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Indexation of U.S. credit?

by Richard Freeman

In September 1979, money market certificates (MMCs)—time deposits with maturities of 26 weeks issued by commercial banks in denominations of $10,000 or more—comprised 34 percent of all time deposits under $100,000, according to figures released by the St. Louis Federal Reserve Bank. In September 1980, the MMCs now comprised 55 percent of small time deposits, a leap of 20 percentage points in a 12-month span.

Making MMCs so attractive is the fact that in contrast to fixed maximum interest rates paid on passbook deposits, the maximum rate payable on MMCs is tied to the discount rate on newly issued 26-week Treasury bills.

As striking as the shift toward variable rates in small-denomination deposits may be, it characterizes the overall shift in the U.S. credit markets. A structural shift of profound importance is under way as the entire market moves toward both the short side and toward variable or movable rates. These rates are very volatile, as opposed to the stability of long maturities for fixed industrial, agricultural or housing investments.

What this means is that the U.S. credit markets will be much more reflective as a whole of the erratic interest-rate movements in the Eurodollar markets. This linkup of U.S. credit markets to the Eurodollar hot-money flows will be heightened should the establishment of International Banking Facilities (IBFs), proposed by the Federal Reserve Board on Nov. 19 by a six to zero vote, actually be implemented.

In short, the U.S. credit markets are dangerously close to becoming *indexed.* This is the system worked out and tried by economist Milton Friedman in Chile, Argentina and Israel, where basic items—such as cost-of-living adjustments and housing costs—are indexed to the rate of inflation. In Argentina and Israel, the rate of inflation is now triple-digit.

The way this indexation is being applied to the U.S. is the following: As U.S. short-term rates fluctuate upward with inflation, all loan contracts, for items including mortgages and plant and equipment costs, will become in effect indexed to the sharp jump in interest-rate changes. The U.S. will move into hyperinflation.

MMCs represent only the front end of the profound shift in U.S. credit market structures. Other nodal changes in this structure include:

Changes in corporate debt: Corporations have been increasing their short-term exposure for a while now. The net effect is that, while corporate borrowers have usually run toward the commercial paper market in great volume to issue their unsecured IOU's of 270 days or less, the commercial banks are retaliating, as noted by the Nov. 17 *New York Times,* by offering what are called LIBOR loans. These are loans pegged to the London Interbank Offered Rate, which can sometimes be three points below the U.S. prime. Overall, this abundance of short-term instruments, combined with Volcker's credit crunch, has lowered the ratio of bonds outstanding to total bank loans and commercial paper liabilities from 1.5 in 1976 to 1.1 in 1980.

Within the system of corporate bonds there has also been a change. There exist in the corporate bond market denominations called medium-term notes, which have maturities of only 5 to 10 years instead of the 20 to 30 years usually carried by corporate bonds. In 1980, 42 percent of all corporate industrial bonds were of the 5-to10-year variety.

Housing debt: Effective July 1, 1979, savings and loans have been authorized to issue variable-rate mortgages, which are adjustable by 1 percent per year. This was followed when effective April 3, 1980, thrift institutions were allowed to issue renegotiable-note mortgages, which have a 3-, 4-, or 5-year term, secured by a long-term mortgage of up to 30 years, and automatically renewable at intervals.

In the short time this type of mortage has been around, it has become anywhere from 5 to 20 percent of new thrift institution mortgage commitments. The Monetary Control Act of 1980 will give the thrift institutions enlarged powers to issue increased volumes of variable-rate and renegotiable-rate mortgages.

Consumer investment: In addition to the MMCs above, which are a form of consumer deposit, there is the explosion in the growth of money market funds, which are replacing traditional equity investments, and are pegged to the prime lending rate.

Appraising the importance of the change that is occurring in the domain of corporate bonds, in a comment that could be applied to the entire U.S. credit markets as a whole, James O'Leary, chief economist for New York's U.S. Trust, stated Nov. 20: "Many of the traditional investors in long-term fixed rate bonds and mortgages are being forced to sharply cut back their investments in such obligations." He added, "This change isn't cyclical, but long-lasting."

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