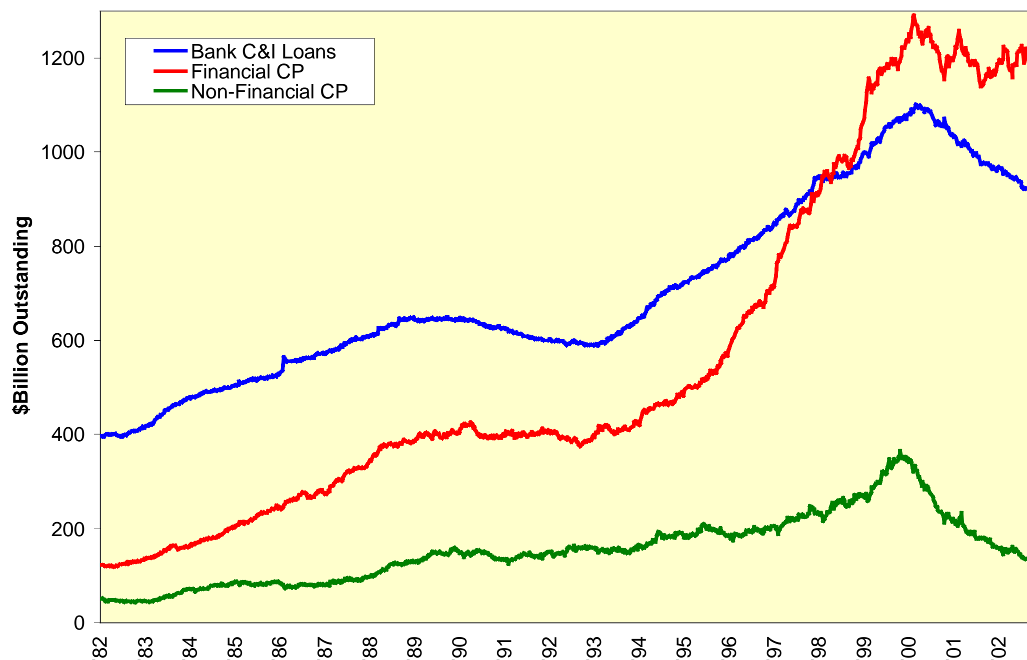
(Commercial) Paper Tigers

Recent comments by various Federal Reserve officials have left no doubt about their intention to maintain the low short-term interest rate environment. And, recent economic data have left little doubt that we are in an economic expansion of some sort; I will sidestep the question of how sustainable this expansion is and may continue to be until the conclusion. Finally, the strong rallies in TIPS, gold, industrial materials, the euro and reported producer prices are sending out signals of impending inflationary pressures.

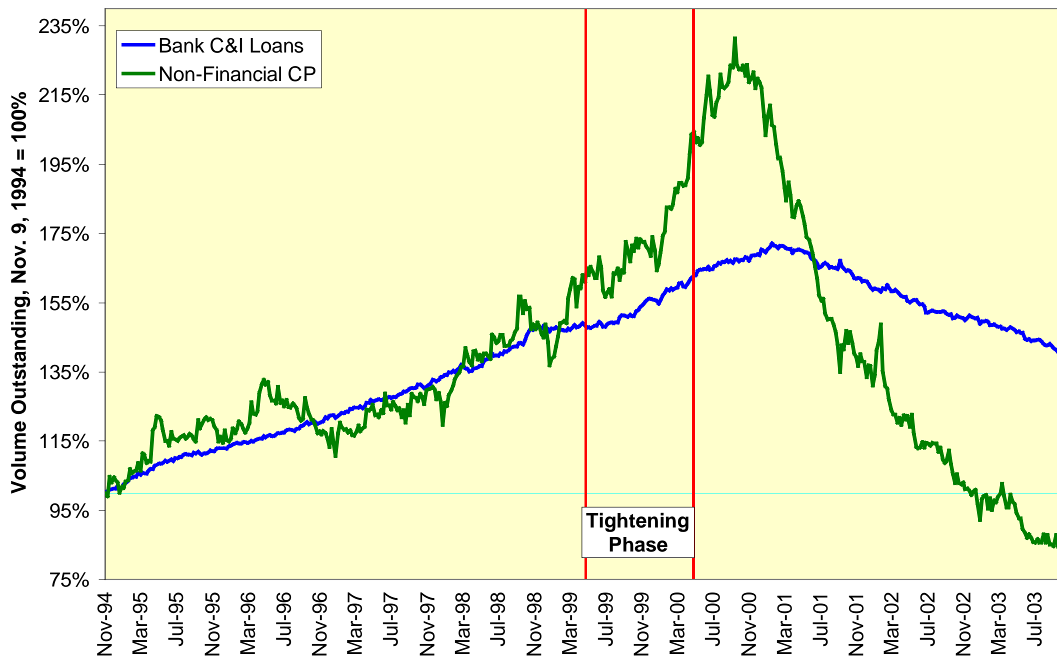
One datum totally inconsistent with these observations is the continued slow growth or contraction, dependent on the measure and time period used, of the various monetary aggregates. One reason for this inconsistency offered recently is the continued growth of the commercial paper as a corporate funding source. Bank loans increase the supply of money and credit when the funds are re-deposited and re-lent. However, non-financial corporate borrowers in the commercial paper market cannot re-lend and thereby expand the supply of credit.

