Recent Developments in the Capital Markets

During the latter half of 1970 and early 1971, sluggish economic activity together with the Federal Reserve System's pursuit of stimulative monetary policy gave rise to considerable relaxation of capital market conditions. Consequently, interest rates throughout the maturity spectrum declined appreciably from their peaks of 1970 even though debt financing by corporations and state and local governments reached record proportions. More recently, capital market conditions have firmed somewhat, and the earlier dramatic decline in rates has been partially reversed although rates remain well below their 1970 highs.

The lower interest rates and the Federal Reserve's policy of monetary expansion have also significantly reshaped the pattern of financial flows in the economy. One manifestation of this development has been the growth and restructuring of the commercial banking sector's balance sheet and the reemergence of the banking sector as a primary supplier of credit in the economy. For example, over the nine-month period ended with the first quarter of 1971, commercial banks supplied about 49 percent of the funds advanced in credit markets, whereas in the three preceding quarters commercial banks provided only 13 percent of the total volume of funds. This has been accompanied by the renewed inflow of deposits to savings and loan associations and mutual savings banks. As a result, the mortgage markets have become less dependent upon the Federal agencies for housing as a source of support, though some recent difficulties in the secondary mortgage market have caused a resumption of active participation by the Federal National Mortgage Association (FNMA).

Shifts in the composition and maturity structure of credit market demands have also been dramatic. In 1969 and early 1970, state and local borrowings in the tax-exempt market were sharply curtailed, but the improvement of credit market conditions since then has prompted them to step up their borrowings. Corporate demands for funds have remained heavy despite the slowing of investment spending. In part, this reflects the continued wide spread between investment outlays and internally generated funds. In addition, corporate liquidity building and the substitution of long-term for short-term debt has produced a record volume of bond financing. In the household sector, consumer credit demands have remained relatively modest at the same time that mortgage borrowing has increased substantially. Recent data indicate that consumer credit may be resuming a more rapid rate of expansion. Nevertheless, consumers continue to acquire time and savings deposits at a rapid rate, reflecting both a high rate of saving out of current income and the reinvestment in interest-bearing deposits of the proceeds of maturing short-term securities purchased in 1969 and 1970 when open market rates were high relative to deposit rates.

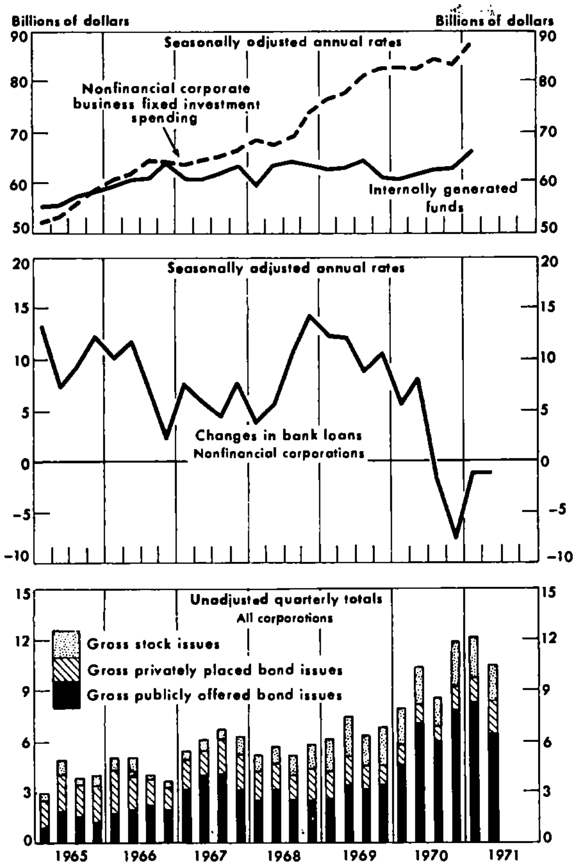
BUSINESS FINANCE

The slackened pace of fixed investment spending and inventory accumulation in 1970 and early 1971 has resulted in a somewhat reduced rate of advance in overall business financing requirements. To some extent, this trend has been reinforced by a slight narrowing of the gap between total capital expenditures and internally generated funds. In the first quarter of 1971, the ratio of fixed capital outlays to internally generated funds was 1.32, whereas at the end of 1969 that ratio stood at 1.36. However, even at its first-quarter level, that ratio reflects a $21 billion spread between fixed investment spending and funds generated internally (see Chart I). Thus, corporate demands for external funds have remained relatively heavy despite the economic slowdown and the reduced pace of inventory spending.

