Recent Capital Market Developments

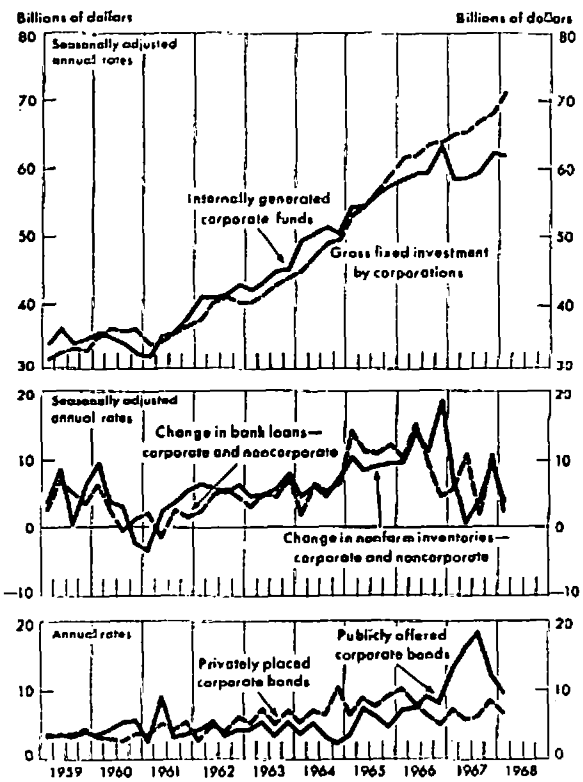
The nation's capital markets were subjected to strong pressures during the first six months of 1968, and interest rates pushed through their 1967 peaks. It was not until late June that the Congress enacted legislation incorporating a 10 per cent income tax surcharge on individuals and corporations and a reduction in budgeted Federal spending. Consequently, monetary policy had to bear the entire burden of economic restraint throughout the first half of the year. Evidence of greater monetary stringency was reflected in the deepened net borrowed reserve positions of commercial banks, increases in the Federal Reserve discount rate in March and April, and an increase of ½ percentage point in required reserves on member bank demand deposits, effective in January. The impact of uncertainty over the timing and dimensions of fiscal restraint on the expectations and actions of both borrowers and lenders was compounded by the ebb and flow of optimism over negotiations for a peace settlement in Vietnam. Moreover, the pressures on interest rates from the rapidly growing domestic economy were reinforced by the impact of the gold crises and rising apprehension in foreign markets concerning the stability of the dollar.

While demands for funds by nonfinancial business abated slightly from the record levels of 1967, business needs remained high when viewed in the perspective of earlier years. The large Federal deficit resulted in an increase in outstanding Treasury indebtedness during the first half of the year, a period normally marked by debt retirement. Borrowing by state and local governments declined slightly from the record amounts of 1967, but nevertheless remained strong. Consumer credit rose sharply, reflecting increased purchases of automobiles and other durable goods. Aggregate mortgage lending, while slightly below the pace of the second half of 1967, was maintained at a generally high level in spite of gradually rising pressure on the principal suppliers of these funds.

BUSINESS FINANCE

Expenditures by nonfinancial corporations for fixed investment rose sharply during the first quarter of 1968 (see Chart I). During the same period, the major sources of internally generated funds—retained earnings and capital consumption allowances—declined slightly on balance. Nevertheless, demands for external long-term financing moderated during the quarter and, indeed, for the entire first half of 1968. In particular, during the first six months of 1968, corporate bond flotations (gross publicly offered and privately placed issues) approximated $9 billion, about $2½ billion less than the record six-month

