Recent Developments in the Capital Markets

Pressures have mounted again in the nation's capital markets after having eased in late 1966. Corporations and state and local governments have borrowed record amounts in the capital markets so far this year, and in recent weeks yields on long-term obligations have approached—and in some cases exceeded—last summer's peaks. The prospect of very substantial Treasury financing in the second half of the year and a growing belief that the rate of economic advance will accelerate sharply have weighed more and more heavily on the markets and have led to some anticipatory borrowing.

These developments emphasize the need for prompt action to reduce the Federal budget deficit significantly. A substantial tax increase would go far to relieve the tensions that have been building up in the capital markets. At the same time, a tax increase would help assure that the renewed growth of the economy is held to a sustainable pace.

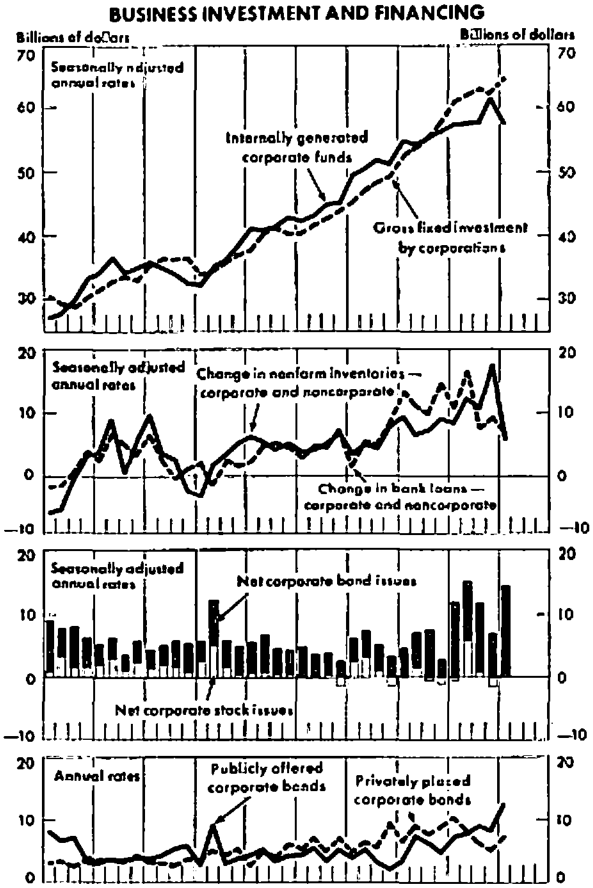
BUSINESS FINANCE

Despite the general slowdown in the economy, business firms have had to raise a substantial volume of funds during the first half of 1967. While the need for funds for inventory investment and for new plant and equipment declined since the beginning of the year, internally generated funds (retained earnings plus capital consumption allowances) also fell, with the result that corporations have had to continue to rely heavily on outside sources of financing (see Chart I). In addition, corporate needs for funds were augmented during the first half of the year by acceleration of tax remittances to the Treasury. The speedup in collections of social security contributions, withheld income taxes, and excise taxes in the first quarter drew off an estimated $650 million of business working capital, and the continued acceleration of the corporate income tax payment schedule added an estimated $4.3 billion to business tax remittances in April and June.

So far in 1967, businesses have exhibited a preference for obtaining funds through the capital markets rather than from the banking system. Through the first half of 1967, bank loans to business have grown at a slower rate than the 14.3 per cent gain recorded in 1966. The reduced rate of business loan growth this year in part reflects corporate restructuring of debt in the wake of very heavy borrowing from banks in 1966. According to data from registration statements filed with the Securities and Exchange Commis-

Chart I

COMMERCIAL AND INDUSTRIAL BUSINESS INVESTMENT AND FINANCING



Note: First quarter 1967 figures are preliminary estimates.

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

Sources: Board of Governors of the Federal Reserve System, Securities and Exchange Commission.

sion, market borrowing for repayment of bank debt rose to 28.6 per cent of new bond financing in the first quarter of 1967 from 21.6 per cent for the same period of 1966, and preliminary data indicate a further increase in the proportion during the second quarter of 1967. The shift to capital market financing was facilitated in the early part of the year by the decline in market rates that followed the move to monetary ease late in 1966. The decline in market rates made borrowing through the issue of capital market instruments relatively attractive, since bank lending rates dropped less during this period.