While the overall demands of corporations on the credit markets have continued relatively heavy, changing financial market conditions have resulted in a significant restructuring of the patterns of corporate borrowing. For example, during 1969 very high long-term interest rates prompted many corporations to step up their short-term financing. As a result, the ratio of net long-term bond issues by nonfinancial corporations to their fixed investment expenditures declined to .15 in 1969, having been as high as .23 in 1967. This ratio rose to .17 in the first

Chart I

SOURCES AND USES OF CORPORATE FUNDS



Sources: Board of Governors of the Federal Reserve System and the Securities and Exchange Commission. Second-quarter estimates by the Federal Reserve Bank of New York.

quarter of 1970, as corporate debt flotation began to increase. After the liquidity crisis of mid-1970 and the eventual turndown in interest rates, a massive shift to long-term financing took place and by the first quarter of 1971 the ratio had risen to .29. This shift toward bond financing reached a peak in the first quarter of 1971 when the gross proceeds from issues of new publicly offered corporate bonds reached $8.4 billion, with $4.1 billion of that total being marketed in March. The volume of public offerings apparently tapered off in the second quarter, though it stood at a level above any ever recorded prior to 1970.

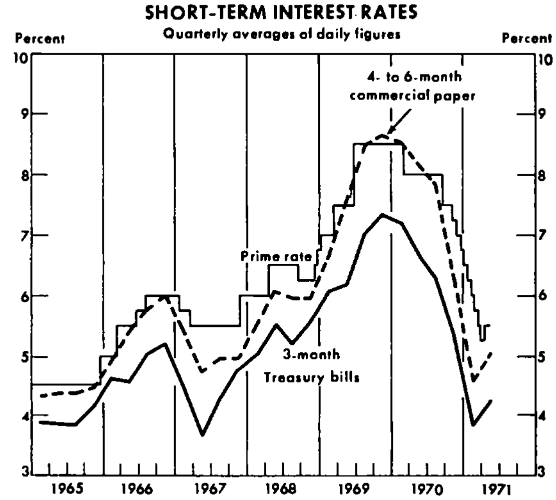
This record volume of new corporate debt offerings over the past year has been accompanied by substantially reduced reliance on business loans at commercial banks as well as lessened dependence on other forms of short-term credit. Moreover, corporations have made substantial additions to their holdings of short-term assets. As a result of these developments, there has been considerable improvement in corporate liquidity positions. Thus, for nonfinancial corporations, the modified quick asset ratio—which divides the sum of demand deposits, time deposits, currency, United States Government securities, and open market paper by total current liabilities—had declined to its record low of .261 at the end of 1969. By the end of the first quarter of 1971 it stood at .306, the highest level since the second quarter of 1966.

The yields corporations must offer on their long- and short-term debt instruments have declined dramatically since their peaks in 1970 (see Charts II and III), although long-term yields remain high by historical standards. Interestingly, however, even after the rises of the past three months, yields are still below the levels that prevailed at the cyclical trough in economic activity, which has been tentatively identified by the National Bureau of Economic Research as November 1970. Indeed, throughout the contraction phase of the current cycle, bond yields displayed an atypical behavior pattern. Traditionally, bond yields, together with short-term money market rates, decline as real activity contracts, reaching a low point about the same time as the trough in real activity is reached (see Chart IV). During the recent cycle, however, the heavy volume of bond financing placed unusually strong pressure on the long-term credit markets at the same time that inflationary expectations made investors reluctant to commit them-

