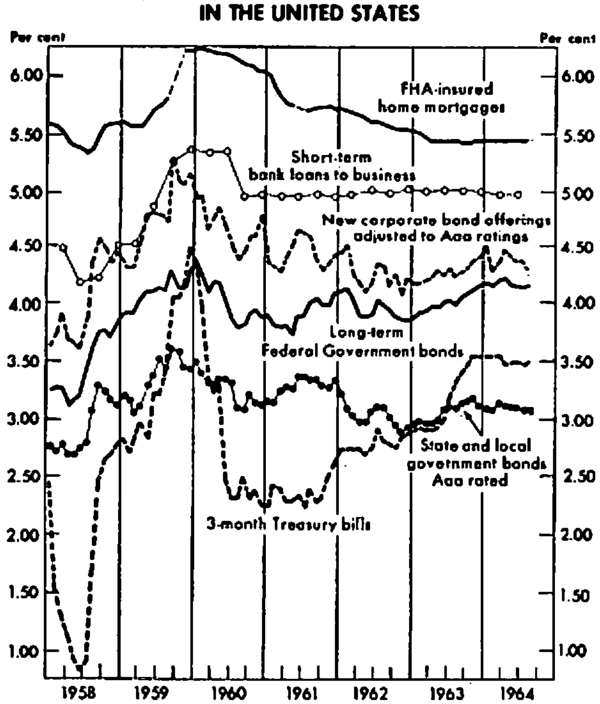
Recent Capital Market Developments in the United States

The first eight months of 1964 have been characterized by marked stability in interest rates, despite the steadily growing credit needs of an expanding economy. Indeed, interest rates are currently at levels almost identical to those prevailing at the end of 1963 (see Chart I). This stability has been due, among other things, to the continued ready availability of bank credit, to the ability of businesses to finance much of their recently increased capital expenditures from internal sources of funds, and to the high rate of financial savings by individuals. Also, market expectations have helped to stabilize interest rates this year. A brief and moderate expectations-induced rise in interest rates did occur around the time of the tax cut, reflecting the widespread belief that the resulting stimulus to the economy would lead to a surge of demands in the capital markets, but this rise was reversed when such a surge failed to develop. Since then, a considerable measure of confidence has prevailed in existing interest rate levels.

Chart I
THE STRUCTURE OF INTEREST RATES IN THE UNITED STATES



Note: Bank loan data are plotted through June 1964; all other series through August.

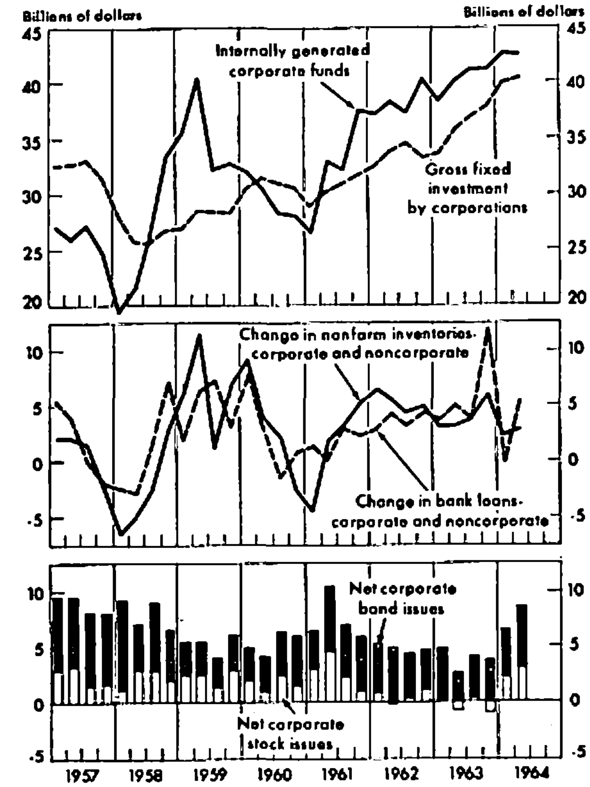
Sources: Board of Governors of the Federal Reserve System; First National City Bank of New York; Moody's Investors Service.

