The financial markets
Current developments

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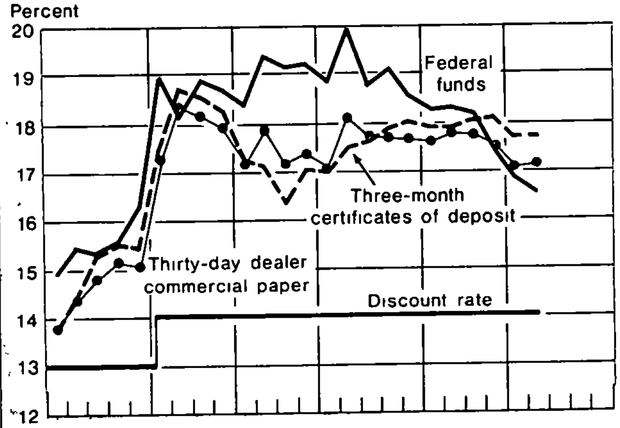
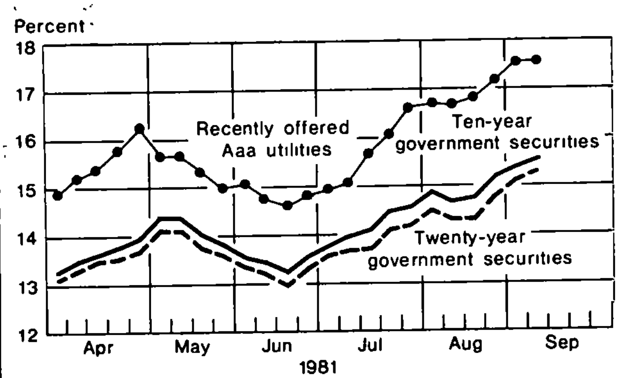


. . . but long-term rates reached record levels.



Sources Federal Reserve Bank of New York and Board of Governors of the Federal Reserve System

Short-term interest rates began to decline during the summer. The overnight Federal funds rate fell from an average level of 19 percent in July to 16½ percent in the second week of September Most other short-term rates, however, fell by only 100 basis points or so during this interval. The ensuing reductions of commercial banks' prime lending rates, which began in mid-September, brought the prevailing prime rate down to 19½ percent by September 21. On the same day, the Federal Reserve reduced the surcharge imposed on loans to those large banks who are frequent borrowers from 4 percent to 3 percent. In the long-term markets, in contrast, yields continued to rise during August and September, and record-high yields were established in many sectors Although bond yields began to fall in mid-September, the markets remained fairly unsettled Investors were concerned with the sizable Treasury borrowing schedule for the next few months, as well as the deficits contained in the fiscal program planned for the next three years (chart).

Certain aspects of the fiscal program have had a particularly adverse impact on the markets for tax-exempt securities. Forthcoming reductions of the highest marginal tax rates on personal income, and the introduction of the tax-exempt all savers' certificates, may have reduced the household sector's willingness to hold these securities at yields consistent with historical relationships between the returns on taxable and tax-exempt issues The effects on state and local government budgets of scheduled reductions of Federal spending also may be a factor behind these markets' recent performance, as investors assess more carefully the fiscal strength of government borrowers.

Quite apart from the effects of fiscal policy changes, market participants report that two important groups of traditional investors in tax-exempt securities—commercial banks and property and casualty insurers—have been backing out of the market in recent months. Both groups of institutions face reduced needs for tax-exempt income. And, like other investors, these institutions have been concentrating their purchases of tax-exempt securities in the shorter maturities. As a result of all these factors, yields on municipal securities—especially long-term issues—were bid up rapidly throughout the summer.

Mergers and acquisitions

In July, reports of developments in the financial sector were dominated by accounts of the financing arrangements for corporate mergers and acquisitions. Much of the attention focused on firms in the energy and chemical industries. In one six-week period, bank credit lines totaling more than $40 billion were arranged to support (or defend against) prospective business combinations involving firms in these industries.

By themselves, these credit lines will not have a substantial impact on United States bank credit growth. American banks and their overseas branches are responsible for only $20-25 billion of these lending commitments, with foreign banks holding the remainder. But this estimate of the total lending commitment of United States banks overstates the volume of lending that is likely to be undertaken. In several cases, a single prospective acquisition attracted the interest of several possible buyers, each of which arranged a credit line With this double counting removed, the maximum volume of lending by American banks as a result of these commitments is on the order of $10 billion[1] In comparison, the sum of loans and investments at United States commercial banks in July was nearly $1,300 billion. Of this total, business loans amounted to almost $350 billion.

Although public attention has been focused on a few large transactions, the overall pace of merger activity seems to have picked up in 1981. In the first six months of the year, both the number and dollar volume of mergers and acquisitions exceeded their totals for the comparable period in 1980. Several factors are at work here. The most pervasive may be an apparent relaxation of Federal antitrust policy. While the new Administration has continued to pursue cases against firms that exercise monopoly powers in fields that clearly would benefit from increased competition, it has tended not to impede business combinations—even those involving large firms—that would not create monopoly power.

