting investor attitudes provide a kaleidoscope of opportunities. As fluid as these baffling circumstances may be, the approach must be aggressive.

Based on your illustrious history of creditable performance, I am persuaded you and your associates in the life insurance industry will accept the risks of prudent leadership.