# MONEY MARKET PROSPECTS: 1965

by

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## I. Introduction

The strong expansion of income and employment during 1964 did not bring either tight money or higher interest rates. The interest rates that state part of the financing terms for various types of enterprises hardly varied throughout the year. In general the money markets did conform to the prescription laid down by President Johnson in his 1964 Economic Report of the President and my discussion of money market prospects in Business Scope last February. All in all, 1964 can be characterized as a year of financial stability in the context of a strong expansion.

Last year Chairman Martin of the Federal Reserve System warned that it might be necessary to offset some of the stimulus to the economy from the then-anticipated tax cut by tightening money. These warnings proved to be false alarms as none of the signals that would indicate to the Federal Reserve a need for tighter credit appeared. The expansion during the year was not accompanied by either a marked rise in prices or a deterioration in our foreign balances. In fact, in late November, when the Federal Reserve System did raise the discount rate in response to the rise of the British bank rate to 7 percent, the Federal Reserve was quick to announce that this was being done solely on account of the short-term foreign balances in the United States and that this action should affect only short-term interest rates.

Given this most successful year, the natural assumption to make about economic policy--and thus about Federal Reserve actions that affect the money market--is that next year will see the various policy authorities try to replicate their performance of this year. If 1964 is to become a

pattern for United States economic policy, we can expect a mix of monetary and fiscal policy to emerge in which fiscal policy is the essential dynamic element and monetary policy is the passive permissive component. Thus monetary policy will henceforth be called upon to play a dynamic expansionary role only if there is insufficient fiscal expansion, i.e. if tax and spending policy do not adjust to overcome the fiscal drag implicit in any given tax schedule in a growing economy. However, the question remains whether the monetary authorities--primarily the Federal Reserve System--can maintain an even financial keel in the financial and economic situation that will emerge during 1965.

The task of evaluating money-market prospects during 1965 therefore consists of three parts: (1) an estimate of what the economy will do, (2) a look ahead at the financial developments that may, independently of what happens to income, affect the money market, and (3) in the light of the above, predict the likely behavior of the Federal Reserve System and of money market variables.

Prior to doing the above, a quick review of the money markets in 1964 seems to be in order so that we can see what financial stability in the context of vigorous economic expansion looks like.

Before undertaking a short review of 1964 a warning that was included in my money market piece for Business Scope last year should be repeated. The Federal Reserve System, and the other government authorities cannot control the money market in the strict sense that the financial markets will behave as the authorities will them to behave. In good part they can set the stage, but to a significant extent they must operate within a setting of money and financial flows that are a part of the income-generating process. In addition even the relations between the monetary authorities' operating

instruments--open market operations, debt policy, discount rate, etc.--and the money market variables are modified by the ever-changing pattern of financial usages. Thus forecasting financial market developments is not simply a matter of discovering the authorities' objectives and translating them into money market variables, rather it is necessary to evaluate the fundamental evolutionary forces at work in the American and even the world economy.

## II. What Happened in 1964

The year 1964 has been characterized as one of vigorous economic expansion and financial stability. Gross national product rose by $39.2 billions (estimated), and the unemployment rate in the fourth quarter was down to 5.1 percent. In spite of the increase in the Federal Reserve Discount rate to 4 percent in late November (in response to Britain's action), the prime rate at the years' end was still 4.5 percent. The yields on Treasury bonds, mortgages, and A.A.A. private bonds all moved within a very narrow range during 1964. The Treasury Bill rate was well nigh stable throughout the year until the discount rate was increased, at which time it rose by some .35 percent to 3.85 percent.

In part this financial stability was achieved because the Federal Reserve furnished reserves to the member banks so that the money supply could increase at a substantial rate. Beginning in September 1962 the money supply (demand deposits and currency) has been increasing at the rate of approximately 4.2 percent per year; over the same period the money supply plus time deposits has been increasing at a rate of 8.6 percent per year.

Accompanying this increase in the money supply has been a rise in bank credit and investments. In the year ending October 28, 1964, Commercial Bank loans increased by 11.6 percent, and investment by 2.8 percent. This

increase in investments was the result of a decline of $0.9 billion of U.S. government securities and a rise of $3.6 billions in other securities. Thus the observed financial stability was in part the result of an expansion of bank credit to the private sectors accompanied by a substantial increase in money or in bank liabilities; however, it is important to note that bank loans increased at a substantially faster rate than the money supply or money plus time deposits.

