Recent Developments in the Capital Markets

The continued advance of economic activity has led to a considerable intensification of pressures on the nation's capital markets during the past several months. Overall demands for funds have attained record levels, and yields on long-term obligations of corporations and governments have risen strongly to postwar highs following a period of comparative stability which had begun in late 1961. Home mortgage rates have also increased sharply, after having remained virtually unchanged at reduced levels in 1964 and most of 1965, as depository institutions specializing in mortgage lending found it increasingly difficult to attract and retain interest-sensitive savings accounts in the face of higher yields available elsewhere. While commercial bank credit has continued to expand at a rate only modestly reduced from last year's rapid pace, the total volume of funds available through financial intermediaries as a group has not kept up with overall credit demands. At the same time, direct (unintermediated) market lending by businesses, households, and governments has recently assumed a major role in financial flows for the first time since 1960. In this environment, many borrowers have found it necessary to resort to other than their normally preferred sources of credit.

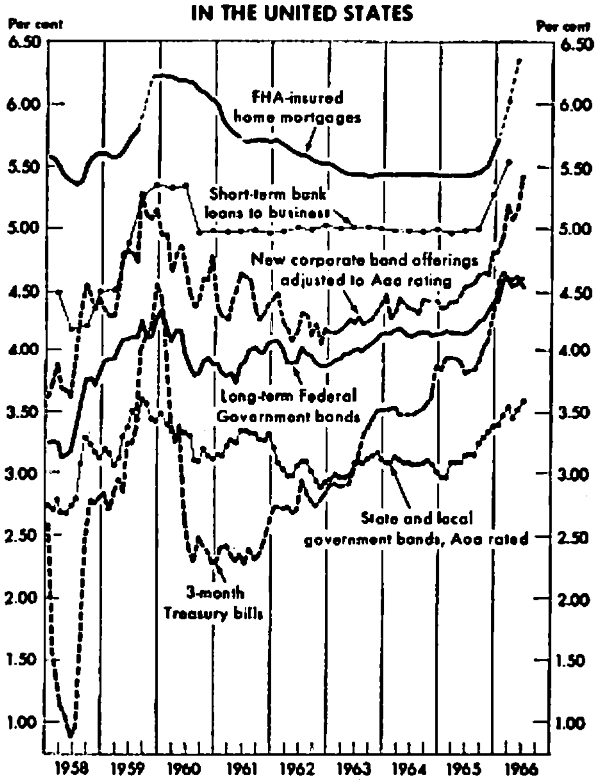
BUSINESS FINANCE

Despite continued growth in internally generated funds, business firms are now experiencing exceptionally large cash requirements, and are relying increasingly on the capital markets for additional funds. This is true although capital market rates have risen substantially (see Chart I), as has the cost of bank loans. Corporate income tax payments, which were speeded up considerably in 1964, were accelerated further beginning April 15 of this year. According to Treasury Department estimates, the adjustment in tax payment schedules added about $3.2 billion to the total tax remittances of businesses in April and June of 1966. In addition, beginning June 20, large employers were required to make more frequent payments to the Treasury of both social security contributions and withheld individual income taxes, drawing off an estimated additional $1.3 billion of business working capital. Moreover, while internally generated funds had exceeded business fixed investment earlier in the expansion (at times by a substantial margin), this net source of long-term corporate funds was eliminated during the past year by the continued sharp rise of plant and equipment spending (see Chart II).

The major supplier of funds to finance these expanding capital needs has been the long-term corporate securities market. Estimated total gross new issues of corporate bonds during the first half of this year amounted to $7,875 million, $1,175 million higher than the total in the corresponding period of 1965 and the largest volume of bond flotations during any half-yearly period in the past eleven years—including the period of the 1955-57 capital-spending boom. According to preliminary figures, *net* bond issues also expanded, at a rate considerably faster than the previous record increase in 1961. At the same time, the supply of funds available for investment in bonds has become less plentiful at those financial institutions which traditionally have offered major support to the corporate bond market. Since the beginning of 1965, direct placement of corporate securities with insurance companies and other institutional investors has not grown so rapidly as publicly offered issues. Faced with the heavy volume of bond offerings thus far this year, life insurance companies have not been able to keep pace with corporate borrowing demands and consequently appear to have run up an unusually large backlog of forward commitments, tying up their investment funds for some time to come. Moreover, a larger than seasonal increase in policy loans at some life insurance companies may have placed an additional strain on their cash flows.

