Financing the Federal deficit in 1975 and 1976

The Federal deficit reached historic highs in 1975 and 1976. As a result, in those two calendar years the United States Government had to borrow a massive amount of funds—a record two-year total of $155 billion net.[1] Despite widespread fear that so large an amount would be difficult to raise, all the funds were obtained without strain and in a time of generally steady to declining interest rates. In retrospect, it appears that the unusual conditions accompanying the recent severe recession and the recovery that followed did a great deal to facilitate the smooth financing of the deficits.

During part of the recession and the latter stages of the preceding boom, the rate of inflation was unusually rapid and short-term interest rates climbed to the highest levels in history. At that time, inflationary expectations and the prospect of shortages contributed to substantial inventory accumulation by business. This accumulation led to a great deal of short-term borrowing and, as the recession wore on, a serious excess in inventories.

Against this background, the financial soundness of a number of corporations came into question and, understandably, investors became more quality conscious about securities for a time. Quality consciousness benefits Government securities, the least risky in the market. Furthermore, as the economic recovery developed, corporate cash flow increased greatly. Businesses seized this opportunity to restructure balance sheets: they substituted long-term for short-term liabilities and they added to their holdings of liquid assets, particularly Treasury obligations.

Businessmen's policies became much more cautious after their chastening experiences during the recession. They were quite conservative in their accumulation of inventories. They increased their investment in fixed assets at a modest rate, in part because the previous severe contraction of economic activity left them with a large amount of excess capacity. These restraints on spending caused the demand for bank loans to be unusually weak. Because commercial banks were faced with such weak loan demand, Treasury securities became an attractive investment for them. This was particularly true since the banks, too, wanted to build up their liquid asset holdings. Other investors—namely, thrift institutions, insurance companies, pension funds, state and local governments, and foreign official institutions—also substantially increased their purchases of Treasuries.

The Treasury's offerings

In raising the considerable sums required in 1975 and 1976, the Treasury adopted several policies designed to improve the market's reception of its issues. It kept the market informed of its estimates of financing needs and offered a wider spectrum of maturities on a regular basis. This procedure enabled dealers and investors to anticipate forthcoming offerings and work them into their portfolio strategy. The Treasury also took advantage of the legislation passed in 1976 that provided it with additional flexibility in financing the deficit. For many years there had been a Federal law setting a 4¼ percent interest rate ceiling on United States Government bonds, but bonds could not be sold at 4¼ percent when interest rates began to rise

[1] All data in this article are drawn from the flow-of-funds accounts of the Board of Governors of the Federal Reserve System. The figures on yearly net purchases of Treasury securities by sector are summarized in Table 1, total holdings at the year-end are summarized in Table 2

in the 1960's. In 1971, therefore, $10 billion of the total amount of Government bonds was exempted from the ceiling. In 1976, the amount of exempt bonds was increased to $17 billion.[2]

Around the same time in 1976 that the amount of Government bonds exempt from the interest rate ceiling was increased, the maximum maturity of notes—which are not subject to interest rate ceilings—was extended from seven to ten years. Given the favorable environment in the debt markets, the Treasury undertook to sell relatively more coupon securities than bills. Thus, 1976 was the first year since 1964 in which the average maturity of the Government debt was extended

Much of the new borrowing was accomplished by regular offerings of coupon securities. Monthly offerings of two-year notes began in February 1975 and later quarterly sales of four-year and five-year notes were added as ordinary parts of the financing schedule. The Treasury also added to its offerings of bills, particularly in 1975.

In 1976, for the first time in six years, the Treasury also made use of fixed price subscription issues. In these issues, coupon rates are set by the Treasury and the obligations are sold at par. The technique was used for one issue of seven-year notes and two issues of ten-year notes offered in minimum denominations of $1,000. These were extremely successful in attracting a greater diversity of buyers. In fact, the obligations were so popular that they were heavily oversubscribed. The Treasury was therefore able to increase the total volume of funds raised through the subscription issues to $18.5 billion, $7.5 billion more than the amount originally planned.

