Living with an Inelastic Bond Market

I.

Many Americans, including some who are unquestionably knowledgeable about U.S. capital market (1), were disturbed by the recent forecast of a $ 12 billion government deficit in the fiscal year 1958-59 on the ground that such an amount could not be financed without substantial new government borrowing from the banks. In other words, the public might not absorb government paper on anything like the required scale.

On my side of the Atlantic too, similar anxieties are frequently entertained about the absorptive capacity of the London market. Speeches in recent years by the Governor of the Bank of England have stressed his concern to unload government securities on the public (2), and frequently this task has apparently seemed to him anything but easy to accomplish.

If anxieties of this nature are entertained in the U.S. and the U.K., with their highly developed security markets, it is not surprising that they are also entertained elsewhere. It is in fact a very prevalent view the world over among officials concerned with marketing government securities, that the market for them is limited, and moreover on occasions so limited as seriously to impede the implementation of monetary policy.

Such an attitude among practical men tends to come as a surprise to academic economists, who are inclined to say: "If you cannot sell all the securities you want to, this simply means that you are not offering a high enough yield". It seems inconceivable that the public's demand for securities should have a nearly zero elasticity. Yet such is apparently the typical view of the practical

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(1) E. g. Senator Prescott Bush.

(2) E. g. his speech at Ipswich on October, 11, 1957, reported in the December 1957 issue of the Journal of the Institute of Bankers.

man: he does not just think that the market is limited at the prevailing price, he thinks it is limited at *any* price. Moreover, his actions are of a piece with his views; very rarely does one come across cases where the authorities deliberately tempt buyers by the offer of a higher yield (3).

Who are right, the academic economists or the practical men? I do not claim to be able to supply the answer. All I hope to do is to clarify some of the issues at stake.

II.

May I first assign labels to the main *dramatis personae*? By " the Authorities " I shall mean the central bank plus the central government and its agencies, taken on a consolidated basis; by " the Banks " I shall mean the commercial banks, plus in Britain the discount houses, likewise taken on a consolidated basis; and by " the Public " I shall mean everybody else.

The transactions with which I shall be mainly concerned are transactions in marketable securities between the Authorities and the Public. The Banks are however interested third parties to such transactions, for they cause changes in the Banks' liquid assets or offset changes which would otherwise have occurred.

Here, then, is the first issue I want to raise: if the market for government securities among the Public is inelastic, the Authorities may lose control of the liquidity of the Banks. For the Authorities have to do a lot of borrowing and lending, and the flow of their new borrowing is inevitably subject to large and erratic fluctuations. There are fluctuations in the balance between current expenditures and tax receipts, fluctuations in capital expenditures, fluctuations in the flow of maturities, fluctuations in the movement of international reserves, and there is no reason why these fluctuations should cancel out. In fact, as we well know, they do not. Thus unless the market for government securities among the Public is sufficiently elastic to take care of these fluctuations, they will be reflected as fluctuations in the amount of cash or other liquid assets held by the Banks. Moreover the latter case (where the banks act as residual buyers

(3) One such case was the Swedish government's offer of 4 per cent long term bonds in 1954. I am indebted to Professor E. Dahmen for bringing this example to my attention.

of government paper) is hardly a possibility unless such paper is made almost as liquid as cash by a willingness on the part of the central bank to act as an *automatic* lender of last resort.

It therefore follows, I believe, that if the Public's demand for government securities were in fact highly inelastic, this would explain why the Authorities cannot readily discipline the Banks by regulating the availability to them of cash or liquid assets. Hence the frequent recourse to other devices. In Australia, for example, the Authorities make use of Special Accounts (4), in England they have recently concocted a scheme for Special Deposits (5), and other examples of similar devices abound throughout the world.

III.

Though it is the market among the Public for government securities *of all maturities* which is relevant to the issue I have just raised (*i.e.*, the disciplining of the Banks), it is for most other issues the market for longer maturities (for bonds rather than for bills) which is relevant.

One such issue is the ability of the Authorities to control the liquidity not of the Banks but of the Public. Control of the latter's liquidity requires of course the control of the former's, in that an increase in the Banks' holding of liquid assets will lead to an increase in the Public's holding of bank deposits. But a control of the liquidity of the Bank achieved by the government limiting the issue of bills to them and to the central bank, but issuing more bills to the Public, cannot do more than obviate a *secondary* expansion in the Public's holding of liquid assets; it clearly will not obviate the *primary* increase. To obviate *any* increase in the Public's liquidity the government has to sell to the Public bonds instead of bills.

Thus controlling the Public's liquidity is more difficult than controlling the Banks' liquidity, in that the latter only requires that the market among the Public for *either* bills *or* bonds should be adequately elastic, whereas the former requires an elastic market specifically for bonds. Admittedly most countries do not have an

(4) See Professor H. W. Arndt's article on " The Special Account Procedure as a Technique of Central Bank Control ", in the December 1956 issue of this *Review*.

