The Cost of Capital: An Update

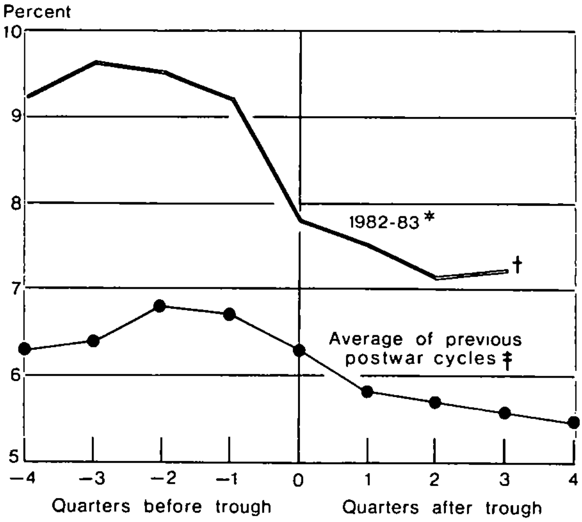
Nominal interest rates reflect both financial market pressures and inflationary expectations Yet what matters for household and business investment decisions are *real rates, i e ,* rates that somehow net out expected inflation In a previous article,[1] an attempt was made to measure such a real rate of interest—the cost of capital

In a rough sense, the cost of capital (chart) is a weighted average of the dividend-price ratio and an inflation-adjusted bond rate The bottom line shows the previous pattern of the cost of capital around business cycle troughs. In the past, the cost of capital peaked two quarters prior to the trough quarter and fell thereafter—for a cumulative decline of about 125 basis points Most of the decline was achieved by the second quarter past the trough

In the most recent U S. experience, two things are noteworthy about the behavior of the cost of capital. First, the overall level is considerably higher than the historical average. The peak level shown in the chart corresponding to the first quarter of 1982 was 9 6 percent This compares with a historical average peak of

[1]See "The Cost of Capital How High Is It?", this *Quarterly Review* (Summer 1982), pages 23-31

Cost of Capital around Cyclical Troughs



* Trough is 1982-IV

† Preliminary estimate

‡ Postwar recoveries, 1949 and 1980 excluded

Sources Estimated by the author, using U S Department of Commerce National Income and Product Accounts, Flow of Funds Accounts

about 6¾ percent Second, the reduction of the cost of capital from its peak level has been quite a bit larger than the average historical pattern The estimate for the third quarter 1983 (shown as the third quarter past the trough) is about 240 basis points below the pre-trough peak, almost double the previous decline around the typical business cycle trough

Why has the cost of capital fallen so much farther than in past cycles? A complete explanation is beyond the scope of this note The main reason lies in the stock market rally of the past year which has served to bring equity financing costs down sharply The drop in the dividend-price ratio "explains" about 220 basis points of the drop in the cost of capital from the peak in the first quarter of 1982 [2]

As of the second quarter of 1982, the relative importance of equity financing in the cost-of-capital measure

[2] By comparison, the decline in the inflation-adjusted bond rate component contributes about 75 basis points to the decline Taken together, the reductions of the debt and equity financing components of the cost of capital overexplain the drop in the measure itself The stock market rally has raised the relative weight received by equity financing costs Since the equity costs exceed debt-financing costs, the effect is to raise the measured cost of capital

was at its highest point in more than ten years This point is underscored by the heavy volume of new equity financings in 1983, amounting to $39 billion thus far this year With equity financing so important, it can be very misleading to look at nominal or inflation-adjusted bond rates alone as a measure of the cost of capital

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