

How long can successful
DEFICIT FINANCING
continue
at falling interest rates?

by Melchior Palyi.

How Long Can "Successful" Deficit Financing Continue at Falling Interest Rates ?

By MELCHIOR PALYI

Lecturer in Economics, The University of Wisconsin

Reprint of an article entitled

"IS FUNNY MONEY LIKELY TO LAST?"

which appeared in

AMERICAN BUSINESS, DECEMBER, 1940

By permission of the editor and author



Published and Distributed by the

ECONOMISTS' NATIONAL COMMITTEE
ON MONETARY POLICY

EDUCATIONAL BLDG., 70 FIFTH AVENUE, NEW YORK

MARCH • 1941

SANDERS PRINTING COMPANY • 40 WEST 17TH ST. • NEW YORK CITY

HOW LONG CAN "SUCCESSFUL" DEFICIT FINANCING CONTINUE AT FALLING INTEREST RATES?

FOREMOST in all financial considerations is the interest rate. It affects not only short-term credits and bond prices, but virtually all investments. No financial disposition of any major importance can be made without some assumption about the future rate which money will command. It is, therefore, most important to the investor and to investing institutions and also to businessmen to visualize the fundamental trend of money rates all over the world.

Cheap money rules the world, lowering the rates almost without interruption in practically every country for the last ten years or so. The most curious thing about this trend of falling rates is that it coincides with vastly growing national debts in various countries.

For illustration, take the case of Germany. In 1913 she was one of the world's richest countries, with a balanced national budget and a solid gold standard. Her total public debt was barely more than 12,000 million marks (3 billion dollars), practically all of it of the long-term type, yielding about 4 per cent interest. When the war started the German rate was raised to 5 per cent and it never fell below that level—until a few weeks ago.

Since 1914, Germany had gone "through the wringer" and now finds herself in the Second World War, with living standards badly

reduced and all resources strained to the limit. Her gold is gone, her currency is already heavily inflated, and it is again practically worthless in terms of foreign exchange. The budget is so hopelessly unbalanced that the debt rises at the average rate of 2,000 million marks each month. Then what happens to the price of the bonds or to their yield? Slowly but surely, the price goes up and the yield falls. At the time when (end of July, 1940) the published national debt reached 59,160 million marks, not counting the unpublished debt of probably more than 10,000 million marks, the yield fell, for the first time since 1913, under $4\frac{1}{2}$ per cent. In the face of obvious bankruptcy, Germany's credit seems to be just about as good as it was during her greatest economic prosperity and financial stability.

Is it not amazing that a capital market should act in such a queer way—that is, the more reason there is to get panicky, the more confidence is expressed by rising bond valuations? But the queerest thing is that exactly the same situation prevails in every capital market (and that few seem to notice it).

Choose any country with an unbalanced budget—unbalanced for some time. Going to war and vastly more into debt seems to boost the national credit. Italian bonds in 1938 carried a 5.6 per cent yield to maturity. By the end of 1939, with intense war preparations and an annual deficit of some 6,000 million lire, the yield had fallen to 5.3 per cent, the lowest since Italy's adventure in Ethiopia started, and has further declined since. The official bank rate is $4\frac{1}{2}$ per cent, lowest in Italian history.

Still more spectacular is Japan's case. Over the three years 1937-1939, while moving swiftly toward paper money inflation, the national debt has risen by 11,105 million yens, of which not less than 8,628

millions had been unloaded upon the Bank of Japan and on other financial institutions. At the same time the yield, already reduced previously from 6 to 4 per cent in 1937, decreased to 3.8 per cent, the lowest in Japan's history, and it proceeds further in this direction.

Or, take France. In March of this year (1940), shortly before the breakdown, the note circulation had risen to the all-time peak of 156,000 million francs, as against some 110,000 millions a year earlier, while the gold reserve declined. The national debt amounted already to some 550,000 million francs (!), and the budget for 1940-1941 foresaw a further growth by at least another 220,000 millions (!). And the yield? It was the lowest in many years, namely, about 5 per cent, against $5\frac{1}{2}$ per cent and more in the peace time a few years earlier.