BUSINESS CREDIT DEMANDS

The continuing growth in business sales, coupled with the need to modernize plant and equipment facilities, has resulted in greatly expanded business spending on new productive facilities. Such spending reached an estimated annual rate of $43 billion (seasonally adjusted) in the first half of 1964, exceeding the rate for the same period last year by almost 15 per cent. Nevertheless, business demands on the credit and equity markets have again been moderate this year as a rising volume of internally generated funds kept pace with the growth of capital expenditures. Funds available internally—roughly equal to depreciation charges plus retained profits—are estimated, in the case of nonfinancial corporations, to have exceeded total capital expenditures by 6 per cent in the first half of this year. While this percentage excess is smaller than that prevailing over the past two calendar years, it contrasts markedly with earlier years of high capital expenditures, such as 1956-57, when internally generated funds actually fell short of capital spending by almost 18 per cent.

The present high level of internally generated funds is due in part to the growth of both profits and depreciable fixed assets, but businesses are also continuing to benefit greatly from two tax measures adopted in 1962. These measures permitted firms to depreciate many assets over a shorter number of years and to deduct from their current profits tax liability up to 7 per cent of the cost of most types of newly purchased equipment. The 1964 reduction in the corporate profits tax rate from a maximum of 52 per cent to

Chart II
COMMERCIAL AND INDUSTRIAL
BUSINESS INVESTMENT AND FINANCING



Note: All figures are seasonally adjusted annual rates. Second-quarter 1964 figures are preliminary estimates.

o Indicates net total of bond and stock issues for periods of net stock redemptions.

Source: Board of Governors of the Federal Reserve System.

a maximum of 50 per cent did not directly benefit corporate cash positions in the first half of this year, however, because Federal taxes on profits earned during the first half of a calendar year are not remitted until the second half. But this tax rate reduction and the scheduled further reduction to 48 per cent in 1965 have added to expected future cash flows and may, therefore, have eliminated some current borrowing for future needs that would otherwise have taken place.

Because of their ability to generate internally the funds needed for expansion of plant and equipment and working capital, nonfinancial corporations have continued to make only moderate demands on the bond and stock markets. Though net bond and stock issues by these corporations have risen this year, both remain at about the same levels as those reached back in 1957 and 1958 when capital spending was much lower (see Chart II).

Despite the recently higher volume of corporate bond financing, the offering yields on new issues continue at historically low levels relative to the yields on United States Government bonds (see Chart I). This reflects, in part at least, the relatively small increases in the supply of corporate issues and the ever-growing demand for them by institutional investors, such as insurance companies and pension funds. These institutions have increasingly dominated the corporate bond market in the postwar period. On the other hand, purchases of corporate bonds by individual investors have diminished in importance.

New stock issues by nonfinancial corporations in the first and second quarters of this year increased sharply from 1963 when repurchases of shares by these corporations exceeded gross new issues. However, the rise this year reflected two special new issues—the $1.2 billion "rights" offering by the American Telephone and Telegraph Company and the $200 million offering by the newly formed Communications Satellite Corporation. Together, these two issues account fully for the total net increase in common stock in the first half of this year. Thus, there was no general return by corporations to the stock market for new funds, despite the fact that stock prices now far exceed the levels prevailing during the 1957-61 period when new stock issues were an important element in corporate finance (see Chart II).

Business demand for short- and intermediate-term credit has also been moderate this year, due to the continuing absence of rapid inventory accumulation. Since investment in inventory is typically financed initially by short-term credit, the slow rate of accumulation has again restrained business demand for bank loans—the primary source of inventory financing (see Chart II).

