MONEY MARKET PROSPECTS; 1964

by

Hyman P. Minsky
Associate Professor, Economics

INSTITUTE OF BUSINESS AND ECONOMIC RESEARCH
UNIVERSITY OF CALIFORNIA
BERKELEY, CALIFORNIA

President Johnson in his Economic Report of January 1964 states (p. 11) that "A strong upswing in the economy after the tax cut need not bring tight money or high interest rates, especially when -- our balance of payments is improving so sharply in response to measures begun in 1961 and reinforced last July; --- the budget for fiscal 1965 will cut the Federal deficit in half and ease pressures on interest rates from Treasury borrowing." He goes on to remark that "It would be self-defeating to cancel the stimulus of tax reductions by tightening money. Monetary and debt policy should be directed toward maintaining interest rates and credit conditions that encourage private investment."

Meanwhile, back at the Federal Reserve, Chairman Martin, in various public pronouncements, including statements before Congressional committees, refuses to guarantee that the Federal Reserve will not operate so as to offset some of the stimulus to the economy that might follow a tax cut. And if any consensus among bankers and other operators in the money market has developed as to what will happen this year, it is that money will be tighter, i.e., interest rates will be higher, in 1964.

Hence in 1964 what happens in the money market may be the result of a showdown between opposing philosophies of Central Banking. The two opposing philosophies of Central Banking that can be identified are (1) the Central Bank is one of a number of coordinate and cooperative arms of government economic policy and (2) the Central Bank is independent of the administration and its organs of economic policy. Under the second "philosophy" it is not only possible for the Central Bank to have its own views as to what economic policy should aim to achieve and what, in a concrete situation, monetary policy should be, but, in addition, the Central Bank can act, independently of government policy to bring about the results it desires..

The 1010 days of the Kennedy administration can be characterized as a period of coordination and cooperation among the various administration monetary, debt management, and fiscal policy agencies and the Federal Reserve System. However, this coordination and cooperation existed not because the Federal Reserve accepted that this was the proper way for a Central bank to behave, rather it existed because there was agreement between the government and the Federal Reserve on the diagnosis of the economic situation, the objectives to be sought, and the way to go about attaining the objectives. In part this concensus was the result of the intellectual strength and prestige of the leading Administration spokesmen on monetary policy, who succeeded in swaying the Federal Reserve to go along with their overall policy. The coordinated policy was based on the following premises: aggregate demand was too low, unemployment too high, inflationary dangers were weak, short term interest rates should be high enough to hold foreign (and domestic) short-term balances in the United States and long-term interest rates need not rise even though short-term rates increase.

The Council of Economic Advisers forecasts a Gross National Product of some $623 billions in 1964, assuming that the tax cut is passed early in the year. This is a rise of 6.5% in G.N.P. which is a substantially faster rate of increase in G.N.P. than the 5.4% achieved in 1963. We can expect this more rapid increase in G.N.P. to be accompanied by somewhat greater price increases than have occurred in the past few years and a reversal of the improvement in the balance of payments. We can also expect that the unemployment rate will not be lowered appreciably, especially if we take into account the large number that will graduate high school this summer. Thus the Federal Reserve, weighing price level increases and balance of payments considerations heavily, would favor greater monetary constraint, whereas the Administration, weighing unemployment heavily would argue for a continuation of relative monetary ease. We can assume that the Federal Reserve will, with a lag, assert its autonomy and operate to raise interest rates. [If it does not, but rather follows the guide lines laid down in the President's Economic Report, then the money market forecast would have to be that in 1964 interest rates will remain pretty much where they are now.]

Implicit in the above, quite popular, view of what lies ahead [in the politics of economic policy,] is the proposition that the Federal Reserve, by its monetary policy operations, can virtually determine the pattern of interest rates. If this were true, any forecast of the pattern of money-market developments would be made in two steps: a forecast of the behavior of the economy in the absence of Federal Reserve action and a forecast of Federal Reserve actions and their expected effects. Under this view a forecast of money-market developments would be, to a large extent, a forecast of Federal Reserve actions and of their likely effect. Given that the Federal Reserve operations are discretionary, this view of the power of the Federal Reserve implies that forecasting money-market developments depends almost entirely upon an evaluation of the likely interpretation of events by the Federal Reserve system.