Chart I
COMMERCIAL AND INDUSTRIAL BUSINESS INVESTMENT AND FINANCING



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

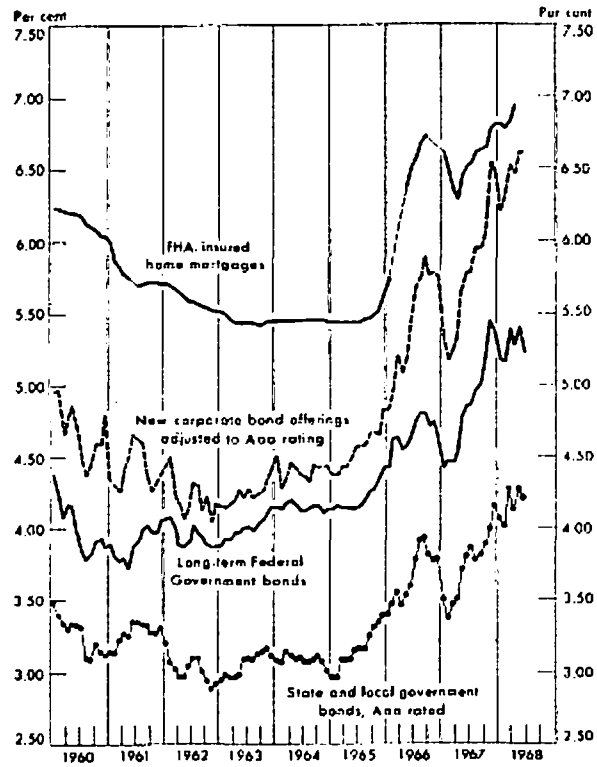
volume of the second half of 1967. While the volume of privately placed issues continued to trail substantially that of publicly offered issues, some recovery of private placements from the depressed levels of early 1967 appears to have been registered.

The moderation in corporate demands for external financing is attributable to a number of factors. Corporations were under less pressure to use long-term financing for building up liquidity positions. The ratio of cash and United States Government securities to total current liabilities—a widely used measure of corporate liquidity—stood at 24.4 per cent at the end of the first quarter of 1968, about 1 percentage point above the 1967 low point reached in the third quarter of that year. Furthermore, during the first half of 1968, corporate income tax payments were relatively low by comparison with 1967, reflecting the accelerated payments in that year.

The strong consumer demand evident during the first quarter of 1968 slowed the rate of inventory accumulation and thus moderated business demands for short-term financing. Reflecting this, during the first three months of the year business loans by commercial banks expanded at a pace somewhat below the 8.2 per cent seasonally adjusted annual rate of growth during the second half of 1967; however, the apparent step-up of inventory accumulation during the April to June quarter may have contributed to a somewhat sharper expansion of business borrowings. In addition, the commercial paper market continued to play a significant role in corporate financing during the first half of this year, although the rate of growth in outstanding paper was well below the rapid expansion during early 1967.

Chart II

LONG-TERM INTEREST RATES



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

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

As a result of restrictions imposed on investments by United States business firms in their foreign subsidiaries, these subsidiaries were forced to place substantially greater demands on foreign capital markets. During the first half of 1968, affiliates and subsidiaries of United States companies issued more than $1 billion of bonds in the European markets, mostly denominated in dollars and convertible into the common stock of the United States corporations. The volume of these flotations was more than double that for the entire year 1967 and, in large measure, represented a shift of demands for funds away from domestic sources.

Some of the record volume of corporate securities flotations in late 1967 almost surely consisted of offerings accelerated in anticipation of tighter market conditions in the early part of 1968. As the new year progressed such expectations were realized, and interest rates were pushed higher while uncertainty concerning the tax increase legislation mounted. Indeed, yields on both outstanding and newly issued corporate bonds exceeded the peak levels reached in late 1967 (see Chart II). These movements reflected effects of both monetary tightening and the heavy volume of financing by all sectors. Rates in excess of 7 per cent on new high-quality issues were witnessed, and at the higher rate levels direct purchases by individuals became an important source of funds in the market.

The flow of new equity market issues—especially from corporations making initial common stock offerings to the public—accelerated sharply during the first six months of 1968. Gross issues of common and preferred stocks amounted to an estimated $2 billion in the January to June period, compared with slightly more than $1 billion during the same period last year.

