Recent Developments in the Capital Markets

The nation's capital markets were subjected to renewed strains as the second half of 1968 progressed. Early in the period, expectations that passage of the fiscal restraint legislation would lead to a scaling-down in the pace of economic activity had led to somewhat easier conditions in the financial markets. However, increasingly heavy overall demands for funds and renewed inflationary expectations among borrowers and lenders soon pushed interest rates back to record levels, and the upward trend continued into early 1969. Despite high costs of credit, the nonfinancial sectors of the economy borrowed near-record amounts in the credit markets in the last half of 1968. Net funds raised during the period by all nonfinancial borrowers totaled about $106 billion at a seasonally adjusted annual rate. This was $16 billion more than in the first half of the year, and only marginally below the peak borrowing pace set in the last half of 1967. All major classes of borrowers contributed to the heavy credit demands in the last half of 1968. Federal borrowing remained strong, despite increased revenues from the tax surcharge passed at midyear, as the Treasury borrowed to rebuild its strained cash position. Households also borrowed heavily, both in the consumer credit and residential mortgage markets.

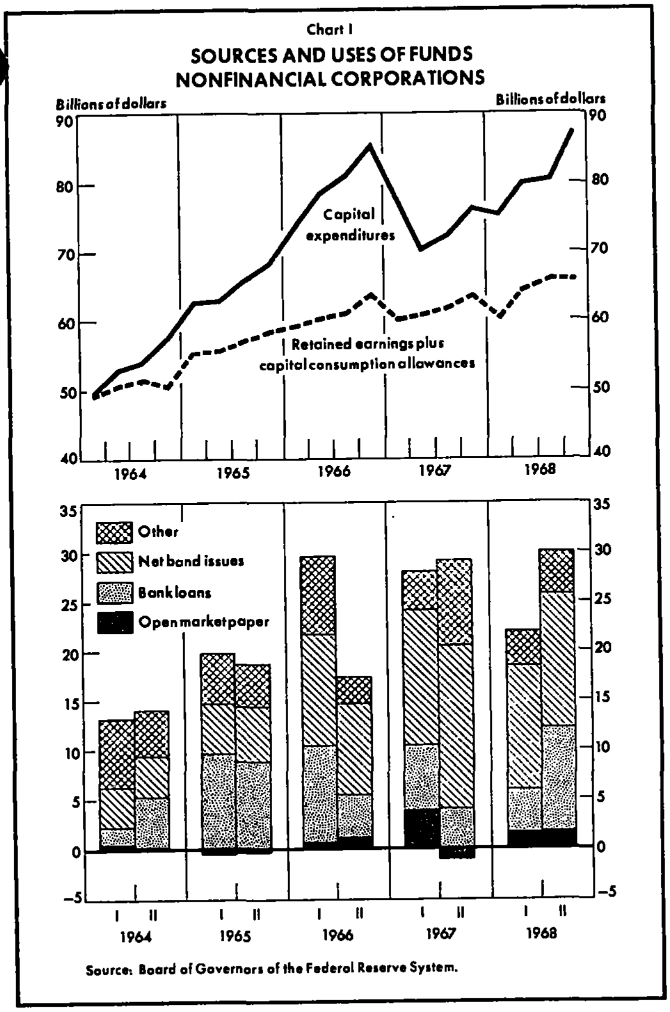
BUSINESS FINANCE

Nonfinancial corporations in the second half of 1968 experienced a substantial increase in funds generated internally through depreciation allowances and undistributed profits (see Chart I). However, an even greater rise in corporate spending resulted in record demands for external funds. Corporate fixed investment and inventory spending both increased in the final six months of last year, and acquisitions of liquid financial assets continued at a high level relative to earlier years.

Total credit and equity market financing by nonfinancial corporations, seasonally adjusted, rose $8 billion to a new peak annual rate of $30 billion during the July-December period (see Chart I), with most of the increase concentrated in short- and intermediate-term borrowing. Gross cash offerings of new corporate bonds amounted to about $8½ billion, a decline of $½ billion from the first six months of the year and the smallest half-year volume since the second half of 1966. Moreover, the flow of both publicly offered and privately placed issues eased, with public offerings showing a somewhat greater drop than private placements. Net bond issues, however, reportedly rose slightly during the second half of the year, possibly owing to the larger volume of noncash bond issues used to effect corporate mergers and acquisitions.