Buyers of debt: nonfinancial corporations and commercial banks

Rising sales and improved profit margins swelled corporation cash flows as the recovery proceeded. Internally generated funds sufficed to cover a major portion of the modest expenditures on plant and equipment.[3] And, of course, inventory accumulation was for the most part also cautious.

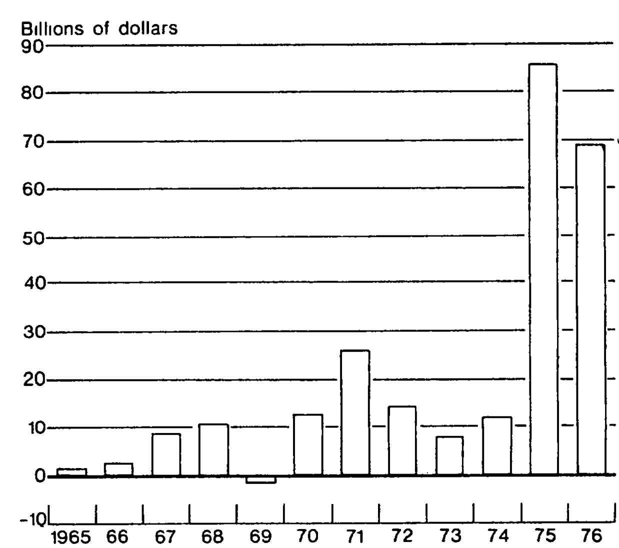
[2] The exemption now applies to the amount of Government bonds outstanding apart from holdings by the Federal Reserve System and Government investment accounts This means that the amount of Government bonds that can be issued under the $17 billion ceiling can change when the Federal Reserve or Government investment accounts purchase outstanding issues that carry a coupon rate of more than 4¼ percent When this happens, additional bonds can be sold to the public As of January 31, 1977, the Federal Reserve Banks and United States Government accounts held $11 billion of the $23 billion outstanding Government bonds with coupons in excess of 4¼ percent

[3] For further details, see "Capital Spending—A Lack of Dynamism", page 14

Corporations have issued a substantial quantity of long-term debt and of equities ever since the present recovery began. The funds raised were largely used to repay short-term borrowing—particularly bank loans—and to purchase liquid assets. In the process, corporations acquired a sizable volume of Treasury securities; they bought a net $17.2 billion of Governments in 1975-76. These purchases raised their total holdings from $5 billion at the end of 1974 to $22.5 billion at the end of last year. The rise in their holdings of Governments along with their repayment of short-term debt improved the liquidity of nonfinancial corporations: the ratio of liquid assets to short-term liabilities increased from a low of 26.6 percent at the end of 1974 to 34 percent at the end of 1976.

Since corporate demand for bank loans was weak, commercial banks were drawn to Treasury securities. Acquiring them also enabled commercial banks to rebuild their own liquidity. Data for weekly reporting banks show that their ratio of liquid assets to liabilities rose from a low point of 8 6 percent during October 1974 to a high of 13.9 percent by December 1976. Over the two-year interval, commercial banks bought a net $46 billion of Treasury securities, thus bringing their portfolio of Governments to $103 billion by the end of last year.

Annual Changes in Treasury Securities Outstanding



Source Board of Governors of the Federal Reserve System

Buyers of debt: households and thrift institutions

Households[4] provided funds to finance the Federal deficit in 1975 and 1976 in two ways. They did so directly through their purchases of Treasury debt. They also did so indirectly through deposits in thrift institutions that used part of the inflow of such deposits to buy Government securities.