(5) See *The Banker*, August 1958, p. 493.

elastic bill market, or even a bill market of any kind, so for them an elastic bond market is needed for either objective, but at least in the U.S. the habit of holding bills is so widespread that one would expect the market to be adequately elastic, though even in this case doubts are sometimes expressed as to whether this is always so.

It might here be objected that if the U.S. bill market is widespread, the U.S. bond market is even more so, and must therefore be even more certainly elastic than the bill market. But this inference neglects the consideration that weighs most heavily with those who lack confidence in the market's elasticity, namely the belief than an increase in yield will cause the investor to become less optimistic about the possibility of capital gain and more pessimistic about the possibility of capital loss. For this consideration clearly applies with relatively much less force to bills than to longer maturities, since the capital value of a bill is relatively firmly anchored to the value at which it will mature after only a few months' or even weeks' delay. Thus there is on this account a greater likelihood of inelasticity in the U.S. bond market than in the U.S. bill market.

What of course the believers in an inelastic bond market have still to explain is why they think that investors' expectations may react perversely to an increase in yield. It is far from self-evident that a fall in bond prices today should be thought to increase the likelihood of a fall tomorrow, and I for one would like to see more evidence in support of this proposition before being prepared to accept it.

Another question I would like to put to the believers in an inelastic bond market is: "Is it inelastic to purchases as well as to sales of bonds by the Authorities?". For experience shows (*e.g.* in Britain at the time of Mr. Dalton's cheap money drive in 1946) that the Authorities apparently *purchase* bonds in a highly elastic market: the Public has to be enabled to switch out of bonds into liquid assets on an enormous scale to achieve only a modest reduction in the yield on bonds. Are we then to infer that the Public's liquidity preference schedule is kinked, being always highly elastic at yields below whatever happens to be the ruling yield and highly inelastic at higher yields? Or is it a continuous curve but so shaped that its elasticity falls off rapidly beyond a certain critical point?

IV.

In formulating my questions in terms of a Keynesian liquidity preference schedule, maybe I am begging another question. Are the dollars which the Authorities attempt to catch with their bond issue sitting birds or birds on the wing? A Keynesian approach surely implies that they are sitting birds; that the Public owns a stock of dollars and must be tempted to exchange some of them for a stock of bonds. If we look at the matter in this way, we shall have confidence in the elasticity of the bond market in so far as we believe that there are pools of money lying around which can be siphoned off by the offer of a high enough yield. One consideration which ought perhaps to encourage our confidence in this regard is the large size of the total stock of money (currency and bank deposits) in the hands of the Public. In the U.S. and the U.K., and in most other advanced countries, the money stock is so large in relation to the annual G.N.P. that one cannot reasonably believe that all of it, or even the greater part of it, is actively in use as a means of exchange: a very large amount must be held as a store of value. But who holds it, and why? Keynes tried to persuade us that some of it was held for precautionary purposes and the rest for speculative purposes, and that the latter holdings are large and elastic to the rate of interest. But what evidence is there that such is the case? Clearly very little — so little indeed that several economist friends of mine remain highly skeptical.

One of them, Dr. Ronald Henderson, is a convinced adherent of the view that the bond market is *not* inelastic, but maintains that one cannot do justice to this point of view within the framework of a static model in the Keynesian tradition (6). He contends that the dollars which the Authorities ought to be trying to capture by the offer of an adequate yield are dollars on the wing, that the aim of the Authorities must be to divert toward themselves a higher proportion of the flow of the Public's current savings. The immediate consequence of such a diversion would be to starve financially all other transactors relying for their finance on their access to the capital market, and thus to force them to operate on a smaller float

(6) See his review of Professor R. S. SAYERS, "Central Banking after Bagehot" in the March 1958 issue of the *Economic Journal*.

of ready cash. The eventual consequence of the diversion of funds would of course be to starve the other borrowers into curtailing their expenditures, *i.e.* there would be a reduction in total effective demand for goods and services. But this eventual outcome could be avoided (if it were thought undesirable) by a timely reversal of policy: the Authorities would up to a point compete vigorously for a higher proportion of the flow of current savings, but thereafter set a more sedate pace.

All this is in a sense idle speculation, since we just do not know the facts. For there is very little relevant information even in the U.S. (and even less for the U.K.) on what funds flow into the capital market (7), and on whose initiative, and for what motives, so we cannot get very far in estimating how the flow would change if bond rates were higher.

V.

The next question I want to put is: Does it matter if the bond market *is* inelastic?