After the first year of the last war, Britain's national debt reached the 1,000 million pound sterling mark. On the eve of the first year of the present war the all-time peak of 10,000 million pounds was passed. And the interest rate? It was 5 per cent at the earlier date, and is 3.29 per cent at present. It is now, with an annual war deficit of at least 2,500 million pounds, where it was in 1913—a time of peace, with a scanty 700 million pounds debts, and with an eternally balanced budget in prospect. It is almost "amusing" to find that the British sell now very short-term treasury paper on a $1\frac{1}{2}$ per cent and lower basis, and use this procedure to a large extent to finance the war, while twenty-six years ago, when there was no British short-term public debt to speak of, the best short-term paper carried $3\frac{1}{2}$ and 4 per cent.

Apparently this is a new age of managed finance, in which the principle that a balanced budget is a better guarantee of the inves-

tor's money than an unbalanced one does not hold any longer. As a matter of fact, one seems better off without than with a balance. The Union of South Africa is not only the world's greatest gold producer but also the one country left over with a balanced budget. South Africa makes almost no war efforts, but registers the highest yields of all "English-speaking" bonds, and has a great deal of difficulty in trying to reduce the rate, while Canada and Australia—both with heavy deficits—came down from 5.4 and 4.8 per cent, respectively, to a comfortable $3\frac{1}{4}$ per cent each. And an agricultural country like Hungary, with a minuscule gold reserve and much trouble ahead, managed to raise her internal debt between 1931-1939 from 136 million pengoes to 1,080 millions, and to lower the net yield on her bonds from more than 17 per cent (!) to a little over 5 per cent.

Needless to say that we are doing "better" than anybody else. When in the last war our national debt rose by some 16 billion dollars, the interest rate went up roughly from $\frac{7}{8}$ to 5 per cent. In those days managed finance had not yet been invented. Since 1929, we added to the debt 25 billion dollars in direct obligations alone, with the miraculous result that the long-term yield declined from 4.26 per cent in 1932 to less than 2.25 per cent—the record low in all known history. And when the Secretary of the Treasury announced the other day that the debt ceiling should be raised so as to extend the deficit by another 20 billion dollars (in direct obligations alone), the market established new highs for the outstanding bonds.

The apparent elimination of the law of supply and demand in the financial field is among the remarkable achievements of the thirties. But is this New Deal in finance likely to last?

Note, in the first place, that in all cases of "successful" deficit-financing at falling interest rates—and the short-term rates are everywhere even more reduced than the long-term yields — the capital market has been more or less completely "isolated" from foreign money centers. British consols are *now* a purely British security, as American government bonds are a purely American investment outlet, to say nothing about the "nationalization" of the French *rentes*, of German or Japanese debt certificates, etc. Every government bond market has virtually lost its interconnection with every other; the once supreme international capital market has practically ceased to operate. Should it ever "reopen," the managed interest rate will face an acid test.

It is management, of course, that interferes with the normal functioning of supply and demand on the credit markets. One used to blame cheap money rates on "the depression"; but they prevail presently also in countries with an inflationary boom like England and Japan. The management consists everywhere in this: (1) Money is printed in sufficient quantities to absorb the bonds; and (2) the investors, and especially the investing institutions, are discouraged from investing in anything much but government bonds. Thus, the demand for the latter is kept artificially at an even keel (or better) with the supply.

How long can such an "upside-down" system of finance last? As a matter of fact, there are two significant limits to its continuation. One is, or would be, an international change of policy, abandonment of cheap money, and a voluntarily raising of interest rates. It is safe to predict that this is not likely to happen in the visible future.

The Achilles-heel of the cheap money system—combined with a growing debt—is due, however, to the necessity of maintaining it by a mounting flow of credit. Sooner or later the painful alternative between raising interest rates or balancing the budget (or else stumbling into a runaway inflation) will have to be faced by each country. But at least, in this country, these possibilities are still pretty remote. In the meantime, we are likely to “enjoy” further the doubtful advantages arising from the accumulation of bigger and bigger public debts serviced at excessively low rates of interest.