Chart II

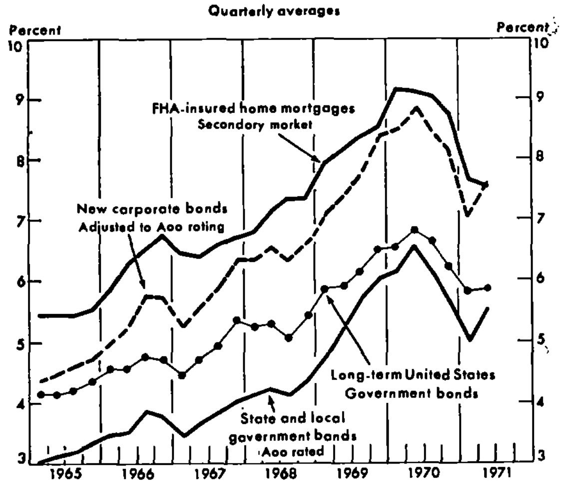
SHORT-TERM INTEREST RATES

Quarterly averages of daily figures



Source: Board of Governors of the Federal Reserve System.

Chart III
LONG-TERM INTEREST RATES
Quarterly averages



Note: In the mortgage yield series, estimates for periods for which the Federal Housing Administration does not provide data were obtained by linear interpolation. Estimate for second quarter 1971 based on April and May data.

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

selves to fixed income securities. Once the trough was reached, bond yields joined money market rates in a steep decline which continued further into the recovery phase of the business cycle than is usual. Although rates have generally been rising since about mid-March, they are still low in relation to their levels at the time of the trough in business activity when viewed in the context of previous post-Korean war cycles.

The high absolute level of long-term interest rates reflects the price expectations premium that has been built into rates in the wake of the rapid inflation experienced during the past few years. As long as prices and profits are expected to rise rapidly, lenders will demand high yields and borrowers will be willing to pay them. Only as inflationary expectations are curbed can long-term interest rates be expected to decline markedly from their current levels.

Private placements of corporate bonds have risen in recent quarters, reflecting the renewed ability of life insurance companies to participate in the bond markets. During 1969 and early 1970 the volume of life insurance company policy loans increased greatly, as policy holders took advantage of the relatively lower yields on these loans. As a result, life insurance companies were able to enlarge their holdings of corporate bonds by only $0.63 billion in the last quarter of 1969 and the first half of 1970, compared with an increase of $3.9 billion in their bond holdings during 1968. At the same time, these companies decreased their holdings of home mortgages. With the decline of policy loans in late 1970 and the first quarter of 1971, these companies have again become active in the bond market, adding a net amount of $0.7 billion in bonds to their portfolios during the first quarter of 1971. While this development is augmented by the continuing decline of mortgage holdings by these companies, it is restrained somewhat by the greater interest of these companies in the acquisition of equity securities.