Now in certain respects an inelastic bond market might be considered a positive advantage, rather than a disadvantage. For, first, it might be thought that if the market for bonds is inelastic, this shows that the existing stock of money is firmly held and is unlikely to emerge from its hiding place at some highly inconvenient moment and start chasing after goods and services. I must confess, however, that I do not find this line of argument wholly reassuring. I suspect that money and other liquid assets can get into the product markets by routes other than the bond market: the fact that pools of liquidity cannot be tapped by an attractive bond issue does not prove at all conclusively that they will not overflow into the product markets, either directly or *via* the equity market.

A second line of argument in praise of an inelastic bond market is that it facilitates the control of inflation, in that with such a market it is easy for the Authorities, by making relatively small sales of bonds, to force their price down and their yield up, thereby impoverishing the existing holders and making new borrowing more expensive. This line of argument is sound enough, with the proviso

(7) Flow of funds statistics are not so far prepared in sufficient detail to be very useful for our purposes.

that you cannot impoverish bondholders unless there are bondholders to impoverish, *i.e.* this particular deflationary brake will have little to grip on unless the Authorities have in the past succeeded in placing a considerable volume of bonds with the Public.

The *dis*advantage of an inelastic bond market can be described in very general terms by saying that it is desirable for the Authorities to have some control over the liquidity of the Public. Most of us would probably agree with a formulation as general as this, but disagreement would begin as soon as we tried to be more specific. Is it, for instance, appropriate to engineer contra-cyclical fluctuations in the Public's liquidity? Or is it sufficient to ensure that the growth in liquidity has a fairly steady trend, more or less in line with the secular growth in real G.N.P., in money G.N.P., in total assets, or in some other macro-economic stock or flow? And if so, which stock or flow is the best guide to the optimum trend growth in liquidity? Or can excess liquidity best be detected by looking at market rates of interest and market prices of securities — and if so, which rates and which prices? Or, finally, does it not matter much how liquidity increases, provided that it does not increase astronomically or fluctuate violently? I leave these questions unanswered.

VI.

Now I come to my last question: Supposing that the bond market *is* inelastic and that the Authorities judge that there is a persistent tendency for the Public to become unduly liquid, what are the implications for monetary policy? My advice to the policy-makers would be on the following lines:

(i) Do not despair prematurely when the market responds weakly or even perversely to an offer of a higher yield; be prepared to take a long view, for the elasticity is likely to be much greater in the long run (when the flurry caused by the change in yield has subsided) than in the short run.

(ii) As a corollary to this: do not be diverted from your objective by business fluctuations. Give up all idea of contra-cyclical national debt management and try to deal with the trade cycle by using other (and more practicable) devices.

(iii) Use your authority to keep short term rates low, particularly the rates on time deposits and bills: bribe the Public to be illiquid, not to be liquid. Of course you cannot allow too wide a gap to persist between short and long rates or you will run into difficulties due to the temptation you thereby offer to private borrowers to borrow short instead of long, but experience suggests that you can probably get away with an average gap of about 3 per cent per annum between the rates on bills and on perpetual bonds. Low short rates may also cause difficulty in encouraging stockpiling when you would prefer that it did not occur, so you cannot go in for low short rates regardless of circumstances. But the general presumption is that short rates should be low and that the burden of proof is with anyone who wants to raise them.

(iv) Do not hesitate to nurse the market. This is what a good issuing house should do for its clients, so why should it be wrong for the Authorities to follow suit? Such was at any rate the view of the British Authorities, for their abandonment of ultra-cheap money in early 1947 did not drive them to the extreme of the "bills only" doctrine: the Government broker has constantly been in the market to buy up maturing issues, to underwrite new ones and to iron out excessive price fluctuations, but always when he has gone in he has succeeded in getting out again. Such temporary interventions may well be desirable in any case, but are almost essential if the bond market is inelastic.

(v) A possible second best to what I have just described may be the issue of bonds on demand through the tap at a published price, instead of in predetermined amounts.

(vi) There are a number of other gimmicks which deserve consideration. Bonds with a maturity value indexed to commodity prices, such as have frequently been issued in France, are not to be ruled out, if investors are frightened of inflation. Nor, if investors are deterred by the fear of rising yields in the future, should one rule out the possibility of promising an increase in the coupon rate if higher yields are offered on future issues. Thirdly, the gimmick might be tried of offering bonds for sale forward. And lastly, attempts might usefully be made to convert bonds ahead of maturity.

This last point is rather a hobby horse of mine. It seems to me that the formidable technical difficulty in all conversion issues is that the holders of the maturing issue and the prospective holders

of the new issue are only rarely one and the same. This is because the former is someone in need of a liquifying asset, while the latter is in need of an asset with a more distant maturity. How much easier it would be if the holder in 1958 of a bond maturing in 1968 were allowed to convert *now* to a bond maturing several years later, for the likelihood is that such a change in maturity would well suit his needs; indeed, the conversion offer would probably give him quasi-automatically the change in maturity he would otherwise have to seek by switching in the market.

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