Households shifted from being large net purchasers of Treasury securities in 1975 to being net sellers in 1976. This shift stemmed from changes in the rates of interest on marketable Treasury securities in relation to the rates available on time and savings accounts. Rates on time and savings deposits do not change very often, and these rates may not exceed specified ceilings. Thus, whenever the yield on Treasury securities rises above the rate on savings deposits, households tend to increase direct purchases of Treasury issues and to reduce the flow of deposits to savings accounts (at times, they may even make net withdrawals). When the yields on Treasury issues fall toward or below the rates on savings deposits, the flow tends to shift back toward savings accounts.

In the period under consideration, households had occasion to do both. Toward the end of 1974 and the beginning of 1975, rates on Treasury securities declined sharply from the extremely high levels attained in mid-1974. Households therefore started to increase their deposits at commercial banks and thrift institutions and were net sellers of Treasury securities. In the remainder of 1975, households were net buyers of marketable Treasury issues, particularly during the third quarter when market rates rose temporarily. Over 1975 as a whole, households acquired a net $6.4 billion of marketable Treasury obligations.

During 1976, in contrast, holdings of marketable Government issues by households actually declined a net $7.7 billion. The reason was that market rates of interest were relatively low and stable in 1976. Indeed, by December, some short and intermediate rates were at their lowest levels in four years. Households therefore were net sellers of Treasury issues in all quarters of 1976 except for the second, when market rates of interest rose briefly. Most of the proceeds appear to have been deposited in time and savings accounts. However, over 1975-76 combined, households also bought a net $8.7 billion of savings bonds. As a result, household holdings of all Treasury debt rose by $7.5 billion to $111 billion.

By the end of 1976, thrift institutions had also enlarged their holdings of Governments. While market rates remained high during the first half of the recession, the deposit gains of thrift institutions slowed down. The subsequent fall of market rates made savings deposits competitive again in 1975 and 1976 With these reflows, both savings and loan associations and mutual savings banks restored their liquidity as they acquired Treasury securities with some of these deposits. In the two years, thrift institutions took on a net total of nearly $8 billion of Treasury securities. In addition, savings and loans repaid borrowings from Federal Home Loan Banks, while savings banks (which generally are not members of the Federal Home Loan Bank system) increased their purchases of corporate bonds. As thrifts rebuilt their liquidity, they also began to expand their mortgage portfolios more rapidly.

Other buyers of debt

As the economy expanded in 1975-76, pension funds[5] and insurance companies received sizable inflows of funds. Previously, these institutions had not been particularly heavy investors in United States Government securities and, indeed, had been net sellers in recent years. The availability of large new issues of these securities during the past two years, however, provided a welcome outlet for the investment of a portion of the large inflows of funds. Thus, pension funds and insurance companies added considerably to their holdings of these securities in 1975-76. Pension fund portfolios of Government securities grew by $11.3 billion, and insurance company holdings increased by $6 5 billion These investments amounted to 16 percent of the financial assets added to the portfolios of these institutions during the two years, as their purchases of other securities also rose. On the other hand, acquisitions of mortgages by life insurance companies slowed markedly since the availability of attractive investments was constricted by the reduced construction of commercial buildings and multifamily residential units.

State and local government general funds also substantially increased their net purchases of Treasury issues in 1975-76. Some purchases—although it is not clear how much—involved using Treasuries as a vehicle for advance refunding of the municipalities' own obligations issued when interest rates were high. The decline in rates encouraged municipalities to undertake such refunding to the extent possible. This can be done, even though the obligations themselves are not yet eligible to be called, by selling new debt at the current lower rate of interest and investing the pro-

[4] The category "households", as used here, includes not only households but also personal trusts and nonprofit organizations

[5] The term "pension funds", as used here, includes private pension funds and employee retirement funds of state and local governments