However, what happens in the money market is not all that precisely the result of Federal Reserve actions. The Federal Reserve system's action to carry out a policy are constrained by the need to maintain orderly conditions in the various financial markets and the effect of changing market organization and behavior upon the relation between money, income and interest rates. The relation between money, income and interest rates is particularly sensitive, in the short run, to the repercussions upon the structure of financial institutions of rising interest rates. During periods of rising interest rates, money economizing institutional changes occur which tend to moderate interest rates increases; such market reactions will temper the results of Federal Reserve designed to constrain economics expansion.

Although in principle the Federal Reserve could offset such effects of induced institutional evolution by tightening up on money even more than it otherwise would, in practice it does not do so. This is so because the Federal Reserve is always anxious to avoid substantial disruption in any financial market. The path between Federal Reserve operations and the economy is almost always by way of the government bond market and commercial banks. Any attempt to compensate for the evolution of financial market institutions by further decreasing the money base will put sharp pressures upon these sectors. The market reactions to such pressures may be sufficiently strong to cause disorderly conditions.[11] It is a law of large and complex organizations that no unit operates so that it may be held responsible for a crisis: and the Federal Reserve, obeying this law, always constrains its operations for fear that it may be held responsible for a financial crisis. Hence, even though the economic indices may point to the Federal Reserve tightening money, market reactions to rising interest rates may be such that the Federal Reserve System falls short of its objectives. Even though the Federal Reserve succeeds in raising interest rates somewhat, the market reaction to the higher interest rates may tend to make the supply of loans at these somewhat higher rates very elastic; thereby preventing any further rise.

There is one specific factor which will tend to offset any attempt by the Federal Reserve to tighten money during 1964.

The tax cut about to be passed is regressive; it will lead to a proportionately greater rise in the disposable income of the rich and the well to do than of the poor. In addition corporate gross profits after taxes, the "cash flow" of corporations, will rise due to both the reduction in corporate income tax rates and the cumulative effect of the revised depreciation rules and the investment tax credit. Both of these tax law effects will tend not only to increase the flow of savings at each income level but also to increase the incremental ratio of savings to income. These high and responsive saving flows will tend to constrain interest rate increases, particularly long-term interest rates.

An additional factor tending to constrain any increases in interest rates during 1964 was cited by the President in his economic report: the net external deficit financing by the Treasury is expected to be substantially smaller in fiscal 1965 than in fiscal 1964. However, this will affect the money markets more in the second than in the first half of calender 1964.

The power of the Federal Reserve System to tighten credit during 1964, therefore, will be constrained by at least three factors, given that the economy behaves as forecast and the Federal Reserve's reaction will be as expected, which is to desire to tighten credit. These three factors are the always present possibility of institutional changes leading to a more efficient use of money, the special circumstances that the tax cut, in combination with other recent tax changes, will be conducive to a rise in savings, and the decrease in the Federal deficit.

Before we attempt to state the prospects for the money market in 1964 more precisely, we had better define this market: to this point we have been like Hamlet without a well-defined Prince.

The money market is a set of markets in which a group of closely related short-term and high-quality financial instruments are traded. It is a wholesale market; the unit of trading is large and the major participants in the market are financial institutions although giant non-financial corporations do participate. In the center of the market are the giant commercial banks.

In earlier periods the major New York City banks and financial institutions headquartered in New York made up the New York money market and there were regional money markets in, for example, Chicago and San Francisco. Today, with modern communications, the United States money market has become truly national, if not international, even though the "place" where transactions are cleared remains, to a predominant extent, "Wall Street."

The content of the term the money market can be made even more precise by enumerating the financial instruments which are traded on this market. As good a list as any of the instruments which makes up the money market is contained in the table labeled "Money" that the New York Times publishes each week day. The table as published on Saturday, February 1, 1964 is attached.