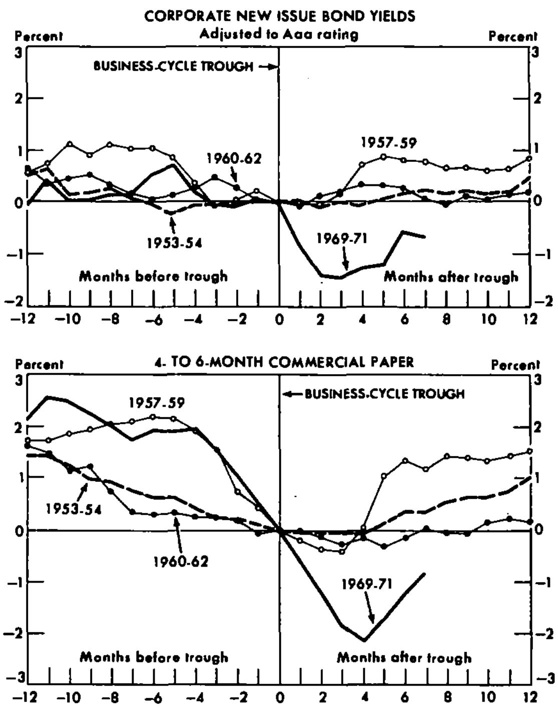
CONSUMER FINANCE AND THE MORTGAGE MARKET

Over the last several quarters, consumer spending and saving decisions have been affected by the uncertainties arising from increasing unemployment and the unsettled behavior of the economy generally. In part, these factors have fostered attempts to rebuild liquidity positions, as indicated by the high savings ratio and the rapid rate at which consumers have acquired time and savings deposits at both commercial banks and thrift institutions. Concurrently, the pace at which households have incurred additional liabilities in recent quarters has remained well below the rates which prevailed in 1968 and 1969. Thus, for the nine-month period ended in March 1971 the volume of outstanding consumer credit had increased at an annual rate of 1.2 percent, compared with its average growth of 8.3 percent during the preceding two-year period. In large part, the sluggish pace at which consumer credit expanded over this interval was a reflection of the reduced pace of consumer spending on durable goods.

Toward the end of the first quarter and into the second quarter, however, there were indications that both consumer spending and consumer credit were beginning to expand at a more robust rate. In April and May, total outstanding consumer credit rose at seasonally adjusted annual rates of $928 million and $638 million, respectively. The April increase was the largest monthly rise in consumer credit since May 1969. Similarly, commercial bank loans to consumers appeared to strengthen late in the first quarter and into the second quarter.

While consumer credit growth slowed during 1970 and early 1971, home mortgage credit expanded at a strong pace, reflecting not only the demand for such credit but also the changing pattern of its supply. Together with the high rate of consumer saving, the decline of money and credit market yields caused the combined total of savings capital at savings and loan associations and deposit shares at mutual savings banks to grow at an average annual rate of $31.1 billion during the three-quarter period ended March 1971, compared with its growth at an average annual rate of $6.9 billion in the preceding nine-month period (see Chart V). At the same time, household holdings of United States Government securities declined sharply at an average annual rate of $29.5 billion. The inflow to thrift institutions was assisted by the growing use of savings certificates and other forms of special deposits which offer higher yields than passbook accounts. Growth of deposits took place at a historically high annual rate of $49.1 billion during the first quarter of 1971 but subsided somewhat in April and May, the last two months for which figures are available. As a result of this strengthening of deposit flows, savings and loan associations were able to increase their participation in the home mortgage market at the same time that they began repaying their advances from the Federal Home Loan Bank System—which in 1969 had provided 47 percent of the net new liabilities of its members. Coincident with this development, the mutual savings banks continued their more restrained participation in the home mortgage markets and greatly added to their portfolios of corporate bonds.

Chart IV
CYCLICAL PATTERNS OF INTEREST RATE MOVEMENTS



Note: Yields during each cycle are shown relative to average yield in month of cycle trough, which is set equal to zero. The business-cycle troughs, as identified by the National Bureau of Economic Research, are August 1954, April 1958, February 1961, and November 1970 (tentative).

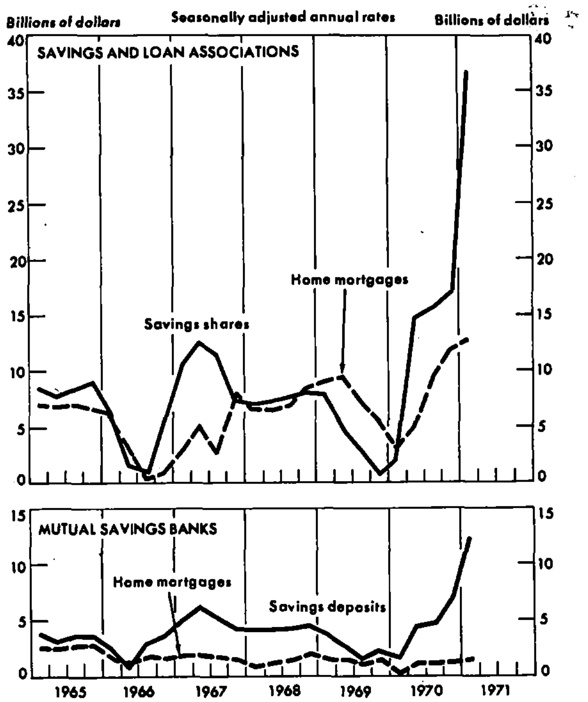
Sources: Board of Governors of the Federal Reserve System and the First National City Bank.

