



"HOW HIGH IS UP?"

Address by
Theodore H. Roberts
President
Federal Reserve Bank of St. Louis

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I am especially pleased to have this opportunity to speak to the St. Louis Chapter of the Financial Analysts Society. One of my earliest business assignments was serving Harris Bank as a financial analyst. During that period I was a card carrying member of the Investment Analysts Society of Chicago. I followed bank and insurance stocks, primarily, but I also kept an eye on finance companies, savings and loans, and mutual fund management companies. During that time I was a member of the Subcommittee on Bank Reporting of the Corporate Information Committee of the Financial Analysts Federation and was involved in the recommendations for improving bank earnings statements. Later as chief financial officer, I marveled at the wealth of information which we routinely made available to bank stock analysts. While my principal problem as a bank stock analyst was obtaining adequate information, it seems to me that today the biggest problem for an analyst is determining what part of the wealth of information is important. I also had the duty of managing investor relations and some of you called on me to discuss your holdings. In view of the recent Canadian interest in Harris, I hope you held on to your stock!

October, Mark Twain once wrote, is one of the most dangerous months in which to speculate in stocks. He noted that the other especially dangerous ones were July, January, September, April, and all the other months. Having been so warned, I am not here today to speculate in stocks. Instead, I would like to speculate about stocks. That is, I would like to speculate about the factors that have influenced the behavior of equity values over the past several years and that are likely to continue to do so into the future as well.

At the present time, the economy is robust, unemployment is declining and inflation is remarkably low. During the past year, virtually across the

board, stock market indicators were pushing up into previously unexplored territory. "Record highs" were reported so frequently that such announcements were almost commonplace. Of course, this was before the computer companies starting surprising us.

Unfortunately, in my opinion, the euphoria associated with recent share price rises has served to misdirect public attention from certain fundamental questions about stock market behavior--both past and future. When I read that the stock market values are "up" to record highs, I am reminded of the childhood conundrum: "How high is up?" In real terms, after adjustment for inflation, stock prices are nowhere near record levels--in fact, they are now about where they were 30 years ago. In real terms, stock prices peaked in the late 1960s and declined steadily thereafter. While the stock market indices have been generally rising to nominal record highs since the late 1960s, in real terms, shareholders, to quote Twain again, "have been fast rising from affluence to poverty."

The fundamental question that must be answered, if we want to understand both the past history and future prospects for equity values, is not, "Why are stocks doing so well now?" The important question is "Why have stocks done so badly over the past fifteen years?" From 1950 to the late 1960s, real share prices were generally rising; over the past fifteen years, they were generally falling. The chief difference between these two periods is that there was little or no inflation in the earlier period, but generally rising and erratic inflation in the latter period. The old adage that stocks were a good hedge against inflation turned out to be dead wrong.

And therein lies the puzzle. We all know, or at least think we know, why higher and more uncertain inflation has adverse effects on the bond markets. But why aren't stocks, which presumably represent some underlying

"real values", immune from the impact of inflation? With the 20-20 vision that always comes with hindsight, we can see clearly that inflation adversely impacts on share prices for several reasons.

First, because depreciation charges are based on historic costs rather than on current replacement costs, profits are overstated and the firm's real taxes rise. Inflation is, after all, a tax; one that firms are unlikely to totally avoid paying.

Second, higher and more variable inflation produces greater uncertainty about the future purchasing power of money and the value of bonds and stocks. This increased uncertainty pushes up the real rate of interest that must be offered to potential and existing shareholders. Third, the greater uncertainty about future values shows up also as a movement up the quality scale and down the maturity spectrum in terms of asset holdings. This attempt to increase the liquidity of investments produces further downward pressure on stock prices.

Finally, there is some evidence that firms have attempted to maintain the real value of their dividends in the face of rising inflation, even though their real after-tax earnings were declining. In so doing, they were simply paying out capital--in other words, partially liquidating the firms over time. This being the case, it should surprise no one that stock prices fell in real terms over this period.

Thus, despite widespread notions to the contrary, inflation is neither good for the stock market nor is its impact neutral on share values. Inflation has a well-documented pernicious effect on business firms and their shareholders.