Yields on new corporate bonds offered for cash receded significantly immediately following the passage of the fiscal restraint legislation in late June of last year, but rates were on the uptrend again by late summer. Toward the close of the year new postwar peaks had been reached, and rate levels moved still higher in the early months of 1969 (see Chart II). As 1968 neared an end, and heavy demands for funds persisted, investors became increasingly selective about making new commitments and underwriters encountered substantial difficulty in distributing many new issues. With individuals reluctant to make additional purchases of corporate bonds, net acquisitions by households during the July-December period fell to less than half the total during the first six months of the year. Manufacturing corporations appeared to have been especially sensitive to the rising cost of long-term financing. Their gross bond offerings fell by one fifth to $2½ billion, the smallest six-month total since the second half of 1965. Public utilities, however, raised a record amount of funds in the bond market during the second half of 1968.

Corporate borrowers placed substantially increased demands on commercial banks during the second half of 1968, as the availability of funds from that source increased greatly. Banks supplied 35 percent of the funds obtained by nonfinancial corporations in the credit and equity markets, 15 percentage points above the share supplied during the previous six months and the largest such proportion since the last half of 1965. The heightened demands by corporations for bank financing was reflected

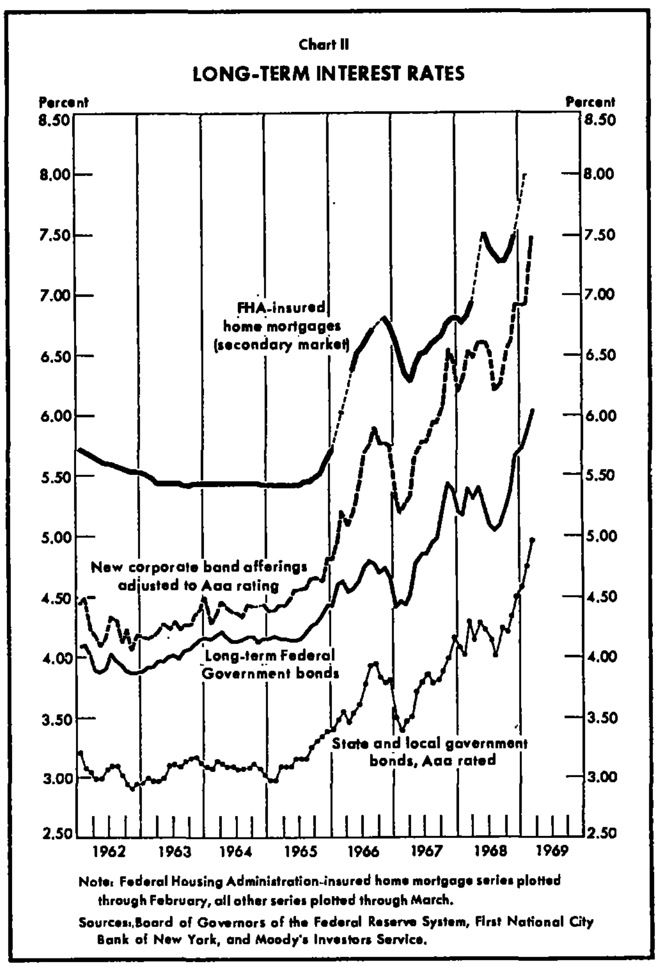


in an 11½ percent annual rate of increase in outstanding business loans of commercial banks during the July-December period, about half again as large as the rate of increase during the preceding six months. Furthermore, the commercial paper market continued to be an important and growing source of shorter term funds to corporate businesses during the second half of 1968. Nonfinancial corporations raised about $1¾ billion in this market during all of 1968; prior to 1966, commercial paper sales had been a negligible source of new funds for these borrowers.

Gross new issue activity in the stock market was at a peak during the second half of 1968, both in terms of dollar volume and number of issues involved. Gross common stock offerings totaled $2.4 billion, $0.8 billion more than during the previous six months and $0.4 billion greater than the previous record for a half-year period. At the same time, over 700 new common stock issues were offered for sale during the period, a rise of almost 70 percent above the first half of the year. Nonetheless, net stock issues of corporate businesses were negative during the second half of 1968, apparently as a result of the substantial number of corporate mergers that involved the direct or indirect exchange of bonds—frequently convertible issues—for outstanding common stock.