The President's announcement on March 31 of a limited de-escalation of the Vietnam war provided the impetus for a sharp rise in stock prices and trading activity. Standard and Poor's broad-based index of 500 New York Stock Exchange common stock prices rose more than 10 per cent to 99.58 during the second quarter, while trading activity on this exchange averaged 14.3 million shares daily —a rise of almost 41 per cent from the average turnover during the first quarter of the year. Prices on the American Stock Exchange and in the over-the-counter market increased even more sharply in greatly expanded trading activity. The pace of trading became so hectic that the major stock exchanges and the over-the-counter market decided to close one day a week from mid-June through the end of July to facilitate the handling of accumulated paper work. Concern with the rising speculation in the securities markets prompted the New York and American Stock Exchanges to make extensive use of special margin requirements in their efforts to moderate such activities. In March, the Board of Governors of the Federal Reserve System tightened its controls over the use of credit to finance the purchase of securities by extending margin requirements to convertible bonds and to stock market loans from most previously unregulated lenders. In addition, in early June the Board of Governors increased the minimum downpayments on purchases of listed stocks and convertible bonds by 10 percentage points to 80 per cent and 60 per cent, respectively.

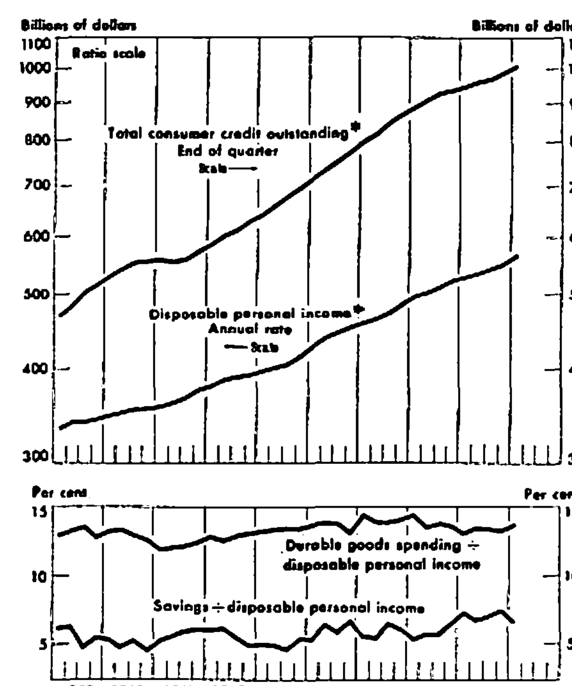
CONSUMER AND MORTGAGE FINANCE

Outstanding consumer credit rose by $3.4 billion (seasonally adjusted) during the first five months of 1968. On an average monthly basis, this increase exceeded by about 62 per cent the expansion of such credit during the second half of 1967 (see Chart III). Clearly, the impetus for this development was a strong surge of consumer spending, especially for durable goods. During the first quarter of the year, total consumer spending mounted by a record $17 billion, about $3 billion greater than the rise in disposable personal income.

As a result of the sharp expansion in consumer spending, the savings ratio declined to 6.6 per cent during the first quarter of 1968, ½ percentage point below the average rate during 1967. This development plus the increased attractiveness of credit market instruments, especially Government securities, resulted in a diminished flow of funds to thrift institutions. During the first five months of this year, total savings capital and deposits at savings and loan associations and mutual savings banks grew at a seasonally adjusted annual rate of approximately 6½ per cent, 4 percentage points below the growth during the comparable period in 1967 but well above that during the January to May period in 1966 (see Chart IV). Deposit growth at mutual savings banks in the first five months was only about 10 per cent lower than that during the same period a year earlier, while at savings and loan associations the growth was about half that of the comparable months of 1967. The more aggressive promotion of premium-rate, longer maturity savings instruments, particularly at savings and loan associations, undoubtedly slowed outflows of funds in the face of rising market yields.

