

Dynamics
of Forecasting
Financial Cycles
Theory, Technique and
Implementation

by LACY H. HUNT, PH. D.
Vice President and Economist
Fidelcor, Inc. and The Fidelity Bank
Philadelphia, Pennsylvania

Foreword by Professor ROBERT A. KAVESH
Graduate School of Business Administration
New York University



JAI PRESS
Greenwich, Connecticut

CONTENTS

Foreword	vii
Preface	ix
Acknowledgments	xii
Table of Tables	xvi
Table of Graphs	xx
Table of Equations	xxiii
I Introduction	3
WHAT IS THE FINANCIAL CYCLE?	3
THEORETICAL AND INSTITUTIONAL CONSIDERATIONS	4
A FINANCIAL FORECASTING MODEL	5
II Theoretical and Empirical Relationships	
Underlying the Financial Cycle	12
MONETARY POLICY	12
Alternative Reserve Aggregates	15
<i>Monetary Base</i>	15
<i>Total Reserves</i>	18
<i>Nonborrowed Reserve Measures</i>	21
<i>Reserves Available For Private Nonbank Deposits</i>	23
Monetary Aggregates	24
<i>Narrow Money Stock</i>	25
<i>Treasury Deposits</i>	28
<i>Broader Money Measures</i>	34
THE TREASURY'S FINANCIAL OPERATIONS	38
Measuring the Budget	38
<i>Treasury Cash Balances</i>	43
<i>Publicly Held Government Debt</i>	44
Financing Federal Agencies	49

III Economic Conditions and Financial Markets	55
CYCLICAL TURNING POINTS IN BUSINESS AND FINANCIAL INDICATORS	55
Money and Capital Market Yields	55
Business Credit Demands	61
Reserve and Monetary Aggregates	61
Total Credit Flows	63
Bank Investments	70
Treasury Financing	73
MONEY MARKET CONDITIONS: TWO RECENT EXAMPLES	79
INTERNATIONAL INFLUENCES ON FINANCIAL MARKETS	84
Foreign Demand for Treasury Securities	84
Abolishment of U.S. Capital Controls Program	86
Growth of Foreign Financial Markets	89
IV Forecasting the Narrow Money Stock and Commercial Bank Assets and Liabilities	96
OVERVIEW OF THE MODEL	96
Structural Relationships	96
Econometric Procedures	102
REGRESSION EQUATIONS	103
The Narrow Money Stock, Nonbank Holdings of Currency, and Consumer-type Time Deposits at Commercial Banks	103
Large-denomination CDs, Borrowed Reserves and Other Liabilities of Commercial Banks	114
Commercial Bank Loans	123
Commercial Bank Investments and Excess Reserves	131
V Forecasting Asset and Liability Items of the Thrift Institutions, Corporations, Municipal Governments and Others	142
REGRESSION EQUATIONS	142
Thrift Institution Deposits	142
Nonbank Commercial Paper	145
Corporate Bonds, Municipal Bonds, Government Debt, and Mortgages	149
Foreign Sector	157
IDENTITIES IN THE MODEL	160
The Total Debt and Liquid Asset Proxies	160

VI Forecasting Domestic Money Market Yields	165
REGRESSION EQUATIONS	165
The Federal Funds Rate	165
The Three- and Six-Month Treasury Bill Rate	176
The Rate on Negotiable CDs, Commercial Paper, and Prime Commercial Bank Loans	180
The Discount Rate of the Federal Reserve Bank of New York	188
VII Forecasting Long-term Yields and Key Foreign Interest Rates	192
REGRESSIONS FOR DOMESTIC LONG-TERM BOND YIELDS	193
Newly Issued "Aa" Utility and Industrial Bonds	193
<i>Real and Nominal Corporate Bond Yields</i>	196
<i>The Gibson Paradox and the Fisher Effect</i>	199
Intermediate and Long-term Government Security Yields	203
The Mortgage Yield and Government National Mortgage Bonds	206
Yield on Long-term Municipal Bonds	208
REGRESSIONS FOR MAJOR FOREIGN MONEY MARKET RATES	211
Eurodollar Rates	211
The U.K. Interbank Rate	212
The U.K. Treasury Bill Rate	214
German Interest Rates	216
VIII Forecasting With A Financial Model	220
MODEL RELATIONSHIPS	220
DYNAMIC PROPERTIES OF THE MODEL	224
Multipliers	224
Model Simulations	244
<i>Thirteen One-month Simulations</i>	248
<i>A Thirteen-month Simulation</i>	255
<i>Concluding Remarks on the Simulations</i>	265
IX Policy Implications	273
Appendix A	278
Appendix B	284
Index	290