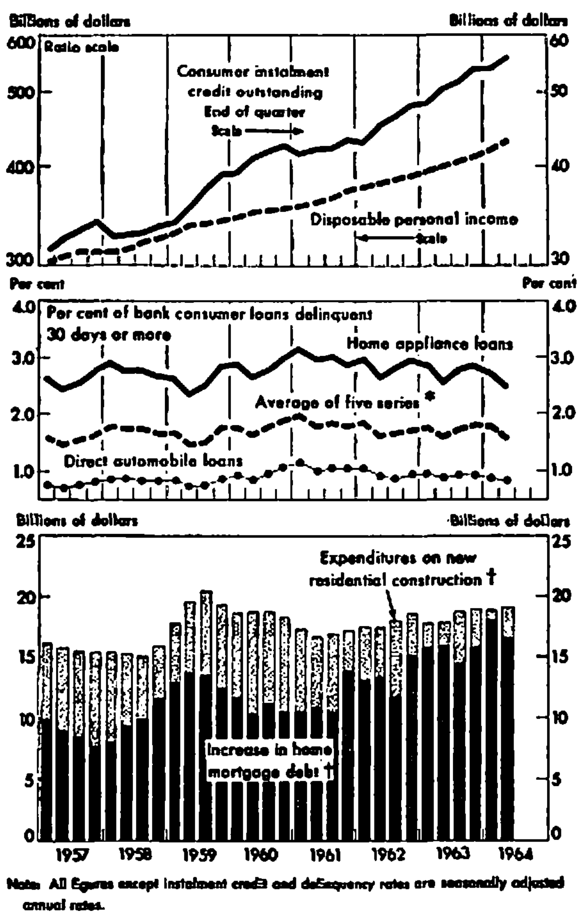
CONSUMER FINANCE

Individuals this year have continued to borrow heavily to finance purchases of homes and consumer goods. With the rise of personal incomes and the cut in income taxes, however, new borrowings have not increased quite so rapidly as in the past two years, and repayments on old debts have accelerated somewhat. Also, individuals this year again added to their financial investments at a substantial rate, with some indications that their investment in credit and equity market instruments was increasing.

Due to rapid increases in consumer instalment debts over the past few years (see Chart III), total repayments on these debts now equal a record 14 per cent of personal disposable income, nearly a full percentage point more than at the beginning of the current business expansion. Nevertheless, these debts continue to grow, suggesting that households are finding the current burden of repayments to be of manageable proportions. This conclusion also seems to be borne out by the data compiled by the American Bankers Association on consumer loan delinquencies at commercial banks. Loans with payments past due by thirty days or more now average less than 1.7 per cent of the total, near the low end of the range prevailing in recent years, and markedly below the rate attained in the late 1940's and early 1950's, when total consumer debt repayments ran considerably lower relative to total disposable income and average family income was less.

One important factor in the continued growth of consumer credit may be the use of this form of financing by more households. Information in this area is limited to surveys of relatively small groups of families—and these can be subject to considerable error—but such studies by the University of Michigan's Survey Research Center indicate that the proportion of all households having instalment debts may have increased by as much as 4 or 5 percentage points from early 1962 to early 1964. If true, this would mean that the increased volume of consumer credit has been spread over more households, or, in other words, that the average indebtedness of debtor households has not increased so much as total outstanding credit. Additional Michigan Survey data do in fact suggest that debtor families are generally not much further in debt relative to their incomes now than they were a few years ago. Thus, the rise in the aggregate repayments ratio mentioned earlier does not appear to be indicative of substantially increased borrowing per family.

Chart III
CONSUMER BORROWING PATTERNS



Note: All figures except instalment credit and delinquency rates are seasonally adjusted annual rates.

* Direct and indirect automobile loans, home appliance, property improvement and personal loans.

† 1964 figures are preliminary estimates.

Sources: Board of Governors of the Federal Reserve System; Department of Commerce; American Bankers Association.

The ready availability of mortgage credit and the relatively liberal terms offered by lending institutions have made possible further substantial growth in home mortgage debt (see Chart III). Net borrowing has again increased relative to households' expenditures on newly constructed residences as lenders continued to finance large percentages of the purchase prices of homes. However, other factors, such as borrowing on homes to finance major nonhousing expenditures and the refinancing of older homes at higher prices, are doubtlessly also contributing to the sustained growth in home mortgage debts.

Despite the strong demand for mortgage credit, the supply of mortgage funds continues to be quite ample. The contract terms on mortgage loans—including interest rates, required downpayments, and years allowed for repayment of loans—all continue to be quite favorable to borrowers. Market rates of interest on FHA mortgages have held constant this year at the level established in the spring of 1963 following a three-year decline (see Chart I). There has been some flattening out this year in the growth of time and savings deposits at commercial banks and savings and loan associations, and this has tended to lessen somewhat the availability of mortgage loans from these important sources. Insurance companies have increased their participation in the market, however, thus helping to offset any tightening of mortgage credit that might have otherwise occurred.

The tapering-off in the rate of deposit growth at some savings institutions during the first half of this year coincided with, and may have been partly due to, an increase in the rate of individuals' purchases of stocks, bonds, and mortgages. These purchases in total ran almost $1.5 billion higher in the first half of the year than in the same period last year. Investment in common stock was particularly large by comparison with recent years, reflecting the large offerings by the American Telephone and Telegraph Company and the Communications Satellite Corporation mentioned earlier. These two issues together absorbed about $1 billion of funds from individuals.