With the sharp rise in publicly offered issues, yields on new underwritten corporate bonds have advanced to record postwar levels (see Chart I). Similarly, the spread between underwriters' offering rates on new corporate bonds and market rates on outstanding corporate and Treasury issues has recently approached levels attained in the 1959-60 period of peak interest-rate pressures.

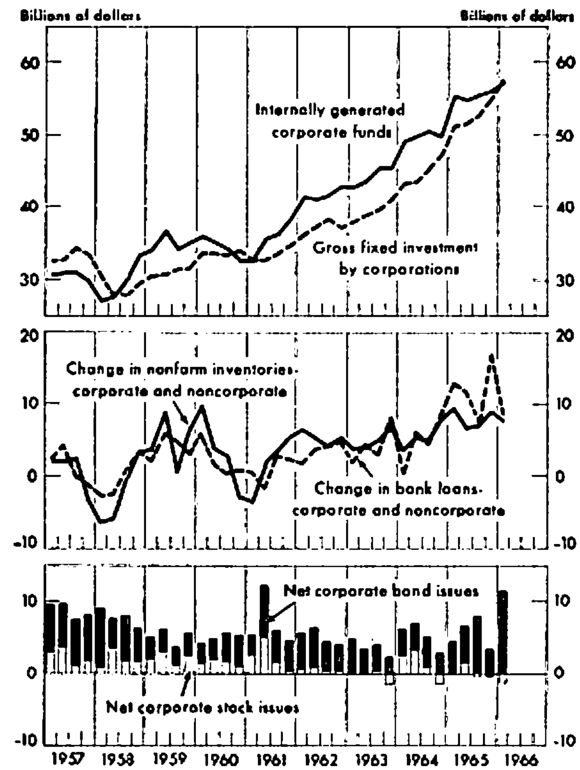
Chart I
THE STRUCTURE OF INTEREST RATES IN THE UNITED STATES



Note: Bank loan data are plotted through March 1966, mortgage yields through May, all other series through June.

Sources: Board of Governors of the Federal Reserve System; First National City Bank of New York; Moody's Investors Service.

Chart II
COMMERCIAL AND INDUSTRIAL BUSINESS INVESTMENT AND FINANCING



Note: All figures are seasonally adjusted annual rates. First-quarter 1966 figures are preliminary estimates.

o Indicates net total of bond and stock issues for the fourth quarters of 1963 and 1964 and third quarter 1965 through first quarter 1966.

Source: Board of Governors of the Federal Reserve System.

Net new issues of common and preferred stock remained virtually zero in the first quarter. Gross new stock issues rose substantially, but conversions of outstanding preferred issues into bonds and repurchases of common stock for corporate-administered pension funds and employee stock option plans again apparently provided more than an offset. Nevertheless, the fact that gross new stock issues have recently increased provides some additional evidence of the enlarged need of corporations for long-term funds.

