CREDIT MARKETS

Money supply measurement skewed, so is the banks' arbitrage policy

An article entitled "Impact of Money Market Funds: Rapid Growth Could Distort Fed's Statistics," in the March 6 *New York Times* reviews the fact that the ability of the Federal Reserve Board to control the size of the nation's money supply is out of whack.

This argument — that the Fed is unable to control, or at least to predict money supply growth — has been advanced by a variety of economists over the last two years. The possible causes of this problem, they say, range from the swelling of the federal budget deficit to the large run-up in commercial bank sales of Certificates of Deposit (CDs).

The actual reason for the haywire performance of money supply numbers is straightforward: over the last few years the U.S. banking system has not been generating profits, which translate into new reserves and credits, from net increases in tangible wealth output. Rather, U.S. bank profitability has been derived as a result of a kind of arbitrage, the raking of a middleman's cut on the intermediation of funds.

Increases in tangible wealth output are achieved as a by-product of investments which create and transmit technological innovations in industry, agriculture, and basic science. But as readily available flow of funds figures demonstrate, in 1978 the yearly increase of corporate debt and equity borrowing (net of mortgage borrowing) was $64.3 billion, just 18 percent of the $355 billion total volume of new funds raised by nonfinancial sectors in 1978.

However, when banks and other financial institutions are not making the bulk of their profits—and creating new money—through increased industrial development, then they perforce are making it through various secondary processes of arbitrage, that is, paper profits based on capitalizing on the short-term differentials in interest rates prevailing on various money market instruments. Whatever commodity or piece of paper has the fastest rising interest rate becomes the "hot item" for the moment, sucking in huge pools of short-term funds and causing violent and *unpredictable* swings in money supply.

Forecast of whether M1 or M2 will rise or fall or by how much under such generalized "arbitrage" conditions is virtually impossible.

The growth of money market funds

One example of this arbitrage upsurge, the one that caused the fuss at the *New York Times*, is the spectacular increase in money market funds. A money market fund is a mutual fund that invests in short-term debt securities such as Treasury bills and commercial paper.

Between September 1978 and the present, money market funds have grown by $5.3 billion to a current level of $15.5 billion. The securities these funds purchase are currently yielding about 10 percent, more than double the 5 percent interest rate the Federal banking authorities allow commercial banks to pay on daily passbook accounts. In addition, small investors can buy into money market funds, which don't have the $10,000 minimum standards existing on such securities as CDs. Under these conditions, demand deposits at commercial banks declined by $4.2 billion to $261.7 billion, while saving deposits were falling by $5.9 billion, during the same September-to-March period.

More arbitrage

Yet if money market funds were the only arbitrage problem facing the U.S. credit markets, the markets would not be in their present shape. Since November 1978, nationwide Commercial and Industrial (C & I) loans, instead of rising by $5 to $10 billion, have actually fallen by nearly $2 billion.

At the same time, other arbitrage-type practices have contributed to unhinging the ability for accurate prediction of money supply:

- Various corporations have forsaken the long-term bond market and term-loans from banks, where prime rates charged best corporate customers are around 11.75 percent, for the issuance of commercial paper—30 to 270 day unsecured promissory notes. The advantage for corporations is the "arbitrage difference"; 30 to 60 day commercial paper rates are currently between 9.63 and 9.98 percent. However, this hampers corporate ability to plan and make long-term capital formation and plant and equipment investments.
- Various banks have shifted their lending portfolios to give wider investment to straight-out foreign exchange arbitrage. During 1978, such arbitrage accounted for between one-quarter and in some cases, 45 percent of money-center banks' profits.
- In October 1978, savings institutions were given permission to offer six month certificates linked to Treasury bill yield, which allowed savings institutions to hold onto depositors. But this arbitrage trick cut so deeply into savings institutions' profits, as rates went up, that the savings institutions recently have cut back considerably on their issuance of these certificantes.

—*Richard Freeman*