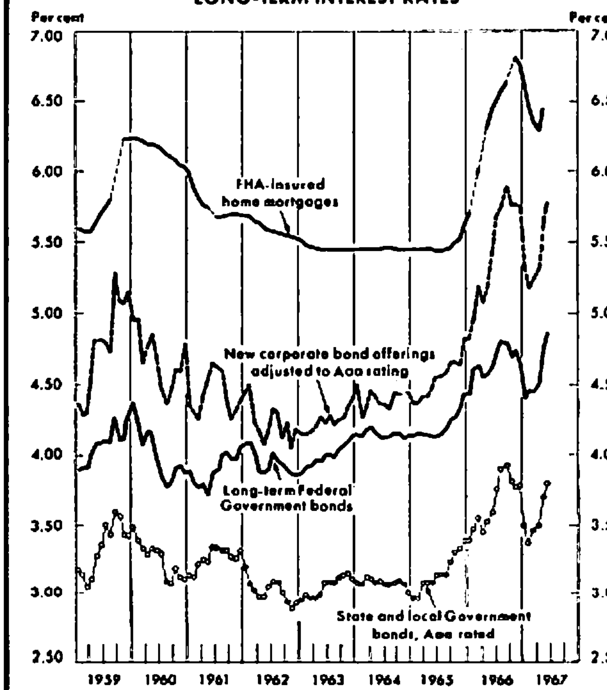
Gross new public and private issues of corporate bonds during the first six months of 1967 are estimated at $10.6 billion (compared with $8.4 billion in the same period last year), a record amount for any half-yearly period. During the first half of 1967, as in the second half of 1966, the amount of new bonds publicly offered has substantially exceeded the amount of new bonds privately placed with insurance companies and other institutional investors. The last half-year period in which the volume of publicly offered bonds exceeded that of private placements was the first six months of 1962 (see Chart I). Individuals and mutual savings banks lent important support to the long-term corporate bond market by purchasing a sharply increased amount of corporate bonds in the first three months of this year.

With the sharp rise in the volume of new issues, and expectations of even heavier demands on the markets in the second half of 1967, long-term corporate yields have reversed the decline which began in the fourth quarter of 1966 and have approached—and in some cases have exceeded—the postwar highs recorded late last summer. The market has at times been quite congested with new issues and, partly as a result, the spread between underwriters' offering rates on new corporate bonds and the market rates on outstanding corporate issues has been widening. Nevertheless, the spread remains below the levels attained in the third quarter 1966 period of peak interest rate pressures.

Business firms appear to have recently placed somewhat more reliance on the equity markets as a source for long-term funds, although this source of financing continues to be marginal. Estimated new issues of common and preferred stock (net of repurchases and retirements of outstanding issues) increased in the first quarter of 1967 from the final quarter of 1966. With bond yields rising (see Chart II), corporations have turned increasingly to the issuance of convertible bonds, which, because they can be converted to equities, bear lower interest rates than comparable bonds which lack this feature. Moreover, convertible bonds may appeal to a wider spectrum of investors than regular debt issues.

Chart II

LONG-TERM INTEREST RATES



Note: Federal Housing Administration - insured home mortgage series plotted through May, all other series plotted through June.

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

In addition to having raised a record volume of funds in the long-term capital markets in the first half of this year, corporations have turned increasingly to the commercial paper market as a source of funds. Issues of commercial paper by nonfinancial corporations had risen sharply during the second half of 1966, as business firms strove to find a source of funds alternative to the use of commercial banks. Through the first five months of 1967, nonfinancial corporations appear to have expanded their outstanding volume of commercial paper at a somewhat faster rate. This partly reflects the lower cost of raising funds in the commercial paper market as compared with the cost of borrowing at commercial banks.