Market Segmentation

Commercial paper issuance can be subdivided several ways: Direct-issue, dealer-placed, asset-backed, and whether the issuer is a financial or non-financial entity. If we trace the growth of commercial paper outstanding divided by whether the borrower is financial or non-financial, and compare it to the stock of bank commercial and industrial loans, some trends become apparent.



First, bank loans still dominate non-financial commercial paper in the amount outstanding by a multiple of almost 7 to 1. The 19.7% decline in outstanding commercial and industrial loans since their peak in January 2001, the very month during which the Fed's rate-cutting campaign began, is and must remain a matter of great concern. But markets operate on the margin. The much smaller non-financial CP market's size relative to bank loans highlights credit conditions since the late 1990s bull market began in November 1994.

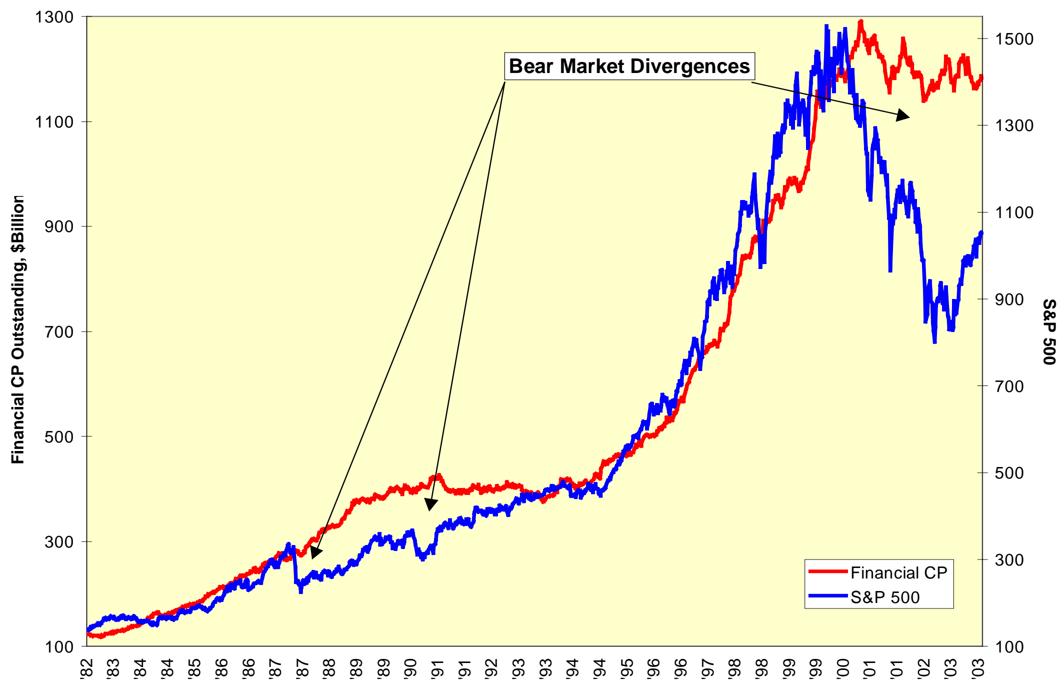


The two financing sources grew in a parallel fashion until the Federal Reserve began raising interest rates in June 1999. As the Fed grew tighter and raised the fed funds rate target from 4.75% in June 1999 to 6.50% in May 2000, corporations were able to tap into a commercial paper market made liquid by the business conditions then prevailing. It is telling that the growth of the non-financial CP market peaked in the third week of September 2000, the very week marking the irrevocable descent into the bear market.