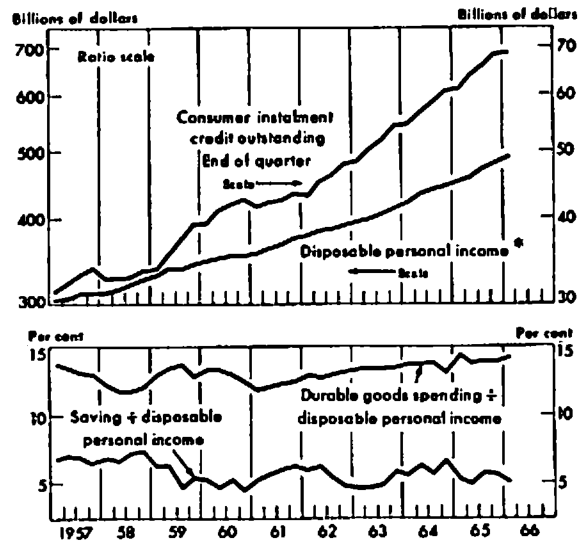
Faced with substantial cash drains and with a sizable rate of inventory expenditures (see Chart II), nonfinancial businesses have continued to place considerable demands on the commercial banks for short- and intermediate-term loans, despite the rise in commercial bank prime lending rates last December, in March, and again in June.

Bank loans to businesses have grown about as rapidly so far in 1966 as the 19 per cent rate for 1965. Also, many large corporations have turned to the commercial paper market for additional short-term credit, as bank borrowing costs have risen relative to this alternative.

There are signs that funds for smaller businesses are also in short supply. Trade credit borrowing by noncorporate business has recently expanded at a rapid pace, with an even larger increase in corporate trade receivables. Thus, nonfinancial corporations with greater access to commercial banks and the capital markets are apparently being called upon to finance more of the short-term needs of their smaller noncorporate customers. Moreover, perhaps also reflecting reduced availability of bank credit to many borrowers, finance companies increased their business lending volume by almost $1½ billion in the first quarter of 1966, the largest quarterly increase in over fourteen years. Judging from their current heavy borrowings at commercial banks, finance companies most probably have continued to extend a substantial amount of business credit to small- and medium-sized firms in the second quarter of the year.

Chart III

INDIVIDUALS' BORROWING PATTERNS



* Seasonally adjusted annual rates.

Sources: Board of Governors of the Federal Reserve System; United States Department of Commerce.

CONSUMER FINANCE

Although the increase in social security taxes at the beginning of the year has restrained the growth of take-home pay of individuals, consumer spending nonetheless continued to grow strongly through the first quarter of the year. As a result, saving in the first quarter declined to 5.0 per cent of disposable income, $\frac{9}{10}$ of a percentage point below its 1961-65 average (see Chart III). Perhaps partly due to anticipation of the reimposition in mid-March of automobile excise taxes, total consumer spending on durable goods absorbed a higher proportion of income in the first quarter of the year than in 1965, and instalment credit, which usually finances much of such expenditures, grew significantly. This pace of consumer borrowing has not carried over into the second quarter, however. Undoubtedly, the recent slowdown in automobile sales has reduced the demand for instalment credit, but credit supply conditions may also have been a limiting factor. Thus, as credit conditions have gradually tightened, lending at commercial banks has become progressively more selective in all areas—including loans to consumers. Moreover, small consumer finance companies have also reportedly been experiencing some difficulty in meeting applications for instalment loans. The extent of these developing pressures on the supply of consumer credit was reflected in recent increases of bank rates on this type of loan.

The supply of mortgage credit to home buyers is also currently under pressure in many regions of the country. Following an earlier three-year decline, market rates on mortgages remained remarkably stable during 1964 and the first half of 1965. But since mid-1965 these rates have increased markedly, and the rise in the past few months has been especially sharp (see Chart I). The explanation for this development can be found primarily in the changing pattern of individuals' holdings of financial assets as the structure of interest rates has altered. Those thrift institutions which are the major suppliers of home mortgage loans—savings and loan associations and mutual savings banks—had for many years been able to offer their depositors interest rates which were highly competitive with, if not superior to, rates available to individuals on alternative investments. But since mid-1965, when open market rates began to move up, the competitive position of these financial intermediaries has been gradually impaired. Thus, while their deposit rates have changed little in the past twelve months, yields on prime-grade marketable securities have risen by as much as ½ to ¾ of a percentage point.

