

Research Department
Federal Reserve
Bank of
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Gestalt Money

During the first quarter of 1982 the narrowly-defined monetary aggregate M-1 appeared to signal a rise in monetary stimulus, as that aggregate rose at a 10.4-percent annual rate—nearly double its rate in the preceding quarter. The major components of M-1, however, did not all send the same signal. Traditional non-interest-bearing demand deposits fell in absolute terms, while “other checkable deposits” (primarily interest-bearing NOW accounts) grew at almost a 50-percent annual rate. Can the composition of the M-1 component growth help answer the question: “Is money growth excessive?” The answer lies in whether the growth of NOWs represents a cyclical demand for precautionary balances or represents a demand for transaction deposits.

The puzzle on the liability side of bank balance sheets does not find a ready answer on the asset side. During the first quarter, commercial-bank business loans grew at a 16.8-percent rate—more than double real-estate growth, and in sharp contrast to the stagnant growth of consumer loans. The contrast was even sharper in May, when business loans grew at close to a 20-percent annual rate. Why should this be, in the face of the first quarter’s record business-inventory decumulation and the apparent continuation of liquidation in the April-June period? With such growth of business loans, why was the demand-deposit component of M-1 so sluggish? Simply put, should the behavior of credit, both bank and nonbank, influence one’s views of money—specifically, one’s views on whether money growth is stimulative or contractionary?

The long and the short

Let us first consider the demand for credit, specifically corporate demand. Real GNP has declined less in the current recession than in the average postwar recession, but the conjunction of two back-to-back recession years makes the current downturn look much more

severe than usual. Pre-tax corporate profits fell by \$43 billion in the first quarter of 1982, one of the sharpest profit declines in the postwar period, and indeed have fallen almost steadily since 1979. This has resulted in severe cash-flow problems for the corporate sector. The problem, however, is not completely cyclical, because pre-tax profits, relative to interest payments, have fallen ever since 1960 (see Chart 1). The current cyclical decline is sharper than the 1973-75 decline, but pales into insignificance compared with the interest-coverage decline which took place in the second half of the 1960’s.

Along with this decline in interest coverage has gone a growing dependence on short-term debt. Again there are both cyclical and secular aspects involved. The ratio of long- to short-term debt has declined dramatically since 1960 (see Chart 2). And in cyclical terms, nonfinancial corporations have reliquified themselves, increasing their average debt maturity by increasing long-term financing during the early stages of the recovery period. Nonetheless, long-term debt has trended downward in relation to short-term debt, making corporate liquidity and profits increasingly sensitive to volatility in short-term interest rates.

The corporate financial structure obviously has become more highly leveraged—and leveraged increasingly with short-term debt. As a result, interest expenses in 1981 amounted to more than 40 percent of pre-interest and pre-tax profits, compared with 38 percent in the 1974 recession year. The increased corporate reliance on debt leverage at the short end of the maturity spectrum has made money-market watchers of us all, but especially of corporate treasurers, who have seen their profits blown by the winds of short-run interest-rate movements at the same time that they have been shut out of the long-term debt market.

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Risk premiums and real rates

With the trough of the current recession close at hand, we would normally expect nonfinancial corporations to begin to reenter the long-term debt market and extend the average maturity of their debt. But one need not be a Wall Street wizard to see that this may not happen, given the high level of long-term interest rates—especially real interest rates.

Measurement problems are involved here, primarily because the real rate is defined as the market rate less the *anticipated* rate of inflation, the latter being a major stumbling block. But recent history provides us with at least a crude measure of anticipated inflation. Thus, in Chart 3, we plot the long-term seasoned Aaa corporate-bond rate less the average inflation rate of the past three years. During the 1960's, then, the real interest rate averaged about three percent, and, without much volatility around that figure. It dropped sharply in the first half of the 1970's but began to return to trend in the latter half of that decade. After 1979, however, the real rate rose dramatically and displayed much more volatility than economists appear able to explain.

If high real rates are mainly involved, it is not surprising that corporations are staying out of the long-term market, and increasing their reliance on bank loans and commercial paper. If, on the other hand, large inflation premiums account for the high nominal long-term rates, why is it that potential debtors are not willing to issue long-term debt when they can feel reasonably secure of paying the principal and interest payments in the future with considerably depreciated dollars? The question remains largely unanswered at a theoretical level. The fact is, however, that corporations are not issuing much long-term debt.

The problem is complicated by several other factors. One major factor is the magnitude of Federal-government financing needs. Although estimates vary, the Federal government clearly will be running large deficits over the next several years, regardless of the pace of real economic growth.

Secondly, while top-rated corporations may enter the long-term market with a bit more ease in the future, lesser-graded corporations will have to pay a very large risk premium. The risk premium of Baa over Aaa long-term corporate debt averaged no more than 80 basis points during the 1960's, but it rose to almost 200 basis points in early 1975, and since 1979 has often risen even higher (see Chart 3). Firms with lower-rated bonds hence will have a more difficult time extending the average maturity of their debt, so that they will have to increase their reliance on short-term credit suppliers. Also, with more and more firms suffering a downgrading of bond ratings this year, we can expect corporate demand for short-term debt to remain strong. In this environment, policy attempts to restrain money growth with a "closed" long-term market could make the nonfinancial corporate sector more vulnerable than in previous anti-inflationary periods.