Money For Nothing, Upticks For Free

A second observation derived from the general financing trends noted above is the relative growth rates for the S&P 500 and financial CP. During the 1982-87 and 1995-2000 bullish phases of the stock market, financial firms were willing and able to increase their borrowings in the CP market at a pace rivaling the stock market's growth. The 1987, 1990, and especially the 2000-2002 bear markets saw stagnant CP borrowings by financial firms.

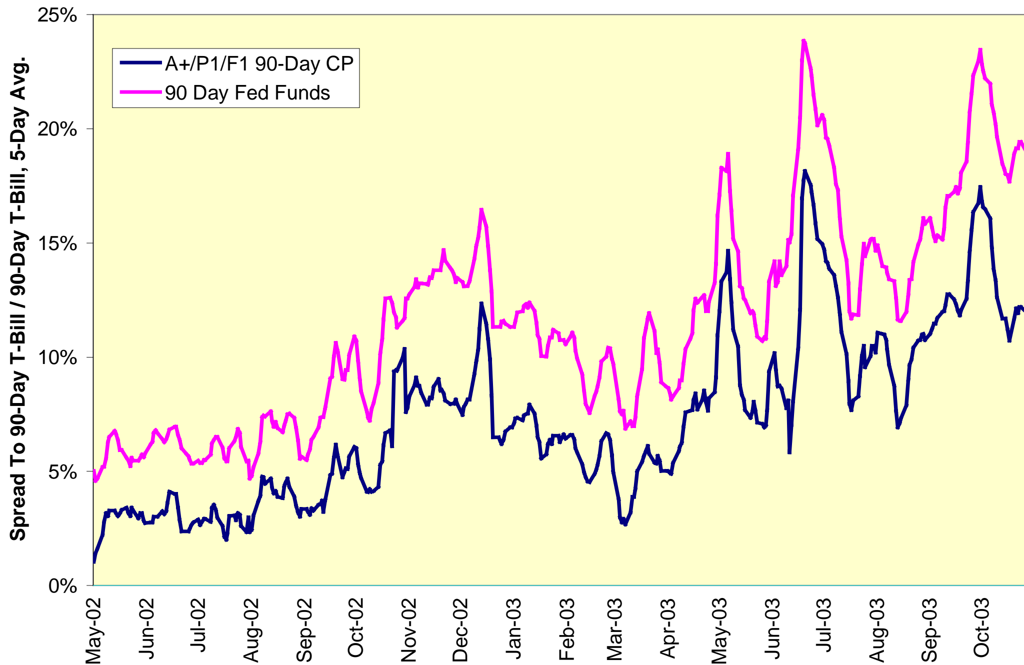
Parallel To A Point



Given the experiences of the past, we should expect to see growth in this CP demand soon. That we have not seen it already may reflect either the relative cheapness of alternative financing sources, or that real financial demand has not yet caught up to levels discounted in the stock market, or both.

The Big Easy. Or Is It?

We all know how the Fed has pushed down the overnight funds rate to 1.00%, a rate of limited utility to all those whose investment horizon is greater than overnight. Once we head out on the money market curve, the term funds rate and the commercial paper rates, both of which are unsecured, should reflect both supply/demand factors and credit assessments. Once we get to the 90-day horizon, the spreads of these two rates to the 90-day T-bill rate, taken as a percentage of the T-bill rate, should reflect a risk premium in the money market.



This risk premium measure has been on a gradual if erratic trend higher over the past eighteen months. It would be difficult to interpret this as the result of strong demand for funds as we have seen that both bank lending and CP lending have been on the decline during this period. And it would be equally difficult to interpret this as the result of increased risk aversion in the financial system: All longer-dated credit spreads for instruments as diverse as emerging market debt, high yield bonds, syndicated bank loans and speculative stocks have narrowed, especially since October 2002.

The one remaining explicatory variable for these greater money market spreads, soft loan and CP demand and the lagging money supply is the quantity of money itself. Here the Federal Reserve faces the same dilemma its predecessors faced during the early days of the Great Depression and later the Bank of Japan faced in the 1990s, and that is how to distinguish a low price of money from an adequate supply of money. While an overnight rate of 1.00% may look cheap, it may not be evidence of easy credit conditions in the absence of a growing money supply. It is, however, evidence of slack credit demands. We can excuse slack credit demands as the result of excess capacity in a post-bubble environment, but like all excuses this cannot last forever.

Until we see growth in the money supply and in credit demand from the channels of both commercial paper and bank lending, we will need to view the strong economic data as artifacts of fiscal stimulus. In other words, the economic recovery is not yet self-sustaining.