At the same time, commercial banks, due to the relatively short maturities of their loan portfolios, have been able to keep the rate of return on their earning assets closer to prevailing market interest rates than have other depository institutions. This, in turn, has permitted banks to remain more competitive in the rates they can offer on time deposits of businesses and savings certificates of individuals. (On the other hand, commercial banks are restricted under Regulation Q to a 4 per cent maximum rate on passbook savings accounts.)

The result of the generally diminished competitiveness of savings and loan associations and mutual savings banks has been a shifting of interest-sensitive funds away from these institutions and a resulting contraction in the supply of new mortgage credit from these important sources. Even though individuals have continued to put record amounts of new funds into these thrift institutions, others have withdrawn deposits in record volume. In view of the estimated all-time high of a $3.3 billion increase in consumer holdings of marketable securities during the first quarter, practically as large as in all of 1965, a substantial portion of the funds withdrawn from thrift institutions has evidently been placed directly in market instruments rather than in the fixed-claim assets of other intermediaries.

GOVERNMENT FINANCE

Despite sharply rising revenues, state and local governments have made exceptionally heavy demands on the capital markets thus far in 1966. These borrowers marketed $2.9 billion of new bond issues (gross) in the first quarter, the largest first-quarter amount on record, and are estimated to have issued another $3.2 billion in the second quarter as well. At the same time, commercial banks reduced substantially their net purchases of state and municipal bonds, thereby removing much of the important buying support they had given to this market in earlier years. As a result, market yields on these bonds were breaking into new high ground for the postwar period during March, and individuals, partly through bank-administered trust accounts, apparently purchased the bulk of the supply of net new tax-exempt issues brought to market in the first quarter of the year.

The Federal Government has also exerted pressure on the bond markets in 1966 despite larger than anticipated tax receipts. To be sure, the current calendar half year represents a period of seasonal debt repayment by the Treasury, and redemptions have been larger than usual this year. However, offerings of securities by Federally sponsored agencies have been exceptionally heavy. Agency borrowing amounted to an estimated $3,368 million in the January-June period, an increase of $2,259 million over the comparable period of 1965. Sales to the public of participations in Federal loans have totaled another $2,201 million thus far this year, more than twice the amount offered in all of 1965. The Federal National Mortgage Association increased its outstanding indebtedness by $764 million in the first three months of the year to finance the largest quarterly volume of mortgage purchases in the 11½-year history of its mortgage market support operations. Also, the sharply reduced net growth of deposits at savings and loan associations, discussed earlier, prompted these institutions to seek record amounts of borrowing from the Federal Home Loan Banks. These banks, in turn, found it necessary to raise $1,088 million of new funds during the first six months of the year in the short and intermediate sectors of the financial markets.

These numerous agency financing operations had a considerable tightening effect in markets already strained by record corporate and state and local borrowing, especially since agency issues compete relatively directly with some types of private securities. Moreover, the clustering of agency issues in the shorter term area of the market has contributed to the especially sharp rise of interest rates in the one- to five-year maturity area relative to other segments of the maturity spectrum.

New long-term borrowing by the Treasury has been severely restricted by the recent substantial increase in Government bond yields to levels exceeding by a wide margin the 4¼ per cent legal ceiling for coupon rates on securities of five years or longer maturity. With Treasury financing operations confined entirely to short- and intermediate-term issues, the average maturity of the public debt has been shortened somewhat from five years at the close of 1965 to an estimated four years eleven months as of the end of June.