In spite of the moderation in the inflow of funds to savings and loan associations, these institutions continued to expand mortgage holdings at a pace comparable to the last half of 1967. Pressure on liquidity positions eventually emerged, however. During the January to May 1968 period, savings and loan associations obtained about $300 million in advances from Federal Home Loan Banks, while during the last six months of 1967 the rise in borrowings was only $85 million. At mutual savings banks, in contrast, the expansion of mortgages has been weak since mid-1967. Restrictive ceilings on mortgage interest rates imposed by usury laws in several of the states in which these institutions operate have induced the diver-

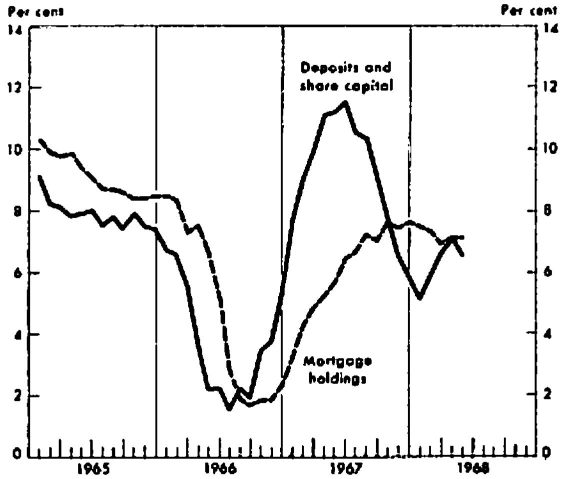
Chart III
INDIVIDUALS' BORROWING PATTERNS



*Seasonally adjusted.

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

Chart IV
SAVINGS BANKS AND SAVINGS AND LOAN ASSOCIATIONS
Change from three months earlier; seasonally adjusted annual rates



Note: Seasonally adjusted by the Federal Reserve Bank of New York.
Sources: Federal Home Loan Bank Board and the National Association of Mutual Savings Banks.

sion of a high proportion of their new funds into corporate bonds. However, several states have recently liberalized these ceilings, a move which should increase the relative attractiveness of mortgage lending. Furthermore, the ceiling rate on Federally insured mortgages was raised in early May from 6 per cent to 6¾ per cent, although the new rate is currently below levels prevailing in the secondary market for Federal Housing Administration-insured mortgages.

A notable development to improve the responsiveness of mortgage prices in the secondary market to changes in credit conditions was the adoption during the first half of 1968 by the Federal National Mortgage Association (FNMA) of a system of auctioning commitments (bearing maturities of three, six, and twelve months) to purchase new mortgage loans. Under the former system, which involved mortgage transactions at administratively fixed prices, the volume of mortgages purchased by FNMA was determined largely by the sellers, mainly mortgage bankers. In contrast, the auction system now permits FNMA to set the volume of mortgage purchases and thus have greater control over the magnitude and timing of its financing operations. In its initial weekly auction in May, FNMA invited tenders for commitments to purchase $40 million of mortgages, and by late June the weekly offering had risen to $90 million. The average three-month commitment price for mortgages declined through the third week in June, but since then prices have recovered somewhat.

GOVERNMENT FINANCE

The Treasury placed strong demands on the financial markets during the first half of the year—a period that is ordinarily marked by some reduction of Government debt. The Treasury's net cash borrowing from the public—including the banking system and the Federal Reserve—is estimated to have reached almost $3 billion during the first half of 1968, a sharp contrast to the net redemption of more than $8 billion of publicly held securities in the same period of 1967. The volume of marketable Treasury securities held by the public rose slightly during the first half of 1968, whereas during the same period of 1967 the amount of such securities held by this sector declined by about $7 billion. Part of this increase of Treasury securities was offset by lower sales of certificates of participation in Federal loans. In the first half of 1968 the net increase of public holdings of these certificates was about $700 million less than the additions during the comparable period of 1967.