Now it is tempting as we view the present situation, to hope that we are over the inflation "hump." We have gone from the double-digit inflation

of a few years ago to rates that currently rival those of the 1950s and early 1960s. However, in my opinion, it is premature to conclude that prospects for increased inflation are nonexistent. In several key respects, the current situation closely resembles that which existed in the late 1960s and which precipitated fifteen years of accelerated inflation and declining stock values.

There are two things that we know about inflation. First, inflation is primarily a monetary phenomenon. While there are a wide variety of non-monetary factors that influence price behavior from year-to-year, these influences essentially net out over longer time periods. The chief driving force behind inflation is excessive money growth. For example, from 1954 to 1966, money growth was 2.5 percent per year and inflation averaged 2.2 percent per year. From 1967 to 1982, the money stock grew about 6.4 percent per year and prices rose about 6.5 percent per year. Thus, if we want to determine what causes persistent inflation, we must find out what causes persistent high growth rates in money.

Second, we know that changes in money growth have little or no immediate affect on inflation--money affects inflation with a fairly long lag. Our research at the Federal Reserve Bank of St. Louis shows that persistent changes in the money stock are followed initially by changes in real output. It takes roughly three years before the full impact of changes in the money stock show up in prices. Thus, while the long-run link between inflation and money growth is close, the short-run relationship is fairly loose and, at times, tenuous. Accordingly, one should not view the combination of current low rates of inflation and the 11 percent money growth over the past year as an anomaly. The full impact of that money growth should show up in 1984 and 1985 price levels, not in the present ones.

The natural question to ask at this point is what precipitated the acceleration in money growth starting in the late 1960s? Those of us with long memories will recall that, around the middle 1960s, fiscal policy decisions were made which entailed greater expenditure for both domestic and international programs. The rise in expenditures, unaccompanied by higher taxes, produced greater deficits and upward pressure on interest rates. From that time, until late 1979, the Federal Reserve attempted to "lean against" these interest rate movements. In retrospect, it was more like spitting in the wind.

In general, monetary policy is implemented mainly through supplying and withdrawing reserves of depository institutions through open market operations. The changes in reserves produce an expansion or contraction of credit by these institutions.

Since interest rates are the price of credit, the net injection of reserves and subsequent increase in the supply of credit, everything else remaining constant, should cause a decline in interest rates. A net withdrawal of reserves, during periods of downward pressure on rates, holding everything else constant, should produce the opposite results. If this line of reasoning is pursued to its logical conclusion, then it appears that the Fed could set some interest rate and hold it there forever by simply supplying or withdrawing reserves in appropriate amounts.

Unfortunately, as our experience since 1965 has shown, there is a fatal flaw in this analysis. The flaw is that everything else does not remain constant. In particular, supplying or withdrawing reserves has predictable effects that produce significant changes in the economy and, not surprisingly, in financial markets as well. When reserves of depository institutions rise, these institutions actively expand their loans and

investments. In so doing, they also create additional checkable deposits-- that is, they create additional money. And an increase in the money supply impacts the economy in precisely those predictable ways that I just detailed. Initially, it induces an increase in real economic activity--in output and employment; ultimately it produces an increase in inflation. A decrease in reserves, of course, produces opposite and symmetrical changes.

These predictable results are not missed by bond and stock market participants. If lenders expect inflation to accelerate, they will try to protect their purchasing power by demanding higher nominal interest rates. And borrowers, under the same circumstances, will pay the higher rates. Bond and stock prices will decline.

Thus, prolonged and repeated attempts to keep short-term interest rates from rising actually produces, over the longer run, accelerating inflation, higher and more volatile interest rates and lower share prices. For example, in a recovery, when credit demands are rising, an attempt to hold interest rates constant by accelerating reserve and money growth, simply fuels the recovery even further. It generates increased inflationary expectations and causes prices and interest rates to rise even higher than otherwise. In an economic contraction, attempts to keep interest rates from falling, will produce an even deeper contraction and eventually a drop in interest rates. In other words, attempts to use monetary policy to stabilize short-run interest rates produce, in the long run, unstable prices, unstable employment, and unstable long-run interest rates and lower real stock values--precisely the pattern we have observed, at considerable expense, until recently.