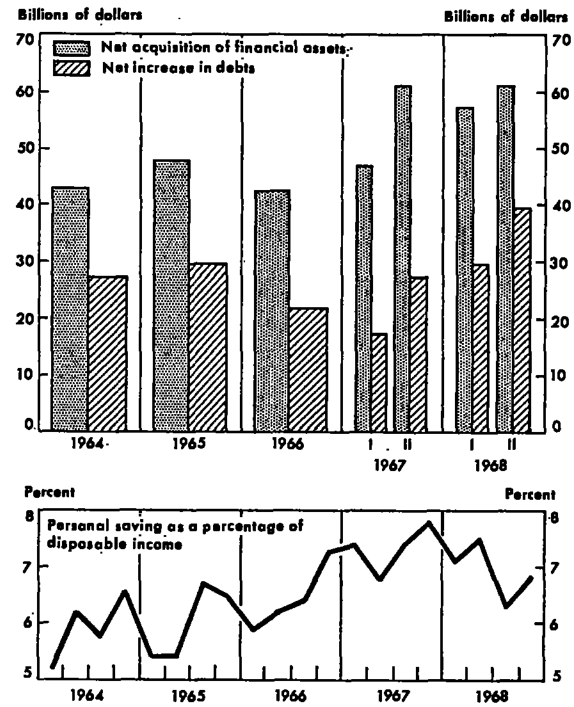
Corporate liquidity positions were considerably improved at the year-end, reflecting heavy acquisitions of liquid assets throughout 1968. Preliminary data indicate that nonfinancial corporations added approximately $2 billion (seasonally adjusted) to their liquid asset holdings during the second half of the year. Over 1968 as a whole, corporations increased their liquid asset holdings by considerably more than in the preceding four years combined.

Corporations over the course of 1968 made marked



adjustments in their holdings of liquid interest-bearing assets, primarily in response to the changing relationship between rates obtainable on large certificates of deposit (CD's) issued by banks and rates on other closely similar short-term instruments. In the first half of the year, when the Regulation Q ceilings generally restricted issuing rates on large CD's to noncompetitive levels, corporations reduced their holdings of bank time deposits and acquired unusually large amounts of United States Government securities and commercial paper. By contrast, in the second half of the year, when competing market rates dropped below the Regulation Q ceilings on large CD's and banks bid very aggressively for CD money, corporations acquired record amounts of bank time deposits while their holdings of Government securities remained unchanged. Corporations in the second half of the year continued to invest large sums in commercial paper, however, as a heavy volume of new offerings kept rates on these instruments at favorable levels relative to CD's.

Chart III
HOUSEHOLD SAVING AND CHANGES IN FINANCIAL ASSETS AND LIABILITIES



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

CONSUMER AND RESIDENTIAL MORTGAGE FINANCE

Pretax personal income posted a strong gain during the second half of 1968, but increased income tax withholdings begun in mid-July sharply reduced the growth of after-tax income. The rise of consumption expenditures outstripped that of disposable income, and a substantial reduction occurred in personal saving—measured both as a percentage of income and in dollar terms. The personal saving rate fell 0.8 percentage point to 6.5 percent, the lowest half-year average since the first six months of 1966.

A significant feature of the financial behavior of households during the second half of 1968 was their heavy acquisitions of financial assets during a period when expenditure growth exceeded the rise in after-tax income. Indeed, the estimated $61 billion (seasonally adjusted annual rate) rise in the household sector's holdings of financial assets was barely below the all-time high and almost $4 billion above the gain during the first half of the year (see Chart III). Holdings of money increased strongly, while net additions to interest-bearing deposits at commercial banks and thrift institutions held at about the first-half pace.

The large further increase in the financial assets of households during the last half of 1968 reflected increased reliance on borrowings to finance their consumption and housing expenditures. In fact, the record $39½ billion (seasonally adjusted annual rate) rise in total financial liabilities of the household sector, indicated by the preliminary flow-of-funds accounts, was about one-third above the increase in the first half of the year. Consumer credit, which had expanded at a $9.2 billion annual rate during the first half of the year, rose at a record $13 billion rate during the July-December period. The expansion in consumer credit during all of 1967 totaled only $4.4 billion. Furthermore, the record $4.8 billion seasonally adjusted annual rate rise in other (nonmortgage) borrowing from commercial banks was more than double the first-half total.

Residential construction expenditures by households during the second half of 1968 remained about unchanged from the first half of the year. However, mortgage borrowing to finance home purchases was about $1 billion higher at an annual rate. This extra margin of debt increase also helped free funds for investment in financial assets or spending on consumption goods.

