Remarks of Mr. Robert P. Mayo
President, Federal Reserve Bank of Chicago
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Financing Sound Economic Growth

A few weeks ago I mentioned to several acquaintances that I was going to be talking at a conference on working capital at Champaign. One asked jokingly, "Why you? The Fed doesn't have a working capital problem, does it?" The other quickly retorted, "No, the Fed only makes working capital problems." And he then began to describe his financial difficulties in 1969-70 and again in 1973-74.

Obviously, we at the Fed don't set out to make working capital problems for anyone. It's not one of our management objectives. But this good-natured bantering did bring to mind again that success in working capital management is closely related to the stability and health of the total financial environment--and indeed the real economy as well. Working capital needs are only a subset of the total capital requirements of business enterprise. And the market for funds with maturities ranging from overnight to 100 years represents a spectrum of closely related rates. Even a corporate executive with a firm grasp on the most sophisticated economic theories and approaches to working capital management often will be confronted with problems in periods of financial instability and uncertainty and economic maladjustments.

I would, therefore, like to take advantage of my position as a luncheon speaker--who is usually defined as someone given the opportunity to take a broader look at the topic of the meeting--to talk about the necessity of maintaining a healthy and stable financial environment in the world in which we live. And for me that is the same as talking about the financial environment necessary for sound economic growth.

We are just entering the third year of recovery from the bottom of the most severe economic setback our nation has experienced since the Great Depression of the 1930s. We are only now reaching or exceeding the levels of output and real income which prevailed before that setback, even though we have long since exceeded earlier employment levels. As we look at the economic problems we face today, it is easy to think of the period before this recession as the "good old days." One easily thinks back to the long, relatively uninterrupted rise of stock prices from 1948 through 1968. The prime rate never exceeded 5 percent from 1946 to 1965 and was below 4 percent most of that time. During that same period internal funds provided virtually all of the capital needed to cover capital expenditures. External funds raised by all non-financial corporations never exceeded $15 billion a year for a long time, before rising to a rate of nearly $100 billion in mid-1974.

Other statistics can be cited which also appear to paint a rosy picture of the post-war period, at least until the middle 1960s. But despite these seemingly pleasant memories, it seems to me that it can be argued persuasively that the climate for corporate financing has been deteriorating progressively since the end of World War II. The recession which the National Bureau has officially dated as beginning in November 1973, was not an isolated abnormality in the long-term economic growth pattern of the economy; it was the culmination of a series of external shocks to the economy plus a series of internal financial excesses.

Many of the external shocks to the economy have resulted directly or indirectly from international political events. They began with the cold war confrontations which followed almost immediately on the heels of the Japanese surrender. Then came the Korean war, the Suez Canal incident, Viet Nam, and the 1967 and 1973 Middle East conflicts. All had impacts on the U.S. economy. The list could easily be expanded to include the still continuing problems in Africa--Angola, Namibia, Rhodesia, and now Zaire--with no clear end in sight.

Out of this list, which is far from complete, two events in particular stand out, the Viet Nam war and, as a direct outgrowth of the 1973 Middle East conflict, the oil embargo and the subsequent escalation of oil prices by OPEC. Our stubborn insistence on a "guns and butter" policy throughout the Viet Nam conflict produced extreme pressures on our productive capacity in 1965-68. This, along with the more recent rapid increase in energy prices, produced the tidal wave of inflation which has receded only gradually.

Certainly, there were other factors and perhaps other policy errors, such as the price controls of 1971-73, which remained in place far too long. But, the essential point is that inflation emerged as one of the dominant disintegrating influences in our economy and our financial system. Inflation clearly impaired our ability to achieve sound economic growth--both here and throughout the free world.