Table 1

Net Annual Purchases of Treasury Securities

In billions of dollars

Sector	1972	1973	1974	1975	1976
Nonfinancial corporate business	−2 6	− 5.3	2.1	9.0	8 2
Commercial banks	2 4	− 8.8	−2 6	28.8	17.4
Thrift institutions	−0 3	− 2.9	−0.6	4.5	3 3
Savings and loan associations	−0 5	− 2.4	−0.2	2.3	2.2
Mutual savings banks	0.2	− 0 5	−0 4	2 2	1.1
Households	3 0	17 0	9 2	10.5	− 3.0
Savings bonds	3 3	2 7	3 0	4 0	4.7
Other Treasury	−0 2	14.3	6 2	6 4	− 7 7
Private pension funds and state and local government retirement funds	0 5	− 0 9	−0 9	5 4	5 9
Insurance companies	−0 3	− 0 5	−0 1	3.3	3 2
State and local government general funds	4.4	− 0 1	−1 8	6 3	10.7
Foreign	8 4	0.3	3.7	8 1	10.1
Federal Reserve	−0 3	8.6	2 0	7.4	9.1
Other*	−1 0	0.5	0 9	2 7	4 4
Total	14 3	7.9	12 0	85.8	69.1

Table 2

Holdings of Treasury Securities

In billions of dollars, at the year-end

Sector	1972	1973	1974	1975	1976
Nonfinancial corporate business	8.5	3.2	5.3	14.3	22 5
Commercial banks	68.0	59 2	56.6	85.4	102.8
Thrift institutions	9 2	6 2	5.6	10.1	13 4
Savings and loan associations	5 7	3.2	3.1	5.4	7.5
Mutual savings banks	3 5	3 0	2 6	4 7	5 9
Households	77 6	94.6	103 9	114.3	111 4
Savings bonds	57.7	60.4	63.3	67.4	72.0
Other Treasury	19.9	34.2	40 5	47.0	39.3
Private pension funds and state and local government retirement funds	6 5	5 6	4 7	10 1	16 0
Insurance companies	6 7	6 3	6 2	9.5	12 6
State and local government general funds	26.2	26 1	24.3	30.6	41.3
Foreign	54 4	54.8	58 4	66 5	76 6
Federal Reserve	69 9	78 5	80.5	87 9	97.0
Other*	4 5	5.0	5.9	8.6	13 0
Total	331 5	339 4	351.5	437.3	506 4

* The category "Other" consists of investment companies, money market funds, securities brokers and dealers, credit unions, and Federally sponsored credit agencies

Source Board of Governors of the Federal Reserve System

ceeds in special Treasury securities The municipality generally earns enough on the Treasury securities to cover its new interest payments. As soon as the old municipal obligations carrying the high rates mature or can be called, the municipality pays them off with the proceeds from the special Treasury issues—issues that were designed to mature at the same time. In this way, the municipality has substituted new, lower interest debt for older, higher interest debt Of course, until such a switch can be made, the municipality must continue to service the original higher interest debt.

Purchases of Treasury securities by foreign official institutions and international organizations provided a major source of funds for financing the 1975 and 1976 Federal deficits Over that period, foreign holdings of Treasury issues rose $18 billion, nearly five times the rate of acquisition in the 1973-74 period. Major groups of foreign purchasers in order of importance were: (1) central banks and governments of industrial countries, (2) OPEC governments, and (3) international organizations, particularly the World Bank. Acquisitions by industrial countries, which accounted for one third of total foreign purchases over the two-year period, were especially heavy in 1976 and resulted from the large amount of dollars obtained through exchange market operations by central banks, particularly those of Germany, Switzerland, and Japan. Purchases by OPEC members, which were more than one fourth of total foreign acquisitions in 1975-76, grew steadily over the period, reflecting the continued strong surplus position of those countries. At the same time there was a marked shift in the OPEC portfolio toward longer term Treasury obligations.

During 1975 and 1976, the Federal Reserve acquired a net $16.5 billion of Treasury securities. These purchases reflected the Federal Reserve's policy of providing enough bank reserves to support a growth of the money supply compatible with the System's aim of helping to achieve stable and noninflationary economic growth.

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