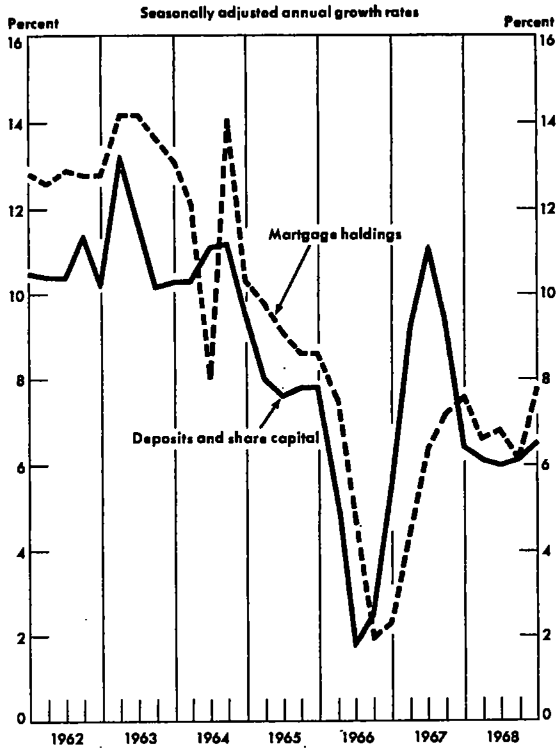
Market yields on new Federally insured home mortgage loans eased somewhat during the summer and early fall.

Before that, they had moved sharply higher in response to the ¾ percentage point increase in the maximum permissible contract rate on such loans in early May. However, rising pressures throughout the long-term capital markets pushed rates steadily upward toward the year-end and into early 1969, culminating in a second ¾ percentage point upward adjustment in the ceiling rate in late January to 7½ percent. During the second half of the year, and in fact throughout 1968, there appears to have been a trend toward placing greater reliance on nonmortgage credit to finance residential construction activity, in large part a result of the greatly increased importance of multifamily projects which afford both lenders and developers a wider spectrum of debt and equity financing instruments.

Chart IV

SAVINGS BANKS AND SAVINGS ASSOCIATIONS

Seasonally adjusted annual growth rates



Note: Deposits and share capital seasonally adjusted by the Board of Governors of the Federal Reserve System; mortgage holdings seasonally adjusted by the Federal Reserve Bank of New York. Growth rates measure the increase in seasonally adjusted levels from the end of the preceding quarter to the end of the current quarter.

Sources: Federal Home Loan Bank Board and the National Association of Mutual Savings Banks.

The pace of mortgage lending at savings and loan associations and mutual savings banks picked up somewhat on balance during the second half of 1968, about in line with a slight upturn in the growth of deposits and share capital (see Chart IV). Net mortgage extensions at savings and loan associations exceeded savings inflows by a considerable margin during the period. These institutions drew down liquid asset holdings to gain funds for mortgage lending, and they also borrowed an additional $375 million from the Federal Home Loan Banks. Moreover, the lending ability of the associations was enhanced by the Federal Home Loan Bank Board decision to reduce the minimum liquidity requirement of member savings associations by ½ percentage point to 6½ percent, effective August 1. Although the increased ceilings on residential mortgage interest rates that went into effect around midyear in several Eastern states encouraged mortgage lending at mutual savings banks during the second half, these institutions continued to acquire substantial amounts of corporate bonds during the period.

Commercial banks provided expanded support to the residential mortgage market during the second half of 1968, when their net acquisitions rose by one third to $2 billion. Although the pace of mortgage lending at life insurance companies and private pension funds also picked up slightly in the July-December period, their total acquisitions during the year trailed those during the preceding year by a considerable margin, thus continuing a trend evident since 1965.

GOVERNMENT FINANCE

The Federal Government continued to place large demands on the nation's financial markets during the second half of the year. The enactment of the income tax surcharge in late June greatly reduced the Federal deficit, but the need to rebuild Treasury balances kept borrowing at a high level, especially in the third quarter. Thus, total net borrowing by the Federal Government amounted to an annual rate of about $16 billion in the July-December period, not much below the $17½ billion borrowing rate in the first half of the year. Direct Treasury borrowing in the securities markets actually increased a bit from the first to the second half of the year on a seasonally adjusted basis, but this increase was more than offset by a decline in borrowing by Federal agencies and a decrease in net sales of loan participation certificates.

Net borrowing by the major Federally sponsored credit agencies during the July-December period was well below the total during the first half of the year but moderately above borrowing during the comparable six months of

1967. Despite a moderate rise in advances to member institutions, the Federal Home Loan Banking System did not engage in any net new borrowing but drew on internal liquidity to finance its expanded operations. Similarly, in the second half of 1967, the Home Loan Banking System had also placed substantial reliance on internal liquidity as $525 million of outstanding borrowing was repaid while the level of advances rose slightly. In contrast, the Federal National Mortgage Association, which is now under private ownership, raised about $500 million to finance its secondary market operations during the period, sharply below the $850 million raised during the second half of 1967.