The effect of inflation on the American productive enterprise has been widely noted. But it must continue to be re-emphasized. While inflation is normally thought of as excessive liquidity, it means exactly the opposite for the business firm. Inflation severely drained corporate liquidity. Corporate profits were overstated through one-time inventory profits and severe underdepreciation of assets. Ballooning of fictitious profits, in turn, served to reduce true profits for many firms through added taxes. But yet the illusion of profit gains seduced management into letting true profit margins shrink and excited labor into reaching for higher wage settlements. Corporate balance sheets were badly distorted. The tax structure injected a bias toward debt and away from equity. Yet, inflation, with the record-high interest rates it caused, affected firms' credit standings. Corporations found themselves pushed toward short-term debt in the hope that somehow tomorrow would see cheaper long-term money.

When World War II ended, the liquid assets of financial corporations was about equal to their short-term debt. This ratio dropped rapidly to about 55 percent where it remained until 1950. Then a long, pervasive decline began, dropping the ratio to the neighborhood of 25 percent by 1974.

Now, undoubtedly, part of the drop was due to significant improvements in cash management techniques; part was encouraged by our tax laws, and part also reflected the abnormal liquidity at the start of the period. But a significant part was also due to the escalation in the degree of risk that firms were willing to take. By the late 1960s for some and not until the 1970s for others, business firms began to become concerned with their liquidity and tried to rebuild it. But by then the rapid advance of inflation caught them up, tending to drain away liquidity.

The escalation of financial risk, while operating at the same time as inflation, is, I think, a separable element. This was one of the weaknesses in the economy that had arisen before the immediately preceding boom. It had been accumulating as a danger for a long time. The escalation showed its colors in many ways, but among the more obvious was the increasing use of leverage for the merger-acquisition game and in the rapid development of REIT's.

A number of factors undoubtedly contributed to the increase in the financial risk in the economy. Certainly, one of the more obvious was the fading of the memories of the major financial crises of the 1930s. A new generation of top and middle management had arrived. To many of them the great depression was a legend--never to be repeated. Added to this was the fact that government had had a reasonable degree of success, although far from complete, in moderating business risk from major recessions. The consequences of excessive risk did not materialize immediately and, consequently, over time, there was a tendency to undervalue the risk--especially when everyone else began to accept the evaluation as a standard. And on top of it all was the fact that an environment developed in which it was possible for the bright, aggressive individual to take a chance "on winning big" because if he lost, he was confident he could always get another job.

I don't wish to disparage risk-taking. It is an essential element in a properly functioning economy like ours. But, I suspect that the degree of risk-taking varies over time, growing as the results seem to indicate that the ground is safe for others to follow. At some point--nobody knows quite where--some go over the brink and the rest, scared, retreat to firmer ground.

Risk escalation and inflation, in my view, are among the most important elements in the financial picture in recent years. Business reactions to both have shaped the most recent economic recovery and are setting the stage for both public and private policies in the period ahead.

The shock waves of the most severe recession of the post-war period have set in motion a trend toward greater financial caution. There has been a concerted effort to rebuild balance sheets and a move toward more conservative financing. On 1975, the ratio of liquid assets to short-term liabilities climbed to over 31 percent and it appears likely that it climbed further, to about 35 percent, in 1976. The slow accumulation of inventories which appears to be continuing suggest that further movements toward conservative cash positions were taken in early 1977. At the same time, there has been an extensive move both toward long-term debt instruments and a substantial reversal of equity financing.

Progress has also been made on the inflation front. The improvement is not as great as any of us would like. There are still substantial risks ahead. But I would like to hope that the present turnaround is more than just evidence of the strength of the recovery, and represents a move toward a longer term improvement in the climate needed for sustained economic growth.

There are many things the new Administration and the Congress can do to help insure a future of more stable economic growth. There are some things the Federal Reserve can do. There are things that all of us, both as capital managers and as citizens, can do.

The Congress and Administration can, first of all, develop and implement an appropriate fiscal policy. The President has stated that it is his objective to achieve a balanced budget by the end of the present term. It is essential that this objective is achieved. It is clear that continued federal deficits are the primary engine of inflation and the financing of those deficits deprives the private sector of funds needed for investment in expansion. We have been fortunate in the last year that both government and private funding needs in the market have been less than generally anticipated, so that the competition for funds has not yet driven up interest rates again. But as the business recovery moves ahead, that competition surely will develop unless government needs moderate rapidly.