Unravelling money

With the Federal government in a large deficit position and the corporate sector stretching to pay off heavy debt commitments, the household sector should provide most of the increased saving to finance the other sectors' increased indebtedness. The only other major credit supplier is the Federal Reserve. How the monetary authorities "read" the monetary aggregates thus will critically affect the cyclical health of the economy and the public's long-run inflationary expectations. This suggests the need to distinguish the demand for credit from the demand for money.

Analysts trying to make this distinction are often greeted with the unkind response, "You're confusing money and credit." Unfortunately for this criticism, money and bank credit are simultaneously created whenever a bank extends a loan. Hence recent demands for credit, especially bank credit, and the origins of these demands, such as the drying-up of the long-term bond market, may help explain why M-1 this year has run consistently, and at times considerably, above the upper bound of its long-run target range, while the broader M-2 and M-3 aggregates

have generally remained near or within their target ranges.

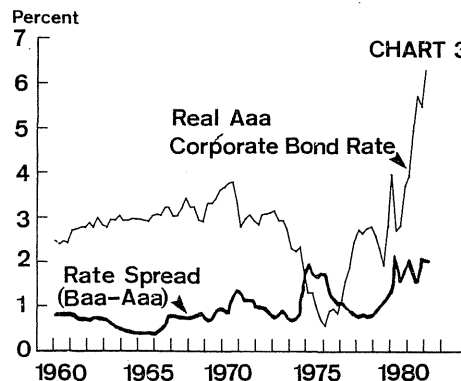
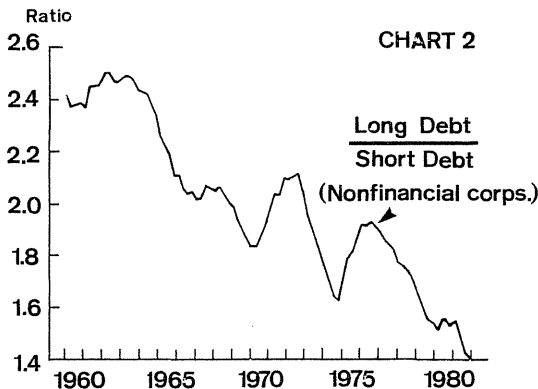
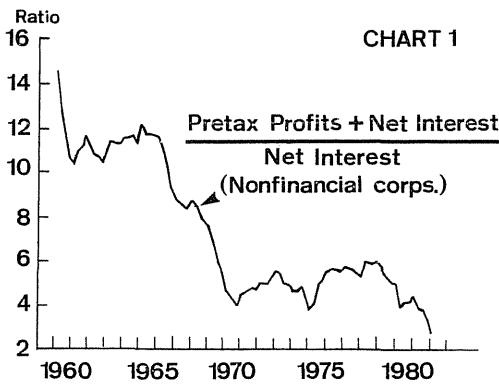
The growth of the aggregates depends on the way banks choose to fund their new loans and investments. Banks normally fund from the cheapest source, causing their liabilities to be substitutable with one another. Thus, the growth rate for large time deposits (CD's) dropped from 30 percent to 9 percent between the third quarter of 1981 and the first quarter of 1982, while the growth rate for "other checkable deposits" (primarily NOWs) increased from 21 percent to 49 percent in the same time-span. Both the public's demand for deposits and banks' deposit-supply behavior thus helped determine the growth of the aggregates in this short-run period.

The recent increase in M-1 growth may represent an atypical shift in corporate credit demands caused by the difficulty of long-term financing, but it could be interpreted instead

as excessive (i.e., inflationary) *monetary* stimulus. In the former case, increased pressure to rein in money growth could worsen and prolong the recession. However, an increase in short-term credit demand is not the same as an increase in the demand for money, and some thus might argue that the rise in money growth should be offset by the monetary authorities.

The current debate between monetarists and non-monetarists once again revolves around the distinction between the sources of money and credit. Harold Ross, the famed *New Yorker* magazine editor, once asked a staff member—"Was Moby Dick the man or the whale?" This question is not far removed from the question of whether the recent upsurge in NOW accounts ought to be considered the same as a rapid growth in non-interest paying transaction deposits. The strength and duration of the economic recovery depends on the answer.

—Joseph Bisignano and Roger Craine



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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities	Amount Outstanding 6/9/82	Change from 6/2/82	Change from year ago	
			Dollar	Percent
Large Commercial Banks				
Loans (gross, adjusted) and investments*	160,571	721	10,440	7.0
Loans (gross, adjusted) — total #	139,663	533	11,535	9.0
Commercial and industrial	44,022	157	6,372	16.9
Real estate	57,282	84	4,700	8.9
Loans to individuals	23,338	9	370	1.6
Securities loans	2,186	160	539	32.7
U.S. Treasury securities*	6,500	254	49	0.8
Other securities*	14,408	- 66	- 1,123	- 7.2
Demand deposits — total#	38,954	-3,158	- 2,679	- 6.4
Demand deposits — adjusted	28,018	1,701	- 1,373	- 4.7
Savings deposits — total	31,151	- 13	778	2.6
Time deposits — total#	95,447	201	15,018	18.7
Individuals, part. & corp.	85,544	14	14,531	20.5
(Large negotiable CD's)	35,499	- 157	4,417	14.2
Weekly Averages of Daily Figures	Week ended 6/9/82	Week ended 6/2/82	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves (+)/Deficiency (-)	114	65	25	
Borrowings	199	98	154	
Net free reserves (+)/Net borrowed(-)	- 85	- 33	- 129	

* Excludes trading account securities.

Includes items not shown separately.

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