CONSUMER FINANCE

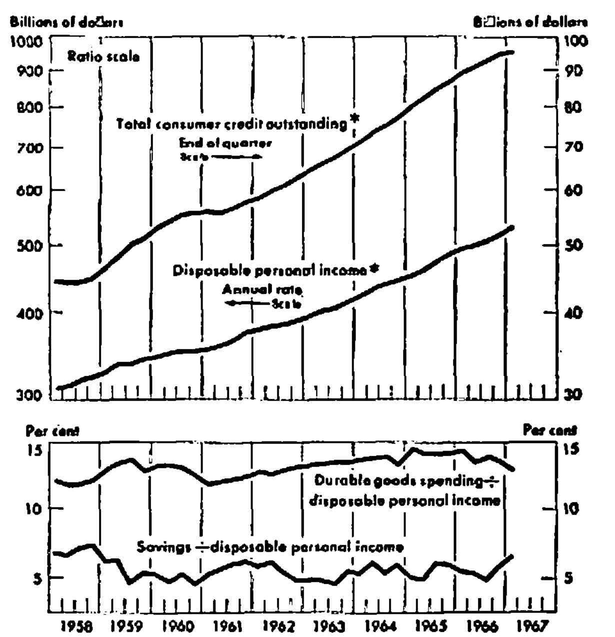
Consumer spending continued to grow through the first quarter of 1967, but at a slower rate than disposable personal income. As a result, personal savings rose to 6.5 per cent of disposable income, %o percentage point above the average savings ratio in the 1953-66 period. Total consumer spending on durable goods absorbed a lower proportion of income in the first quarter of the year than in 1966, and the growth of consumer credit—which usually finances a major part of such expenditures—slowed during this period (see Chart III). During the second quarter, it appears that there was only very modest further growth of consumer borrowing as the demand for durables remained relatively weak. However, if the recent pickup in automobile sales is maintained, the growth of consumer credit should accelerate once more.

The thrift institutions—savings and loan associations and mutual savings banks—which are the major suppliers of home mortgage loans have experienced sharply increased savings inflows so far in 1967. These large inflows reflect the rise in consumer savings and the reduced rates on competitive savings instruments, such as short-term marketable securities. During the first five months of 1967, savings and loan associations recorded a $4.1 billion net inflow of funds, in sharp contrast to the $932 million inflow recorded during the comparable period of 1966. Similarly, mutual savings banks have also experienced greatly increased inflows of funds thus far in 1967.

A substantial portion of the enlarged savings flows to the thrift institutions has not moved into the mortgage market, reflecting in part a less rapidly expanding supply of immediately available mortgages. Savings and loan associations repaid $2.5 billion of their borrowings from the Federal Home Loan Banks in the January-May 1967 period, in contrast to a net increase in borrowing of $711 million during the same period last year. In addition, all thrift institutions have been rebuilding their liquidity through the purchase of short-term securities, and mutual savings banks have purchased a large amount of long-term corporate securities. Nevertheless, during the first five months of 1967, these institutions have expanded their mortgage holdings on a seasonally adjusted basis at a rate more than twice that recorded during the last half of 1966. Rates on FHA-insured thirty-year mortgages declined during the first four months of 1967, but edged upward again in May (see Chart II), reflecting rising rates throughout the long-term capital markets.

Chart III

INDIVIDUALS' BORROWING PATTERNS



* Seasonally adjusted.

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

GOVERNMENT FINANCE

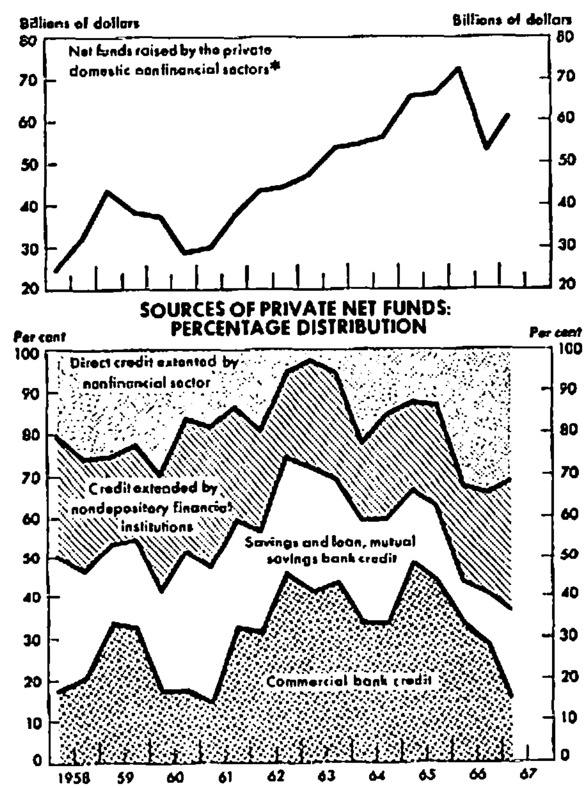
Despite a continuing rise in revenues, state and local governments have made record demands on the capital markets thus far in 1967. These borrowers marketed $4.1 billion (gross) of new bond issues in the first quarter—the largest quarterly volume on record—and are estimated to have marketed an additional $3.5 billion in the second quarter. Commercial banks, after having sharply reduced their net purchases of state and municipal bonds in 1966, have lent important buying support to this market thus far in 1967. Market yields on tax-exempt bonds declined during the early weeks of the year but have subsequently moved up sharply.