The 4¼ percent interest rate ceiling on the coupon rates of new directly issued Government bonds continued to force the Treasury to confine its financing operations exclusively to the short- and intermediate-term maturity area, thus leading to a two-month shortening in the average maturity of the marketable debt. The average maturity of the debt was four years at the end of 1968, down from five years and five months in early 1965. Moreover, although individuals were substantial purchasers of marketable Government securities on balance during the second half of 1968, sales of savings bonds continued to trail redemptions, reflecting the relatively unattractive yields available on such savings instruments vis-à-vis those on marketable issues.

State and local government borrowing expanded sharply to a new record during the second half of 1968. Gross offerings totaled $9 billion, $1.6 billion more than during the first half of the year and more than $1 billion above the previous peak for a half-year period. The pace of offerings during the July-December period was swelled by a speedup in the flow of industrial revenue issues. Under the provisions of 1968 legislation, interest income on individual issues of these securities larger than $5 million in size ceased to be eligible for tax-exempt status after last December 31.

Yields on tax-exempt securities began to ease considerably shortly before midyear, as market participants expected that enactment of the fiscal restraint legislation would give rise to somewhat easier credit market conditions. This triggered an acceleration in financing during the summer and fall that added to the pressures arising from the speedup of industrial revenue issues. The resultant congestion in the market subsequently pushed yields up to the highest levels in more than thirty years by the year-end. Moreover, these high levels were further surpassed during the early months of 1969. It is estimated that the generally unfavorable market conditions during the concluding months of 1968 caused postponements or cancellations of additional issues amounting to at least $¼ billion.

During the second half of 1968, commercial banks were virtually the only net buyers of state and local securities. Bank acquisitions, which exceeded $5 billion, accounted for more than 90 percent of the net increase in outstanding issues, up sharply from the 67 percent recorded during the first half of the year. The expanded bank investment activity which showed signs of a marked slowing near the year-end—and reversal in early 1969—offset the disposal by the household sector of an estimated $1½ billion of state and local government securities, an amount about equal to this sector's net acquisitions during the first half of the year.

ROLE OF THE BANKING SYSTEM

The second half of 1968 witnessed a sharp increase in the share of total credit supplied by commercial banks. Preliminary flow-of-funds data for the last half of 1968 indicate that total borrowing by all nonfinancial sectors rose $16 billion to a $106 billion seasonally adjusted annual rate, and commercial bank lending mounted to $58 billion, or 54 percent of the total. This was a sharp contrast to the first half of the year when commercial banks supplied only $20 billion or 22 percent of total lending. However, the bank credit surge was associated with a marked decline in acquisitions of credit market instruments by households and businesses. Indeed, direct lending by the private domestic nonfinancial sectors dropped to an annual rate of $7½ billion in the last six months of 1968 from nearly $26½ billion in the first half of the year.

The emergence of somewhat easier conditions in the capital markets after midyear prompted commercial banks to undertake a downward adjustment in their prime lending rate in September, but growing pressure on reserves and rising demand for loans, especially from businesses which turned to banks to help finance a rapid growth in inventory accumulation during the fourth quarter, led to two increases in the prime rate in December with subsequent further adjustments effected in the first quarter of 1969 to a peak of 7½ percent in March. Moreover, the pace of expansion of commercial bank real estate loans spurted in response to a sharp rise in construction outlays and housing activity during the latter months of the year. Furthermore, while loans were expanding rapidly, commercial bank securities holdings also increased on balance during the second half of 1968 at a rate more than double that recorded during the preceding six months. However, at the year-end and in early 1969 bank liquidity positions were under increasing pressures, as banks sought to finance their loan expansion in an atmosphere of monetary restraint.

The acceleration of commercial bank lending activity during the second half of 1968 was facilitated by a sharp growth in Treasury demand deposits and in private time deposits, while the expansion in privately held demand deposits moderated slightly. Early in the July-December period offering rates on large certificates of deposit (CD's) were quite competitive with the yields available on alternative short-term market securities, and this fostered a rapid buildup in the outstanding volume of CD's. This growth subsequently tapered off and actually was reversed at the year-end, but the $3.5 billion rise in the volume of large negotiable CD's at weekly reporting member banks in the second half of the year was a marked improvement over the $1 billion decline recorded during the first half of 1968. Furthermore, although commercial banks placed additional demands for funds on their foreign branches in the face of intensifying reserve pressures, the approximately $0.9 billion rise in these liabilities during the last six months of the year was less than half of the $1.9 billion rise recorded during the first half.