Issues of Government agencies (not directly guaranteed) also expanded sharply during the first half of 1968. Net new issues of these securities totaled more than $1 billion during this period, a marked difference from the net redemption of about the same amount of agency securities during the first six months of 1967. One factor in this reversal was the pattern of financing by Federal Home Loan Banks whose borrowings amounted to about $600 million in the first half of 1968, compared with a reduction of indebtedness which exceeded $2 billion a year earlier. This in turn reflected heavy repayment of advances by savings and loan associations in the earlier year and increased borrowings by this sector during 1968.

Yields on both newly issued and outstanding Government securities rose to new peaks during the second quarter of the year, although they moved down somewhat after mid-May. In a May financing operation, the Treasury issued fifteen-month and seven-year notes with a coupon rate of 6 per cent—the highest coupon on a publicly offered Treasury obligation since 1920—and during the month the average yield on newly issued Treasury bills rose to the highest point for any fully guaranteed Treasury security since the Civil War. In addition, the Treasury recently increased the interest rates on Series E and H savings bonds and the "freedom shares" in an effort to increase the attractiveness of these securities.

New issues of state and local government securities exceeded $7 billion during the first half of 1968 and were only about $400 million below the volume of new flotations during the first half of 1967. The flow of new tax-exempt securities was expanded during the early part of

1968 by the accelerated flotation of many industrial revenue bonds which were moved ahead in anticipation of the just-enacted removal of the income tax exemption on interest earned on issues of such securities exceeding $1 million in size and initiated after May 1, 1968.

The market for tax-exempt securities was quite congested during much of the past six-month period, as investors were increasingly reluctant to make new commitments. In 1967 commercial banks had lent strong support to this market by purchasing almost 90 per cent of the net increase in state and local obligations, but in the first quarter of the year this proportion declined to 66 per cent, and commercial banks made no significant additions to their holdings of municipal securities during the second quarter.

ROLE OF THE BANKING SYSTEM

According to preliminary data, during the first quarter of 1968 the volume of net funds raised by all nonfinancial borrowers totaled about $100 billion (seasonally adjusted annual rate), down from $106 billion during the second half of 1967. The commercial banking system supplied 20.7 per cent of this total, a sharp decline from the 39.5 per cent that the banks accounted for during the second half of 1967. However, the drop in commercial bank lending activity was accompanied by a rise in direct unintermediated lending by the private nonfinancial sectors —mainly households and businesses—which supplied about 47 per cent of the net funds raised by all nonfinancial borrowers.

In an environment of reserve stringency the expansion of commercial bank credit slowed markedly during the first six months of 1968. The net rise of approximately 6.5 per cent at a seasonally adjusted annual rate was sharply below the 12.5 per cent growth registered during the last half of 1967. The principal impact of credit restraint fell upon commercial bank holdings of United States Government and municipal securities, both of which grew at a rate only about one third of the strong expansion during the second half of last year. Net loan extensions declined slightly from the earlier period, although the drop was not so pronounced as that for investments. A rise in business loan expansion early in the second quarter was apparently associated with increased inventory accumulation; consumer loan volume was strong throughout the first half in response to a sharp increase in consumer spending, primarily for automobiles and other durable goods; and real estate lending maintained the 10 per cent growth rate in evidence since mid-1967.

Reflecting the pattern of rising yields on competitive market instruments, total daily average time and savings deposits held by commercial banks grew at a seasonally adjusted annual rate of 5.0 per cent during the first half of 1968, sharply below the 12.6 per cent rise during the preceding half-year period. The Board of Governors raised the interest rate ceilings on time certificates of deposit greater than $100,000 at the time of the discount rate increase in April,[1] and commercial bank offering rates subsequently moved up to the new ceilings—which range from 5½ to 6¼ per cent. At the increased rates the volume of certificates issued by large banks changed little on balance during May and June.

---

[1] For additional information regarding the new ceilings, see this *Review* (May 1968), page 97.