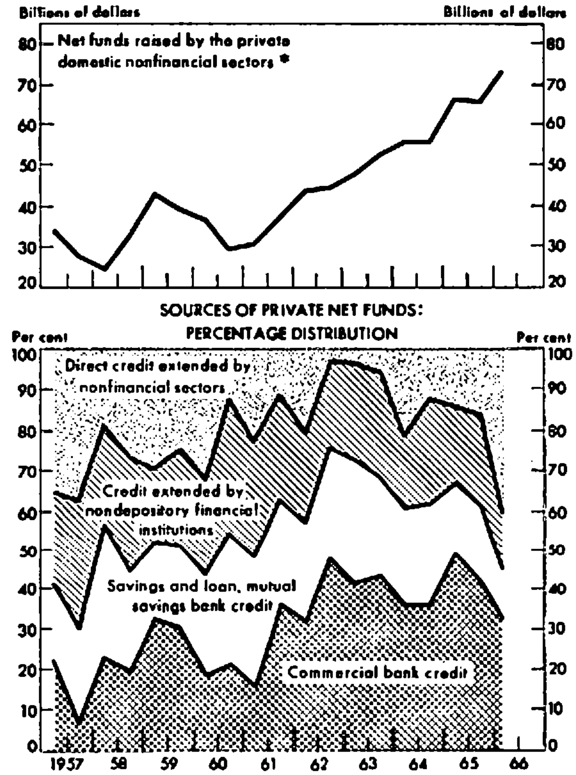
ROLE OF THE BANKING SYSTEM

Commercial banks continued to be important suppliers of funds to the capital markets in 1966. But, with the gradual tightening of bank credit conditions, the relative importance of banks in total credit growth declined somewhat and significant shifts of emphasis were apparent in banks' portfolio decisions.

Total bank credit appears to have grown only somewhat less rapidly over the first six months of this year than the 10 per cent annual rate of increase posted for the year 1965. Nevertheless, the recent tightening in credit conditions has been partly reflected in the fact that banks liquidated even more of their United States Government securities in the January-June period of 1966 than the large $6.1 billion reduction in the like period a year ago. Moreover, as mentioned earlier, bank purchases of the securities of state and local governments were reduced rather sharply from previous levels. Whereas bank pur-

Chart IV

PRIVATE SECTOR BORROWING



Note: Figures are semiannual averages, seasonally adjusted at an annual rate. Latest data plotted are preliminary estimates for first quarter 1966.

* Households and nonprofit organizations, nonfinancial businesses, and state and local governments.

Source: Board of Governors of the Federal Reserve System.

chases of state and local obligations in the earlier years of the current economic expansion ranged between 60 per cent and 90 per cent of the annual net new issues of these securities, in the first quarter of 1966 this participation rate was reduced to perhaps below 20 per cent.

These developments in commercial bank holdings of securities helped make it possible for banks to continue supplying many types of loans in high volume. Business loans in the first six months of the year are estimated to have risen at about last year's rate. Similarly, net extensions of real estate loans have remained only slightly below last year's rate of growth. Consumer loans did, however, experience a decline in growth after a strong first-quarter expansion, but at least a part of this decline was due to a weakening in total demand for consumer credit as a result of the recent downward adjustment of automobile purchases.

Despite the continued strong showing of overall bank lending, commercial banks have recently experienced a reduction in their share of the private credit markets (see Chart IV). Thus, while net funds raised by domestic nonfinancial borrowers other than the Federal Government have continued to grow sharply, bank credit to these borrowers has moderated. In the first half of 1965, bank credit reached a record 50 per cent of total household, business, and state and local government borrowing, but this ratio dropped in the second half of 1965 and then declined to only slightly more than 30 per cent in the first quarter of this year. Moreover, in view of the continued strength of borrowing by these sectors, contrasted with the April and May bank credit growth at a rate unchanged from its first-quarter pace, the ratio is likely to have remained near this level in the second quarter as well. This banking development was paralleled by an even sharper decline in the credit market share of other groupings of financial intermediaries, as direct credit extended by the nonfinancial sectors, discussed earlier, advanced to a record 40 per cent of the market (see Chart IV). To an important extent, the ability of banks to maintain a comparatively sizable share of private credit reflected their continued competitiveness in the market for time deposits. Recently, however, banks have found it necessary to offer the maximum 5½ per cent rate on large time certificates of deposit with shorter and shorter maturities in order to maintain the attractiveness of these deposits relative to other money market instruments. With these certificates of deposit rates now at the Regulation Q ceiling, many banks may find it increasingly difficult to attract the funds they need to maintain their past rates of lending.