Money

Friday, Jan. 31, 1964
(Rates in Per Cent)

FEDERAL FUNDS

Open	High	Low	Close
3½	3½	3½	3½

Discount Rate (N. Y.)	3½
Effective 7-17-63.	
Prime Rate	4½
Effective 8-23-60.	
Brokers' Loan Rate (Govts.)	3½-4
Stock Exchange Collateral	[illegible]-4½
Dealers' Rate (Govts.)	[illegible]-3⅞
3 mos. Treasury Bills (asked)	3.47
Finance Paper:	
30-89 days	[illegible]
90-170 days	[illegible]
Effective 1-21-64	
Dealers' Commercial Paper:	
4-6 months	[illegible]-4[illegible]
Effective 1-24-64	
Acceptances: 30-90 days	3⅞-5¾
90-120 days	4 -3⅞
170-130 days	[illegible]-4
Certificates of Deposit:	
(Secondary Market)	
3 mos.	3.[illegible]
6 mos.	3.[illegible]

Arbitrage

U. K. Treasury Bills:	
(90 days hedged N. Y.)	3.2[illegible]
Canadian Treasury Bills:	
(90 days hedged N. Y.)	3.64
Canadian Finance Paper:	
(90 days hedged N. Y.)	4.00

LONDON MONEY MARKET

Demand Loans	2[illegible]-3[illegible]
60 days	3[illegible]-3[illegible]
90 days	3[illegible]-3[illegible]
Eurodollar: Call	3[illegible]
One month	3[illegible]
Three months	4[illegible]

The discount rate is a policy instrument set by the Federal Reserve Banks. It states the terms under which they are willing to lend reserves to Commercial Banks. Although it is an old fashioned way to state the problem faced by the Federal Reserve System, the Federal Reserve's problem can be said to be to make the discount rate effective: i.e., to furnish just sufficient reserves to commercial banks so that the other money market rates are "correctly" aligned with the discount rate. If we assume that sometimes during 1964 price level increases and balance of payments considerations will make the Federal Reserve raise the discount rate to say 4%, the question is whether the Federal Reserve can, by reducing or constraining the growth of bank reserves, make other rates rise to conform to the higher discount rate.

If we assume a continued ample supply of long-term investment funds, due to the higher saving ratios, then the markets for privately generated money market instruments such as Finance Paper, Dealers Commercial Paper and Bankers Acceptances will not sustain higher interest rates. The organizations issuing this type of paper always have recourse to long-term bond financing. Given stability in the long-term market, any increase in money-market rates will result in a substitution of long-term borrowing for money-market borrowing thus constraining the rise in short-term interest rates.

limitations on the market

It is true that the prime rate--the rate commercial banks charge their largest and best customers--has been at 4-1/2% for well nigh three and a half years. During this period other interest rates have been rising. Even though the prime rate has remained unchanged, bank lending rates have risen due to a decrease in the availability of the prime rate. Given a large non-financial corporate cash flow, the need for bank accommodation by business will not expand rapidly. In addition, commercial banks have been successful in increasing the effectiveness of a given volume of reserves by increasing savings and time deposits. It is my feeling that they have not exhausted the possibilities for economizing on reserves through this device. Hence, I doubt if the prime rate will be raised, and if it is raised, I doubt if the rise will be sustained.

The Combination ~~continuation~~ of a decrease in the expected volume of government borrowing and the expected savings by households and business argues against any rise in interest rates on government debt. The large corporate cash flows, reflecting both increased income and the various tax benefits, indicates that corporate long-term debt financing will be light. If anything, I expect pressure from slack long-term rates will be a force tending to lower money market rates during 1964.

It is obvious from the above that the underlying economic factors make for continued ease in both longs and shorts. If the Federal Reserve follows the conventions and attempts to constrain the expansion by raising the discount rate and engaging in moderate sales on the open market, I expect it will not be able to make more than a small rise in interest rates effective. Hence, money market conditions throughout 1964 should be approximately the same as they are at present: in particular I doubt if the Federal Reserve can establish a pattern of interest rates that is consistent with a 4% rediscount rate.

However a warning is necessary: the United States is in quite a precarious position as far as the international position of the dollar is concerned. An improvement in the United States economy, a strong cash position for domestic corporations, low long-term rates and perhaps a delay or rebuff of the proposed tax on foreign security issues can lead to a sharp decline in our gold reserves. With a crisis forced upon it, the Federal Reserve can feel free to act more aggressively in order to "defend the dollar". Only under such crisis situation do I foresee a substantial rise in interest rates: but such an international monetary crisis will no doubt result in a marked revision of the current international monetary system.