



"BANKING, INFLATION AND MONETARY POLICY"

Address by
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This is a real pleasure for me. I always enjoy getting together with financial analysts, particularly bank stock analysts.

One of my earliest business assignments was serving as a "financial analyst." I followed bank and insurance stocks primarily, but I also kept an eye on finance companies, savings and loan associations, and mutual fund management companies. I say "followed," because we weren't buying much bank stock back there. I don't think it had quite become acceptable to buy another bank's stock. After all, you might want to sell it some day, and then what would its management think? Time has sure changed things.

During those years, I was a card carrying member of the Investment Analysts Society of Chicago. How well I recall the introduction of the Chartered Financial Analyst program. All the older fellows were grandfathered as CFA's, and the young ones were subjected to rigorous entry testing, requiring much advance study and concern about failing. In retrospect, that was a classic case of how to use restrictive entry to improve the stature and value of membership without subjecting current members to testing standards that might have proved their undoing. There's probably an analogy there somewhere with banking, although the bankers' "charter club" seems to have lost some of its value lately.

I could make a whole speech about the effect of deregulation on banking. Since I understand that others are already doing that at this symposium, I will only say that there are now a lot of folks outside banking who are selling traditional banking services and, of necessity, the cost of banking liabilities appears to be approaching market levels somewhat faster than the return on assets, squeezing net interest margins. Add to that the risk from an enlarged spread between asset and liability interest maturities,

overhead levels that look much too high in this new market-sensitive, technologically-oriented environment, and you have an increased management challenge for bankers--before you factor in the monumental challenge of credit risks in the international and energy sectors.

As a former bank stock analyst and bank CFO, I marvel at the wealth of information which is now routinely made available to you. One of the biggest problems for an analyst today must be deciding what part of all that information you receive is really important. In a way, you have to thank me for some of that. I was a member of your Subcommittee on Bank Reporting many years ago along with David Cates and others when we felt it was an accomplishment just to get the banks to turn out a decent earnings statement. Come to think of it, we may have gone full circle with the SEC's new required net income format.

However, all this nostalgia isn't what I promised Frank Barkocy I would talk about tonight. Somehow, I dreamed up the title, "Banking, Inflation, and Monetary Policy." So I had better get back to my subject.

We have just passed the one year mark in this business recovery. With several broad measures of business activity now beyond the previous peaks, it's probably fair to start calling it a genuine expansion. Overall, the economic gains appear to be broad-based and well-balanced. You might say, it's a typical cyclical pattern in most respects. We've gone from severe inventory liquidation to moderate accumulation. The consumer started things rolling by buying houses again when the mortgage rate was still sky high and went on to automobiles and other hard goods from there as rates came down. After a pause last summer, overall retail sales are rising again and most merchants are expecting strong Christmas sales. With higher sales, inventory

levels began to fall and production had to be increased, at first by overtime, then by new hires. Unemployment has started down and personal income is rising. The consumer registers optimism in the sentiment surveys and his borrowing pattern. Even capital spending looks good for this stage of the business cycle, although high real interest rates and tough foreign competition are limiting factors in several basic industries. Labor costs are under good control, and productivity is increasing at a good pace, making possible a moderate 4 percent rise in prices during the past year. I say "moderate" only in the context of the recent past when inflation rates were 10 percent and higher.

Meanwhile, we have the curious situation of relatively high real interest rates despite subdued private credit demand. Businesses are flush with cash from good profits, low inventories, and deferred capital spending. Banks are looking for loans. The principal culprit, of course, is a huge structural federal deficit with no solution in sight even from an economy which reaches full employment. These high real interest rates also attract investment from abroad and hold up the relative value of the dollar in the face of our massive trade deficit. So, we have a vicious circle of high real interest rates dampening prospects for business investment needed to revitalize our basic industries, while increasing the value of our currency which impedes exports and strengthens the competitive position of imports. This environment also complicates the effort to deal with the international debt situation. Our U.S. banks hold about \$100 billion of that debt and most of it is in dollars, paying dollar interest rates. You, of all people, know the difficulty several of these countries are having servicing their debt. You also know that our major bank holdings of this debt exceed their capital.

With that business setting as background, what are the prospects ahead? Well, first the economy can be expected to slow its rapid pace of expansion. Over the years, we have managed to sustain a growth rate in this country of 3 to 4 percent. As we approach a fuller utilization of resources next year, we should see a slowing in economic expansion to near that rate. It's later next year and into 1985 that concerns me. We have added to liquidity at a rapid pace since last fall, measured by any monetary aggregate that you choose--M1, for example, grew at a 13 percent pace from the second quarter of last year through the second quarter of this year. Although some will make arcane arguments about how new forms of transaction balances have distorted money measurement and permanently affected income velocity, I fear that the seeds of higher inflation are already planted in this excessive money growth and will be ripening in the period ahead. Our research at the Fed of St. Louis suggests that an inflation rate of 6 to 7 percent is likely by the end of 1984.

Why is inflation important? Why should we worry about it anyway? The first reason is that it destabilizes interest rates, particularly long-term rates. 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. These higher rates will be translated into higher hurdle rates for capital investments, including stock market valuations. You don't apply the same price-earnings ratios to stocks when governments yield 15 percent.

It's sobering to consider that stock prices in this country are about where they were 30 years ago after you adjust for inflation. They peaked in the late sixties and declined thereafter. While we have heard much about record market highs this year, these are only nominal gains. Since real

stock prices rose steadily in the period from 1950 to the late sixties, why have they fallen over the past 15 years? 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 about stocks being a good inflation hedge turned out to be dead wrong. A thorough explanation of why this is true is best left for another occasion when time permits a full analysis. You know the principal arguments, of course, about inadequate depreciation charges based on historical cost and dividends being paid out of inflated earnings which often means from capital in reality.

Bank stockholders have not been immune from this general decline. In real terms, bank stock prices peaked in the early seventies. Thereafter, for more than a decade, their real value steadily eroded to about 60 percent of the earlier high point. And this measurement ends before the recent sell off reflecting increased specific concern over bank credit quality. In addition to the factors affecting stocks in general, banks suffer in an inflationary period from a net monetary creditor position which tends to erode capital. As interest rates rose under inflation, banks also suffered significant unrealized capital losses from the mismatched "duration" between asset and liability maturity structures. This was also reflected in their income statements as competition from nonregulated competitors paying the prevailing higher market interest rates forced deregulation of bank deposit rates with a resulting squeeze on net interest margins.

If inflation is bad for stock values, what can we do about it? 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 effect 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 spending 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, the net effect was more like spitting into the wind.

In general, monetary policy is implemented through supplying and withdrawing reserves of depository institutions through open market operations. These 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 downward pressure on 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 hold interest rates at some desired level forever by simply supplying or withdrawing reserves in appropriate amounts.

Unfortunately, as we now realize, 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.

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 15 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 15 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?

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!

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 make our living predicting interest rates and stock prices.