## III. Forecast for 1965: Income and Associated Financial Market Developments

The standard forecast for 1965 is that income will rise at a slower rate in 1965 than in 1964. The momentum of the economy is such that a very good first quarter is almost certain to take place. However, in the absence of additional fiscal stimulus, the growth rate is expected to taper off quite rapidly. In fact a pessimist looking at the forecast of 1965 income by quarters would project a decline in income rather than just a slowing of the growth rate by early '66. In spite of these doubts, for the year as a whole, a rise of some 35.4 billions in G.N.P. is forecast.*

One factor making for the forecast decline in the rate of growth of income is the continuing decline in new housing starts. As a result of the decline in the rate of increase of income, the unemployment rate is forecast to rise to 5.5 percent by the fourth quarter of 1965. A simple summary of the forecast for 1965 is that it will be a good but not a real vintage year.

Basically, long-term interest rates reflect the flow of savings and the demands for financing investment. Within the range of variation in the growth rate of income we can expect during 1965, the flow of savings through

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*This review is being written before the shape of the 1966 budget has been revealed. Various programs in the pipeline, including Medicare, may make for considerable fiscal stimulus in the second half of 1965.

insurance companies, pension funds, etc., can be expected to remain high. On the other hand, the decline in new housing starts and the interest rate equalization tax, which decreases foreign demand for long-term financing within the United States, indicates that the demands for financing investment will not be excessive. These factors--adequate supply and constrained demand--will tend to hold long-term interest rates down: in fact, by the end of the year a tendency for lower long-term interest rates can be expected to develop.

Private users of short-term credit--non-financial corporations, consumer credit houses, etc.--have the option of substituting long-term credit for short-term credit. With small differentials in the rates on long- and short-term debt, finance companies, for example, will find it to their advantage to increase the proportion of long-term debt in their liability structure, but a substitution of long- for short-term debt tends to lower short and raise long rates. Thus the essentially flat rate structure we now have is not in the longer run sustainable; the continuing ease if not downward pressure on long-term rates indicates that short-term rates should decrease over the year.

## IV. "Independent" Financial Market Factors

The growth of the economy in the period since World War II, as well as the long business cycle expansion of the past four years, have been accompanied by systematic changes in financial variables. Some of these changes have resulted in trends in the structure of financial variables which cannot be sustained. Thus at some date the growth processes of the economy will have to be modified so that such financial changes need not accompany further growth.

In addition, some of the financial changes ~~in financial interrelations~~ have led to the development of potentially unstable relationships which can lead to significant shocks to the economy and ~~to~~ the rest of the financial system.

Two evolutionary changes or trends in financial relations in the postwar period are:

(1) the rising ratio of commercial bank loans to investments;

(2) the rising ratio of foreign short-term dollar holdings to the United States gold supply.

Neither of these trends will necessarily come to a halt or be reversed during 1965. Nevertheless, these are two aspects of the longer-term pattern of financial changes which seem to be capable of acting either as independent or as constraining factors in money market and income development during 1965.

Whether credit is viewed as a propelling or an accommodating factor in income changes, it is evident that the financial and income-generating processes which have been associated with the growth of loans relative to investments is not sustainable. The attached table shows that between 1945 and 1963 bank loans increased by a factor of 6 while bank investments remained unchanged. In the four years ending October 28, 1964, bank loans rose by more than 40 percent; investments increased by some 20 percent. In the year ending October 28, 1964, bank loans increased by 12 percent while investments rose by 3 percent. Such distortions of bank portfolios cannot continue indefinitely. In time bank portfolios will reach a situation in which balanced growth of assets, at roughly the rate of growth of bank liabilities, will be necessary. That is, if demand plus time deposits increase at 8 percent per year, then from some date on, both loans and investments will have to rise at 8 percent per year.

TABLE I

All Commercial Banks
(billions of dollars)

| | Dec. 31, 1945 | Dec. 31, 1960 | Dec. 20, 1963 | Oct. 26, 1960 | Oct. 30, 1963 | Oct. 28, 1964 |
|---|---|---|---|---|---|---|
| Loans and Investments | 124.0 | 199.5 | 254.2 | 195.7 | 246.1 | 266.2 |
| Loans | 26.1 | 117.6 | 156.0 | 114.8 | 149.7 | 167.1 |
| Investments | 97.9 | 81.9 | 98.2 | 80.9 | 96.4 | 99.1 |
| U.S. government securities | 90.6 | 61.0 | 63.2 | 60.5 | 62.0 | 61.1 |
| Other | 7.3 | 20.9 | 35.0 | 20.4 | 34.4 | 38.0 |
| Deposits: Total | 150.2 | 229.8 | 275.1 | 216.6 | 264.9 | 285.6 |

Over the entire postwar period, the growth of bank financing of business has been faster than the growth of bank liabilities. Thus, banks have been able to finance a more vigorous income expansion than the rate of growth of the money supply would indicate. Once bank portfolios reach an equilibrium ratio of loans to investments (equilibrium at relative yields, of course), the maintenance of a given rate of expansion of loans will require a greater rate of expansion of total bank assets and thus of bank deposits. That is, if a 4.2 percent rate of increase of the narrowly defined money supply was sufficient for a 6.3 percent increase in incomes in 1964, a similar increase in income, once bank portfolio balance is achieved, will require a greater rate of increase in the money supply.