Finally, the available data indicate that consumers again increased their holdings of demand deposits at a substantial rate in the first half of this year. Together with the lessened but still substantial rate of increase in savings deposits, this suggests that individuals are maintaining a high degree of liquidity, which is a favorable element in the outlook for consumer spending on goods and services.

GOVERNMENT FINANCE

State and local governments borrowed slightly less in the bond markets in the first half of this year, with total new issues estimated at about 5 per cent less than the volume marketed in the first half of 1963. Since retirements and repayments rose this year, the net increase in the securities of state and local governments fell about 8 per cent short of the increase during the same period last year. Yet, despite the decline, borrowing by these governments continues at a high level.

Two developments that might have been expected to weaken the market for state and local securities occurred during the first half of 1964. First, commercial banks sharply reduced their participation in the market, as indeed they had begun to do toward the end of 1963. These banks, which absorbed fully three fourths of the net increase in the supply of municipal bonds in 1963, purchased only about 40 per cent of the net increase in the first six months of this year, the lowest share for any half-year period since 1960. Second, the passage of the Federal income tax reductions early this year tended to lessen somewhat the attractiveness of the tax-exempt feature of these bonds to both corporate and individual investors. Nevertheless, the market for municipal securities among high tax-bracket individuals apparently remained broad enough to counter any upward pressures on yields that these developments might have produced. Yields on state and local government securities this year have actually shown only narrow fluctuations about the level existing at the close of 1963. Moreover, the ratio of yields on prime grade municipals to yields on prime grade corporates has continued at about 70 per cent, the same relationship that prevailed on average through 1962 and 1963.

The operations of the United States Treasury in the capital markets have been of significant proportions this year. Although publicly held Federal debt actually declined by almost $2 billion through July, the advance refunding of outstanding issues—that is, the swapping of new long-term securities for outstanding issues with shorter remaining lives—has been used extensively to lengthen the average maturity of the debt.[1] Through these operations, the Treasury this year extended the maturity of $12.3 billion of Federal debt, $6.3 billion of which was refunded with new securities having maturities of nine years or more. Due to these advance refundings, the average maturity of marketable Federal debt was lengthened from five years and one month at the beginning of the year to five years and four and one-half months at the end of July —the longest average maturity since 1956.

These advance refundings have met with considerable success. The July advance refunding—the largest offer ever made by the Treasury—was accorded an unusually good reception, with subscriptions from the public totaling $9.3 billion or 34.7 per cent of their eligible holdings.[2]

THE ROLE OF THE BANKING SYSTEM

Throughout this year commercial banks have continued to play an important though somewhat reduced and changed role in the markets for longer term funds. The decline of bank participation in the market for the obligations of state and local governments has already been noted. On the other hand, commercial banks have continued to acquire mortgage loans at the record high rate established in 1963. Seasonally adjusted commercial and industrial loans expanded at an annual rate of $4.1 billion (nearly 8 per cent) through July, exceeding the growth rate for the comparable portion of 1963. This, on the whole, is still a modest performance for business loans during a period of economic expansion, reflecting, it appears, the already-noted reduced need for external financing by these borrowers rather than any unwillingness by banks to extend such loans.

Bank loans to consumers rose somewhat less through July of this year than last year, but not significantly so. Again, this seems to reflect a moderate slowing of the growth of demand for these loans, a development which appears to be related to the recent cut in personal income tax rates rather than to any change in bank lending resources or preferences.

An important factor shaping commercial bank lending

[1] For a fuller discussion of the Treasury's advance refunding operations, see Ernest Bloch and Joseph Scherer, "Advance Refunding: A Technique of Debt Management", this *Review*, December 1962, pp. 169-75.

[2] See "The Money Market in July", this *Review*, August 1964, pp. 148-49.

and investing practices this year has been the decline of time and savings deposit growth, from 14.7 per cent in 1963 to 10.8 per cent (on a seasonally adjusted annual rate basis) in the first seven months of this year. This slowdown has resulted in part from recent increases in the interest rates paid by competing savings institutions—mostly by mutual savings banks. In this connection, it will be recalled that regulations of the Federal Reserve Board and the Federal Deposit Insurance Corporation currently permit commercial banks under their supervision to pay no more than 3½ per cent on savings deposits of less than one year, and no more than 4 per cent on one-year savings deposits and time certificates and other time deposits with maturities of ninety days or longer.

One important reaction by banks to this slackening in time deposit growth has been, as noted earlier, to restrict purchases of state and local obligations. But, on balance, banks still continue to be important investors in the capital markets, where their participation in recent years has had an important influence on interest rates.