

# FEDERAL RESERVE BANK OF SAN FRANCISCO

# ECONOMIC REVIEW

## **Inflation and Financial Markets**

**E. S. Shaw**      **Inflation, Finance and  
Capital Markets**

**J. R. Bisignano**   **The Effect of Inflation  
on Savings Behavior**

**R. McElhattan**   **The Term Structure of Interest  
Rates and Inflation Uncertainty**

**J. K. Dew**      **The Capital Market Crowding  
Out Problem in Perspective**

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# Inflation and Financial Markets

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Inflation causes many severe problems, most obviously by reducing the living standards of individuals on fixed incomes. But not enough attention has been paid to the way in which inflation undermines financial markets, twisting out of shape the traditional relationships that make it possible for people to do business with one another. To call attention to this aspect of the question, we present four articles dealing with different aspects of how inflation affects the financial system.

Edward S. Shaw describes the “dirty” type of inflation that has beset our economy—especially by obstructing and distorting capital flows and capital accumulation—and discusses ways of cushioning or (better still) preventing such inflation. He emphasizes that inflation typically is not “clean”—that is, constant and perfectly foreseen—but rather that it operates at unstable rates on markets for output, factors and securities. “Financial markets are segmented; relative financial prices are distorted; financial stocks are destroyed; and financial adaptations to dirty inflation are costly and inefficient.” Money and government securities are demoted from the category of “safe” assets, thus destroying portfolio balance, since the accumulation of safe assets is no longer complementary with the accumulation of productive or risky assets. Many other distorting effects of this type can be cited.

Shaw argues that we cannot very well live with inflation because “this disease of the price

system becomes worse when treated with benign neglect.” Thus, ways must be found of either “cleansing” or preventing this disease. One obvious correction for inflationary distortions is to turn old prices loose—removing price floors or ceilings—to find their “market” level. Because of the objections raised to this procedure, corrections are sometimes imposed by governments in the form of indexing, with individual wages, prices and interest rates linked with some market-basket index of free prices. But since indexing at best provides only a temporary solution for inflation, the search goes on for ways of actually curing the disease.

Joseph Bisignano, in his contribution, analyzes the effect of recent inflation (whether anticipated or unanticipated) on personal savings behavior. He shows that the attempt by consumers to maintain a desired relationship between real income and real wealth has brought about a rise in the personal savings rate in recent years. Helping to explain this development is the “surprise” nature of the inflation that has occurred during this period.

This type of inflation represents an unanticipated decline in the real purchasing power of income and wealth. Increased uncertainty causes consumers to retrench on their spending decisions and to increase their precautionary savings balances. Only when unanticipated inflation declines, as in 1972, do we encounter a significant decline in the savings rate. Thus, Bisignano concludes, the savings rate in the

future may remain high unless there is a prolonged decline in unanticipated inflation.

Rose McElhattan provides an analysis of term-structure theory, which explains why securities which are alike in all respects, except in their term to maturity, should provide different market yields. She reviews the "preferred habitat" model of the term structure, which hypothesizes that the long-term rate of interest is an average of expected future short-term rates plus a risk premium—and that expectations are primarily dependent upon the history of interest rates and rates of inflation over several past years. She then shows that this model can be significantly improved with the introduction of inflation uncertainty as an element determining the risk premium.

McElhattan concludes that inflation uncertainty has been a significant determinant of long-term interest rates for the last two decades. In the 1955-65 period, the term-structure risk premium could be explained by variables designed to measure the uncertainty surrounding expected future interest rates and inflation rates. But in the 1966-71 period, inflation uncertainty remained the only statistically significant de-

terminant of the risk premium.

Kurt Dew considers an important current issue—to what extent deficit-inspired Treasury borrowing replaces or "crowds out" private borrowing in U.S. credit markets. In this analysis, he differentiates between long-run and short-run considerations. In the long term, given the assumption of a "neutral" fiscal-policy effect on private savings behavior, persistent deficits are seen to retard private capital accumulation, although this crowding-out effect is not reflected in higher interest rates. Government crowding out of private capital-market investment tends to be analogous to government crowding out of private expenditures in other markets.

In the short run, in contrast, fiscal policy's impact on capital markets and interest rates tends to be uncertain. Nonetheless, Dew's analysis suggests that no damage results from short-run fiscal stimulus, under certain carefully specified and limited conditions. In the depths of recession, fiscal stimulus is well advised. But to avoid long-term damage, we should reduce this stimulus as the economy recovers, balancing recessionary deficits with surpluses during better times.