11-1975

# Trendline, Nov. 14, 1975

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TRENDLINE

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The first part of November witnessed a spate of poor and perplexing news which reinforces the view that the recovery will be either slow and sluggish or aborted. The most distressing 'bad news' in human terms was the rise in the unemployment rate to 8.6%. When this unemployment figure is combined with the resumption of serious inflation, as witnessed by the reported rise in wholesale prices, the prospect of a slowdown in the recovery looms larger.

In addition to the 'bad news' on the employment and prices front, the news from the money market in the past month reflected some evident stresses and strains in the economy. Between October 3 and November 7 the Federal Funds rate dropped by 119 basis points (100 basis points is 1%) while the three month Treasury Bill Rate dropped by 91 basis points. These sharp falls in interest rates reflect a falling away of bank loan activity even as the reserves available to make loans - and in particular the free reserves of banks - increased.

Free reserves are the excess reserves of member banks minus bank borrowing at the Federal Reserve system. A large increasing volume of free reserves measures the unresponsiveness of the Banking System to Federal Reserve policy aimed at stimulating bank lending and money supply growth. For the present at least the Banking System and thus the money supply is not behaving as the Federal Reserve System wants. This periodic non-responsiveness of the banking system to Federal Reserve stimuli or constraint is a serious flaw in the doctrines that have become popular which hold that the Federal Reserve can really call the tune for the economy.

Changes in relative money market interest rates since early September indicates that wariness and uncertainty loom large in financial decisions. Such wariness and uncertainty in financial decisions both reflects and affects the way in which business activity develops.

The attached table of some money market interest rates shows that the differentials between the rates on 90 Day Certificates of Deposits, as traded in the secondary markets, and other money market rates have increased markedly. (The 90 Day Certificates of Deposit that are traded on the secondary market are almost exclusively the liabilities of the very largest banks.) On September 5 the 90 Day Certificates of Deposit interest rate was 46 basis points greater than that of the rate on Treasury Bills, on October 3 this differential rose to 55 basis points, and on November 7 it had increased to 90 basis points. Meanwhile the differential between the rates on Prime Commercial Paper and Treasury Bills rose from 37 basis points on September 5 to 47 basis points on October 3, and to 52 basis points on November 7. Treasury Bills have improved their relative position in the market by a substantial degree as compared to the certificates of deposit and significantly as compared to commercial paper.

Money Market Interest Rates

| | 90-Day CD's | Prime Commercial Paper | Federal Funds | 3 Month Treasury Bills |
|---|---|---|---|---|
| September 5 | 6.94 | 6.75 | 6.06 | 6.38 |
| October 3 | 7.01 | 6.93 | 6.38 | 6.46 |
| November 7 | 6.45 | 6.07 | 5.17 | 5.55 |

These interest rate changes seemingly reflect an increasing concern for quality and liquidity by holders of money market instruments. The well publicized difficulties of the giant banks especially their excruciatingly thin equity bases, (note that the Federal Reserve, on turning down National City's move to acquire regional finance companies, argued that City Bank should use its resources to shore up its equity account rather than extend the scope of operations) and the problems of some of the borrowers from the giant banks, such as the REIT's, the Airlines, tankers, and New York City combine to make the liabilities of giant banks marginally less attractive to large scale lenders to banks and depositors. . . . . . . . . . . . . . .

The increased differential between the interest rate on Treasury Bills and on Certificate of Deposits reflects both the lenders reluctance and a borrowers eagerness. Apparently concerned about the possible repercussions of a New York default, some of the largest banks have moved to improve their liquidity positions by "nailing down" funds. Thus they are pushing their certificates of deposit even as they hold back on loan commitments. Any attempt on a large scale by banks and businesses to improve their liquidity tends to depress economic activity. . . . . . . . . . . . . . . .