Why is this past history relevant today? Because we face virtually the same pressures now that we faced fifteen years ago. Today we have large

government deficits, both current and projected. Today, although interest rates have currently retreated from the recent peaks, we face projections of higher rates for next year. And, each time interest rates tick upwards, we see increased political and financial market pressure on the Fed to control these rates, to keep them from rising by accelerating credit and money growth.

Virtually everyone wants stable interest rates and rising real stock values. You and I, the financial markets, politicians and monetary authorities all do. It is precisely this desire that mistakenly underlies the demands that the Fed should stabilize rates. But, attempting to stabilize the Fed funds rate has a cost: it produces increased fluctuations in long-term rates, accelerations in inflation and reductions in the wealth of shareholders. It has produced fifteen years of real stock market losses.

Should monetary policy attempt to directly stabilize short-term interest rates or to indirectly stabilize long-term rates by directly focusing on longer-term money growth? Where do the greater costs lie? I hope that you will agree with me that the problems posed by daily fluctuations in short-term rates are inconsequential compared to the risks facing stock markets produced by volatile and uncertain rates of inflation. Thus, I would like to see a monetary policy that does not try to prevent every market-induced wiggle in interest rates, but which tries to reduce both the level and volatility of inflation.

Of course, pursuing such anti-inflationary policy actions is easier to advocate than to actually accomplish. That is evident in the experience of the last three years. And, clearly, there are difficulties in engineering a

smooth reduction of inflation. One of the major problems would be maintaining such a policy long enough to wring out inflationary expectations. But we know that there is very little we can do about inflation in the short run.

A decline in reserve growth will, under most circumstances, raise short-term interest rates. This invariably produces widespread concerns over the possibility of inducing a recession. Yet we know that short-term interest rates have little impact on the economy. It is the long-term rates that produce appreciable changes. We can predict with reasonable accuracy what a reduction in reserves will do to the money supply. We can predict how total spending will react. And we have reliable estimates of what can happen to output and what eventually will happen to inflation. The longer run problem is one of political will; in the past, long-run policy actions to reduce inflation have been repeatedly thrown off course by immediate political and financial market concerns about changes in short-run interest rates.

What options do we have? We can continue to demand stabilization of short-term interest rates. But then we ought to remember that chances for reacceleration of inflation or appearance of recession increase substantially. Neither of which would bode well for the stock market.

I, for one, prefer long-term interest rate stability and rising real stock values. This can be achieved only through stable money growth and lower inflation. While we may debate endlessly the definition of money and what happens to velocity, even an elusive monetary target is preferable to attempted stabilization of short-term interest rates.

In summary, if we want to have stock markets that are efficient, that perform their function of channelling savings into long-term investments, and that increase the wealth of shareholders over time, we must maintain low

and stable rates of inflation. And that cannot be achieved by a monetary policy that reacts to every wiggle of the federal funds rate! Yet, to my dismay, financial market participants are often the ones who clamor the loudest for this unsound course. That, perhaps, is the biggest puzzle of all.

Our present situation appears to be an opportunity to accomplish everyone's desired objective--sustained economic expansion without undue inflation. The economy is doing well, inflation is subdued, and the monetary aggregates are squarely within the long-term policy bands set by the Federal Open Market Committee. In my opinion, the best way to keep them there is to concentrate on management of reserve growth-- not the level of short-term interest rates--since, over time, this will determine money supply growth. This is a two-way street. If money growth lags for too long, we could precipitate a recession.

As I review the changes in the principal monetary aggregates, I note that their rate of growth has slackened in each successive month since May. However, I also note that growth of the monetary base has picked up considerably since its low point in July. This leads me to conclude that growth of the monetary aggregates will increase at a more appropriate rate in coming months.

I leave it to you to decide what this means for interest rates and the stock market. One of the offsets to what is euphemistically termed the "public sector discount" to Federal Reserve Bank Presidents salaries is the fact that we don't have to predict interest rates and stock prices.