In contrast to state and local government financing, total Federal Government financing has been smaller in the first half of 1967 than in the same period a year ago. Total Treasury and agency financing in the first half of 1967 has resulted in an estimated increase of $0.3 billion in outstanding securities, compared with an increase of $4.7 billion in the first six months of 1966.

The first half of the calendar year is traditionally a period of debt redemption by the Treasury, and estimated net redemptions of direct Treasury obligations through June are expected to exceed $3.0 billion, compared with redemptions of $1.0 billion in the same period of 1966. At the same time, net agency debt outstanding is estimated to have fallen by over $500 million in the January-June period, as opposed to the net increase of $3.5 billion over the comparable period of 1966. The Federal National Mortgage Association increased its outstanding indebtedness at a much slower rate in the first six months of the year, reflecting its declining mortgage purchases. The sharply increased growth of deposits at savings and loan associations has enabled these institutions to repay a large portion of their borrowings from the Federal Home Loan Banks. Consequently, the Federal Home Loan Banks reduced their own outstanding debt by \$2.3 billion in the first six months of the year, compared with a net increase in borrowing of \$1.1 billion in the same period of 1966. Sales to the public of participations in Federal loans have risen moderately in the first half of this year, with the total amounting to \$2.9 billion, up from \$2.2 billion in the first six months of 1966. An additional \$900 million of participation certificates was sold directly to United States Government trust funds during the first half of 1967.

Yields on some outstanding long-term Government bonds have recently surpassed the peaks recorded in late 1966, reaching the highest levels in forty years. With yields remaining substantially above the 4¼ per cent ceiling on interest rates for Government securities with maturities exceeding five years, Treasury financing operations have been confined entirely to short- and intermediate-term issues. Consequently, the average maturity of the public debt has been shortened from four years eleven months in June 1966 to an estimated four years seven months as of the end of June 1967.

Chart IV
PRIVATE SECTOR BORROWING



Note: Figures are semiannual averages, seasonally adjusted at an annual rate. Latest data plotted are preliminary estimates for the first quarter of 1967.
* Households and nonprofit organizations, nonfinancial businesses, and state and local governments.
Source: Board of Governors of the Federal Reserve System.

ROLE OF THE BANKING SYSTEM

Net funds raised by domestic nonfinancial borrowers other than the Federal Government grew at a substantially increased rate during the first quarter of 1967, but commercial banks supplied a greatly reduced percentage of the funds obtained by these borrowers. In the first quarter of 1967, bank credit supplied only 15 per cent of total household, business, and state and local borrowing. This ratio has declined steadily from the peak level of 48 per cent in the first half of 1965 (see Chart IV). In view of the continued sluggishness of borrowing from banks in April and May, it is doubtful that commercial banks accounted for a significantly increased percentage of total funds supplied to the private sector during the second quarter. Reflecting both the reduced pressure of demands from the private sector for bank financing and their desire to rebuild liquidity, commercial banks acquired large amounts of Federal Government securities. As a result, in the first quarter, the commercial bank share of total credit—which includes funds supplied to the Federal Government—moved up sharply from the reduced levels of the third and fourth quarters of 1966.

Total bank credit appears to have grown at a seasonally adjusted annual rate of 11 per cent over the first six months of the year, almost twice as large as the annual rate of increase recorded for the year 1966. Measured on a seasonally adjusted basis, commercial banks purchased \$3.1 billion of Government securities during the first five months of 1967, in contrast to their liquidation of \$2.7 billion of these securities during the same period of 1966. In the first quarter of 1967, commercial banks purchased an estimated 68 per cent of the net increase in state and local securities, up markedly from the depressed 30 per cent recorded in 1966. Preliminary data indicate that this proportion has remained high during the second quarter as well.

While bank holdings of securities have increased substantially so far this year, loan growth has been slower than in 1966. Business loans in the first six months of the year are estimated to have risen at a rate below last year's. The net extension of real estate loans has remained markedly below last year's rate of growth. Consumer loans have also grown more slowly thus far in 1967, reflecting the weakness in demand for consumer durable goods.

Commercial bank time and savings deposits are estimated to have grown at a seasonally adjusted annual rate of 17 per cent during the first half of the year, more than double the rate of increase recorded in 1966. Corporations, which had reduced their holdings of time deposits by $2.1 billion (seasonally adjusted) during the last half of 1966, added an estimated $2.5 billion to their time deposits during the first three months of 1967. These deposits were attractive to investors, given the relatively low yields then available on short-term Government securities.