But there is much more to be done. Meeting safety, energy, and environmental objectives will require an enormous investment of capital. There is no doubt about that. In planning and implementing the programs to meet these objectives the Federal government must recognize that the funds invested in these objectives are going to be subtracted from the funds available for other investment--investment that is likely to create more new jobs. The rate at which these Federal programs are implemented and the stringency of their requirements on industry must be paced to allow an adequate level of investment funds for private enterprise job creation.

In addition, the consideration of tax policy must give considerable weight to improving the climate for investment, particularly equity investment. Some major steps, such as the increase in the investment tax credit and accelerated depreciation guidelines, have already been taken. It would be helpful if these were made permanent features of our tax code so that industry could be assured of a stable situation for the long term. The Administration is flirting with the possibility of eliminating the double taxation of dividends, a suggestion which seems to have general acceptance in Congress. Such a change would be a major step toward restoring the balance between equity and debt financing.

Finally, there appears to be a growing awareness of the stifling and expensive impact of certain aspects of government regulation of business. While less regulation will obviously make some industries uncomfortable for a temporary period, nevertheless, moves which expand the freedom of the marketplace to perform its proper function are bound to improve the outlook for investment and employment over the longer run.

Investment in our productive plant is one of the most critical elements in insuring sound economic growth. We have a great deal to make up. According to a recently developed measure from the Department of Commerce, additions to productive capacity adjusted for replacement value have averaged about 2.9 percent of GNP since the end of World War II. The figures have fluctuated but appear to show a downtrend. And despite the general recovery of the economy in 1975 and 1976, these two years were the lowest of the post-war period, with 1976 significantly poorer than 1975. Indeed, in only one other year, 1958, was this investment in added productive capacity less than 2 percent.

The Federal Reserve has an obviously important role in financing sound economic growth. And we have accepted that role. Over the past two years we have consistently announced publicly a path for monetary aggregate growth which we believe will lead to reasonable economic growth in an environment of reduced price pressures. I think this policy has been reasonably effective in supplying the funds necessary for the recovery we have experienced so far, while contributing to the decline of the inflation rate from double digit levels. It is widely acknowledged that the underlying rate of inflation today is in the neighborhood of 6 percent. But we are in serious difficulty if we begin to think of a 6 percent rate of inflation as the normal state of affairs. The task of the monetary authorities to direct policy toward further reduction in the rate of price increases must be faced for several years to come. The inflationary spiral we have been through was many years in building. It is going to take a long time to wind it down under the best of circumstances.

Despite the President's goal of the balanced budget by 1981, this year and next will find the needs of the Treasury making enormous demands on the financial markets. Insuring that both private and public demands for credit can be met without exacerbating inflationary pressures arising from too rapid a growth in money will be a formidable task. Yet the solution to this problem is essential for the establishment of sound economic growth.

The task of working capital managers lies in demonstrating that something has been learned from the excesses of leverage and inventory accumulation which occurred in the late 1960s and early '70s. I suspect that for you, too, a somewhat more cautious attitude prevails. Most of the things that you need to do to economize on working capital for the benefit of your firm should, in the aggregate, be consistent with stability in the economy. If the external environment becomes more stable, I see no reason for the excesses to develop again.

We all have a task to perform as citizens. The Federal Government does respond to the voices of those who make their views known. The Congress and Administration are going to have to make broad policy decisions in energy, in environmental control, in fiscal policy, and in a number of other areas which are going to affect the chances for stable growth for many years to come. It is urgent that those concerned with business and the investment outlook are as vocal in getting their viewpoint before the authorities as are those who see business needs as secondary or even inimical to the nation's future. I urge you to make your case clearly and effectively. It has been said that an informed public is necessary to sound government. I think this might be reversed and modified somewhat. A government informed by the public is essential to a sound economy.