Underlying the interest rate and liquidity changes that are going on is an awareness of the vulnerability of the very largest U.S. banks to off-shore deposit and liquid asset preferences. In the past decade, the largest - and some of the not so large - banks engaged in a drive to increase their overseas branches and business. Access to the Eurodollar market, uncontrolled and unregulated by any Central Bank, seemed like access to a virtual money machine. Furthermore the ability to acquire Eurodollar funds tended to insulate those banks who could effectively use the Eurodollar market from monetary policy changes dictated by the needs of the United States economy. In order to keep their Eurodollar liabilities floating, these banks have to satisfy their "depositors" and "investors" of their soundness and liquidity. However the banks which are heavily overseas are largely New York City Banks and banks with thin equity positions. Thus a major need of these banks and of Federal Reserve policy, now that we have allowed the American Banking system to become vulnerable to the whims of offshore depositors, is to assume that American Banks retain the confidence of the offshore depositor. Initially the offshore depositors in the Eurodollar market were the largest multinational concerns which are heavily United States based. However, as the accumulation of dollars by the oil exporters has increased, increasingly the depositors have become official and semi-official agencies of the oil exporting countries. Thus it is necessary for the United States banking system to retain the confidence of foreign based depositors so that a run on the offshore deposits in United States banks will not occur.

If such a run occurs, the Federal Reserve and the Treasury will have to supply acceptable assets to the banks with offshore balances so that they can fulfill their obligations to their offshore depositors.

The need by the Federal Reserve and the Treasury to assure that offshore depositors retain confidence in the American based banks is a significant factor in how the crisis in New York City and State refunding will be determined. Six of the ten largest banks in the United States are based in New York City and these banks loom even larger in the total offshore banking business by United States banks. Any default by New York City and New York State will have a particularily large impact upon these banks. Furthermore such a default will be read as a signal that the giant United States banks do not have the leverage with and protection from their government that the offshore depositors had assumed they had. As a result and on the margin a shift out of New York and American overseas bank deposits will take place if such a default occurs and this will lead to a need for these banks to pay premium interest rates to retain deposits. This in turn will lead to profit pressures and a further erosion of investor confidence in these banks.

These offshore pressures could lead to a virtual run on the offshore deposits at United States banks which will lead to a full fledged 'crisis', but even without a run a deterioration in the relative position of the United States banks overseas can be expected unless the Federal Government steps in to assure that New York City and State can fund their outstanding short term debt, even as they bring their spending into line with their revenues. The need for stability overseas becomes the tail that wags the dog of United States policy. The subtle and important ramifications of a New York City and State default seem to be better understood at the Senate and House Banking Committees - which incidently have come very far in professionalizing their staffs in this Congress - than at the Treasury and White House. The White House seems incapable of understanding the subtle relations involved in Banking and Finance and is more concerned with taking cheap political shots at New York City than in coping with the economic problems of the nation. It will be tragic if the political posture of the White House locks policy into a mold so that default by New York City is required to validate White House rhetoric.

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Another impact of New York's financial crisis was evident in the way in which voters turned down bond issues accross the county in recent elections. We of course know the fate of the County Bond issues in the

October special election, but the anti-spending, anti-expansion sentiments expressed by St. Louis County voters was repeated in jurisdiction after jurisdiction in the November elections. Bond financed state and local spending was carried to new heights, not only in New York State during Rockefellers terms but also throughout the county in the past decades. Not only are voters turning down full faith and credit issues but "moral obligation" issues are practically unmarketable - even if any legislative body would dare vote such issues today.

The putting of bond financing proposals before the voters is analagous to the appropriation stage of the investment process by corporations. If corporate board appropriations or voter approval of debt financed construction or investment projects are not forthcoming then the production of investment output will decline some time later. Thus the results of the polls in 1975 indicates that state and municipal construction will not lend a push to the expansion now underway - in fact a decline in state municipal construction may act as a drag on activity during 1976 and beyond.

It is clear that the voters in November stated a desire for conservatism and consolidation in state and local government rather than for expansion and innovation. The need is for the political leadership to set in motion program changes which look towards a better management and more effective utilization of what we now have rather than continuing to press for new projects and development. It seems as if the mood of the public is set against the ways of the sixties, but as yet this dissatisfaction has not been channeled into the development of constructive alternatives to the inherited path and ineffective programs.

Not only is the financial future likely to be unlike the financial past but real resource utilization patterns are likely to differ from those of the past. Until the economy is set in a new path of efficient utilization of what we have, we can expect either a floundering economy or an economy that continues to cycle between even more disruptive inflations and even greater threats of financial crises.