

MONEY MARKET DEVELOPMENTS, MID-YEAR 1952 TO MID-YEAR 1953

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DEVELOPMENTS IN THE MONEY MARKET cannot meaningfully be viewed from a narrow, technical standpoint. Instead, they should be seen against the backdrop of basic economic conditions. Let us, therefore, begin the analysis of the second period—mid-1952 to mid-1953—by having a look at a few of the more important economic indicators.

In general, the period may be characterized as one of continued expansion of economic activities without commodity price inflation. Mr. Koch has detailed the expansion that began in early 1950 and carried through to mid-1952. The next period was in essence more of the same with culmination at the peak level of all time in mid-1953. Some evidences of impending recession appeared during the second quarter of 1953.

More concretely, between mid-year 1952 and mid-year 1953, gross national product rose from \$345 billion to \$372 billion (annual rates), or by 8 per cent. All components of GNP contributed to the expansion—personal consumption, private investment, and government purchases. The most active contribution was made in the form of additions to business inventories, thus setting the stage for the recession to follow. Other measures of the expansion are the 15 per cent rise of industrial production and the 11 per cent rise in manufacturing employment (Federal Reserve indexes). The value of the dollar remained almost constant. A rise of about 2 per cent in consumers prices was offset by a small decline in wholesale prices.

As one would expect, the expansion of GNP was financed by an increase in the main monetary and banking series. Total loans and investments of all commercial banks rose about 3 per cent which created a similar increase in the money supply (currency and demand deposits). In addition, money was spent somewhat more actively, as evidenced by an increase of 3.5 per cent in the turnover of demand deposits.

Analysis of the money market likewise discloses a continuation of tendencies that had their origins in the preceding period dis-

cussed by Mr. Koch. The outstanding feature was one of the sharpest increases in money rates on record, the bulk of which took place between October, 1952, and June, 1953. Treasury bill rates rose from 1.7 per cent to 2.4 per cent; open market commercial paper rates from 2.31 per cent to 2.75 per cent; U.S. long-term bond yields from 2.74 per cent to 3.09 per cent; and Moody's AAA bonds from 3.01 per cent to 3.4 per cent. Of course, this meant a disturbing break in bond prices which gave rise to the quip that the United States Treasury 2½'s of 1972-67 would break 90 before Ike could do so. I do not know whether Ike won or lost this battle, but the 2½'s did drop below 90 in June, 1953. As you are well aware, they have since recovered to about par.

Now wherein lies the explanation of this sharp rise in money rates? A superficial answer can be given in terms of the net reserve position of the member (commercial) banks which is defined as the difference between excess legal reserves and borrowings at the Federal Reserve Banks. Statistical studies have established a close inverse correlation between the net reserve position of the banks and the level of money rates. That is, when it is necessary for the banks to borrow increasing amounts from the Reserve Banks to meet legal reserve requirements, rates usually move upward. This situation reflects the ascendancy of demand factors over supply factors in the credit market, combined with reluctance of the banks to be in debt to the Federal Reserve. Moreover, this attitude of reluctance may be re-enforced by a rise in the Federal Reserve discount rate. On the other hand, when excess legal reserves are piling up in the hands of member (commercial) banks, rates usually move downward. Supply factors are in the ascendancy. Banks bid down yields on secondary reserve assets and offer loan money more freely at lower rates in an effort to increase income.

For nearly two decades prior to mid-1952 excess reserves substantially exceeded borrowings at the Federal Reserve, that is, a net reserve surplus existed. This meant that the supply of loan money was readily available at low rates. But beginning at mid-year 1952 an almost forgotten phenomenon appeared once again in the form of "net borrowed reserves." Borrowings at the Federal Reserve rose sharply and fluctuated between \$1 billion and \$1.5 billion until late May, 1953. Net borrowed reserves ranged between \$400 million and \$1 billion.

The amount of net borrowed reserves, however, constitutes only a partial measure of the diminished liquidity of commercial banks.

Their secondary reserve position must also be included if the view is to be complete. The record reveals that commercial banks included in the Treasury's monthly survey held \$6.7 billion less U.S. securities with maturities under five years and \$3.1 billion less maturing within one year on May 31, 1953, than on June 30, 1952. Between the same dates their holdings of U.S. securities with maturities of five years and over increased \$3.8 billion. In addition, the market prices of their enlarged holdings of intermediate and long-terms declined well below par, and below cost in most cases. Thus, bank loans could be increased only by borrowing more reserves, by further reduction of short-terms, or by selling securities at a loss. A marked deterioration in bank liquidity had indeed taken place.

The Federal Reserve discount rate was raised from $1\frac{3}{4}$ per cent to 2 per cent in January, 1953. This, together with the diminished bank liquidity just cited, was concrete evidence of an active, rather than a passive, role by the Federal Reserve in regulating the money market. They feared overexpansion and inflation of commodity prices during this period, and therefore approved conditions that resulted in rising interest rates.

This brings us to the deeper question: What underlying factors were responsible for the "net borrowed reserve" position of the member (commercial) banks during this period? In view of the emphasis usually placed on the restrictive policies of the Federal Reserve, it may surprise some of you that the positive forces behind member bank borrowing originated in the free market, and that the Federal Reserve used its powers mainly to soften the effects of these market developments. In fact, money rates would have been much higher had the Federal Reserve banks not purchased a substantial amount of United States securities—about \$1.3 billion between mid-year 1952 and May, 1953. This partially offset a decline of the gold stock of \$0.8 billion and an increase of currency in circulation of \$1 billion.

Another strong influence contributing to higher rates was the intensity of demand for loanable funds by business corporations, individuals, and governmental units. During the first half of 1953 they raised about \$11 billion net of retirements—\$1.5 billion more than in the first half of 1952. Commercial bank loans rose by nearly \$6 billion between mid-year 1952 and mid-year 1953. The flow of current saving was large, but still not sufficient to meet the heavy demand for funds.

Moreover, the investment market was confronted with great un-

certainties, especially during the second quarter of 1953. It appeared likely that the Treasury would have to raise between \$9 and \$12 billion of new money during the second half on top of a heavy private, state, and local demand. This was against the background of repeated Federal Reserve and Treasury statements with regard to the new era of a free market for government securities, the intention to lengthen maturities and to follow sound money policies. The Treasury had issued the 30-year 3½'s on May 1 in line with its well-heralded program of extending maturities. Would more long-terms be offered in the near future in competition with private demands? Also, would the Reserve authorities release reserves to commercial banks to finance both Treasury needs and the seasonal expansion of loans and currency during the second half? These uncertainties prompted some borrowing in anticipation of still higher rates to come, thereby magnifying the upward pressure on rates.

In summary, the period from mid-1952 to mid-1953 may be characterized as one of intense prosperity without commodity price inflation, accompanied by sharply rising interest rates. The higher rates grew out of large demands for credit over against a restricted supply of loanable funds in the hands of commercial banks. The restricted supply in turn arose from a substantial increase in currency in circulation combined with a reduction in the gold stock. Confronted with these conditions and fearing overexpansion, Federal Reserve authorities held the reins on credit supply taut by releasing more reserve money sparingly, with the result that the liquidity of commercial banks was materially reduced.