To put the above another way, the income rise in 1964 saw velocity increase. One way in which an increase in velocity is brought about is by a greater rate of growth of bank loans than of investments. Once banks achieve balanced portfolios, further growth in income will take place without any rise in velocity due to this process: the tendency will be for income and money supply to grow at the same rate.

Thus it is possible that for financial stability to be maintained in 1965 it might be necessary for bank reserves to grow sufficiently rapidly so money can grow at the same rate as income. A greater rate of growth of money than was achieved in 1964 might be called for in 1965.

Even though progress was made in reducing the balance of payments deficit in 1964, the ratio of foreign short-term dollar assets to the United States gold reserves continued to rise. As a result the short-term money market continues to be dominated by the need to maintain short-term interest rates high enough so that these foreign dollar balances are kept in New York. The present (year end) pattern of short-term interest rates is viable only because "cover" for the purchase of sterling is so expensive.

If Britain succeeds in stabilizing the pound, so that investors' confidence is recaptured, or if Britain is finally forced to devalue, the present short-term rate--of 3.85 percent or so--will be too low relative to the expected interest rate in London. At the same time the existing short rate is too high for the expected pattern of long-term rates. To rephrase the above, the short-term money market rates are too low for the international and too high for the domestic financial situation. The only instrument available to the monetary authorities to rectify the international financial problems is to decrease (perhaps make negative) the rate of growth of bank credit or money. However, to the extent that the banks' portfolio situation will not allow them to expand loans relative to investments to the same extent as in prior years, the growth of income may require an increase in the rate of growth of the money supply.

## V. The Likely Behavior of the Federal Reserve System

From the above it seems possible that in 1965 the Federal Reserve System may have to choose between domestic and international monetary stability. Even aside from the prediction that the rate of growth of income will taper off during 1965, there may be a need for a more rapid rate of growth of the money supply. However, the lower interest rates that will accompany such an accelerated growth in the money supply will lead to a drain of gold from the United States, and this will force the Federal Reserve quite soon to cut back on the domestic money supply.

One solution to this inconsistency between domestic and foreign stability is to cut the link between the domestic money supply and the Treasury's gold holdings. Such a move will free some ~~$11 to $12~~ $13 billions of international liquidity now tied up in United States gold reserves for domestic purposes.

Given the successful operation of the economy during 1964 when vigorous income expansion was accompanied by monetary stability, the first assumption about monetary policy in 1965 would be that every effort would be made to replicate the situation that ruled during 1964. However, because of the incipient weakness in income, the expectation is that interest rates which reflect demand for and supply of long-term funds will tend to decrease; this in turn will affect short-term rates which will lead to a loss of dollar balances and gold. In addition the rate of growth of the money supply necessary to maintain financial stability may very well be greater relative to income in 1965 than in 1964. Thus even though the monetary authorities set as their objective the maintenance of stability in the financial markets, it does not seem as if money market stability in 1965 can be achieved by

simply replicating what was done in 1964; and in addition, 1965 may be the year in which the highly gimmicked international monetary system imposes undesired and unwelcome constraints, or even shocks, upon the domestic financial system.

Addendum:

The above was written before the French announced that they will increase the ratio of gold to dollars in their exchange holdings and the subsequent discussion of a loss of 150 millions of gold by the United States. The renewed pressure on the pound and the United States Treasury announcement that legislation to remove the domestic gold cover requirement will be sought followed upon the French announcement.

As things now stand a shock to both the United States and the world economy from the inherently unstable financial apparatus constructed during Roosa's tenure at the Treasury is upon us. Two paths are available. One is a fundamental reconstruction of the international and domestic monetary systems so that the deep problem of achieving the international monetary system

needed in a dynamic world is faced, this would require placing gold in a minor position in the world economy. The other is to ignore the fundamentals and buy time by a partial reduction of the gold cover for domestic money, the addition of new gimmicks and the reassertion of the fundamentally unsound position; that the $35 an ounce price of gold is "immutable."

The indications are that the politically easy path of not facing the fundamental weaknesses of our international gold standard will be followed. Some halfway measure to buy time (i.e. delay the date at which the fundamental issue will have to be faced) by reducing at least part of the United States gold cover will be adopted. This means that a flurry of unsettled financial market conditions will take place, but as long as the path of reducing the gold cover for the

domestic money supply is taken, this will be but a transitory unsettled condition and will soon be damped out. In fact by increasing the free gold holdings of the monetary system these changes may, before the year is out, allow somewhat easier monetary circumstances to rule than would have been the case in the absence of the present "crisis".

Thus the prediction of money market stability – after a flurry – followed by downward pressure on interest rates seem to be even more valid now, because the international financial constraint will be, for the time being, eased than it was when the main body of this piece was written