These large inflows of funds to thrift institutions and the resultant greater availability of home mortgage credit prompted a significant easing in the terms under which mortgages are granted, a development that was encouraged in early 1971 by two reductions of the Federal Housing Administration interest ceiling on the mortgages FHA insures. From their peak level in February 1970, mortgage interest rates had declined about 2 percentage points by the spring 1970 when the markets began firming. FNMA took advantage of the better market tone by lengthening the maturity of its debt and in January 1971 raised funds by selling mortgages from its portfolios, the first time it had done so under its new auction technique. With the rise of interest rates in the second quarter of the year, the new FHA-insured and Veterans Administration-guaranteed mortgages began selling at deep discounts, causing disturbance in the secondary market. To alleviate the unsettled market conditions that arose, FNMA held a special auction on June 9 at which no limitations were placed on bid size and all commitments were for delivery in ninety days. This marked a departure from FNMA's regular auction technique in which an individual bid may not be for more than $3 million of commitments and commitments are accepted for delivery in six to twelve months as well as in ninety days. This auction seemed to stabilize the market somewhat, as yields in the regular June 14 auction were slightly below those set in the June 1 auction.

GOVERNMENT FINANCE

Over the last several quarters, the net capital market borrowings of state and local governments reached record-shattering proportions. Indeed, during the first three months of 1971, borrowings by these political jurisdictions ran at an annual rate of $26 billion—more than double the volume of borrowings undertaken in the year 1970. In the second quarter, these borrowings tapered off somewhat from the hectic pace of the preceding three months but nevertheless remained at high levels by historical standards. In part, this huge volume of financing activity by state and local governments reflects the continued strong demand for public services. Beyond this, however, a sizable fraction of the recent surge in financing activity reflects "catch-up" borrowings which had been postponed in 1969 and early 1970 when market interest rates exceeded the rates that many of these borrowers could legally pay. Some of it represents the replacement of short-term obligations with long-term debt.

Chart V
THRIFT INSTITUTION DEPOSIT FLOWS AND HOME MORTGAGE LENDING



Source: Board of Governors of the Federal Reserve System.

The decline in interest rates on tax-exempt bonds that developed in the second half of 1970 and carried into early 1971 was a major factor in prompting the stepped-up pace of borrowings by state and local governments. Rates on high-grade municipals reached a peak of 6.81 percent in June 1970 and then tumbled 189 basis points before reaching a recent low of 4.92 percent in February 1971. More recently, rates on tax-exempt bonds have moved irregularly higher but at the end of June were still some 116 basis points below their 1970 peak. While declining interest rates have paved the way for the increased volume of state and local borrowings, it should also be noted that in many states and localities the statutory limits on rates payable have been raised or eliminated. These actions have helped to ease the earlier bottlenecks in the tax-exempt markets and should insure a more stable flow of funds to this sector in the future.

A major share of the newly issued state and local bonds floated over the last four quarters was absorbed by the commercial banks, as these institutions resumed their leadership in municipal lending. Since 1961 the commercial banking sector's end-of-year holdings of municipals have averaged 38.9 percent of all outstanding municipal issues, with its holdings increasing at an average annual rate of 14.7 percent. In the last half of 1969, however, banks liquidated municipal securities holdings to finance the growing volume of bank loans. The sluggishness in loan demand in 1970 and the first half of 1971, coupled with the massive flow of time deposits to commercial banks beginning in mid-1970, resulted in a sharp reversal in this situation. Thus, over the nine months ended March 1971, commercial bank holdings of state and local government securities rose by $10.8 billion—an annual rate of gain of 23.5 percent. More recently, a marked slowdown in commercial bank participation has been a major factor in the rise in municipal bond yields.

Reflecting the large Federal deficit expected for the fiscal year ended June 30 and the prospect of a large deficit in fiscal 1972, financing requirements of the United States Treasury have also been heavy. While a sizable part of the funds needed to finance the fiscal 1971 deficit was raised in the first half of the fiscal year, net borrowing activity in the January-June half year was relatively large despite the clustering of tax receipts in this period. In part, the heavy demand for funds by the Treasury toward the end of the second quarter was related to the sizable cash needs that are expected to materialize in the summer months.