In the new regulatory environment, large firms in several key industries have engaged in merger activity. In the financial services industry, this year's most notable mergers have been combinations of nonbank institutions designed to prepare for competition with commercial banks in retail or wholesale markets. And, in the energy field, the belief on the part of some firms that increases in the real prices of oil, coal, and natural gas will continue has spurred their interest in acquiring firms that own such resources (It is clear, however, that the price expectations of the buying firms are higher than those of the market as a whole. Indeed, the market prices of energy stocks may reflect expectations of declining real energy prices.)

The relatively low levels of stock prices, adjusted for inflation, may be another factor behind the increase in merger activity Once a firm decides to expand its operations, stock market conditions are an important consideration in its choice between acquiring other firms and investing in physical assets. For some time now, the relationship between the market value of a firm's equity and debt and the replacement cost of its physical capital at current production costs (that is, the replacement cost of capital) has been recognized as an important determinant of business investment spending When market value is below replacement cost, it makes sense for firms to expand through mergers and acquisitions rather than by investment in physical assets. On the other hand, when market value exceeds replacement costs, it makes sense for firms to expand through the direct purchase of physical assets.

Somewhat surprisingly, previous periods of extraordinary merger activity have not been marked by weak stock market performances. There have been three such intervals in the last century—in the 1890s, during the last half of the 1920s, and again in the 1960s. Stock prices rose steadily during each of these periods, as did the pace of overall economic activity. But this historical evidence should not be interpreted as proof of the irrelevance of comparisons between market values and replacement costs. Trends in aggregate measures of stock prices can mask underlying movements in the relative market value of different firms or industries. Some of the historical evidence suggests that the relationship between market value and replacement cost has had an important effect in determining the means of expansion within particular industries.[2]

[1] There is a further complication The effect of these loans on bank credit *statistics* depends on how the transactions are recorded Loans booked at domestic offices of United States banks are included in the bank credit aggregate, but loans booked at overseas branches are not

[2] See Burton G Malkiel, George M von Furstenberg, and Harry S Watson, "Expectations, Tobin's q and Industry Investment", *Journal of Finance* (May 1979)

Implications for the banking system

This summer's merger activity in the chemical and energy industries reflected a greater than usual reliance on borrowed funds. Investment bankers and others involved in these transactions assert that this is due to the fact that shareholders have a strong preference for being paid immediately and in cash (as opposed to the exchange of shares or payment in debt securities). These assertions cannot easily be verified. If true, however, they would explain the need for acquiring firms to assemble large sums of cash quickly.

A continuation of large-scale bank lending in connection with merger activity would raise important questions for monetary policy. One such question is whether loans extended under these commitments would contribute to the growth of the money and credit aggregates. If they did, there would arise the question of how monetary policy should respond to the growth of those aggregates or to the changing patterns of credit flows that also might result At first glance, it would appear that the appropriate policy response depends primarily on the effects of these activities on the financial system, particularly in the commercial banking sector. It is not possible to state a general conclusion, however, because there is a considerable range of feasible outcomes.

It is likely, though not inevitable, that there would be at least temporary increases in the broad monetary aggregates—M-3, L, and perhaps M-2. Since the borrowing firms manage their liquid assets very carefully, it is unlikely that they would hold the funds drawn from credit lines in demand accounts (and thus increase the level of M-1B).[3] But their temporary investments in repurchase agreements (RPs), certificates of deposit (CDs), or Eurodollars would increase the levels of the broader aggregates.

Once the shares of an acquired firm have been purchased, the former owners of the firm would have to allocate their receipts between reinvestment in equities, buying other financial or physical assets, and consumption spending. Since acquiring firms would have paid more than the market value of outstanding shares, the merger transaction would increase the wealth of the former shareholders. Their profits from the transaction would allow them to increase their consumption spending, bid up asset prices, or both.[4]

Initially, bank credit demand would be increased as a result of the merger financing. But subsequent decisions of corporate officials reacting to financial developments would determine whether the increase in the demand for bank credit would be temporary or permanent. Most of the large syndicated credits have been structured as revolving lines of credit for the first three or four years of the agreement and will be converted to term loans for the last four to six years. Under these arrangements, corporate borrowers can repay any borrowed funds (and terminate the lending agreements) without penalty at any point during the first three or four years. These credit lines relieve corporate borrowers of any immediate concern about the availability of funds for merger activity. But the relative prices of alternative sources of borrowed funds will determine the extent of continued reliance on bank credit. If corporate financial officials perceive the long-run costs of bond issuance or other forms of borrowing to be less than the cost of bank borrowing, they will pay down their bank loans with the proceeds of these borrowings.

In describing the range of possible effects of large-scale merger lending on the monetary and credit aggregates, it is easiest to examine two extreme cases At the outset of any massive merger-financing episode, it is much more likely that banks would finance loans by buying liabilities (such as CDs, Eurodollars, or Federal funds) than by selling assets (loans or securities). If, at prevailing rates, former shareholders of the acquired firm chose to invest their stock-sale proceeds in such bank liabilities, the recycling of funds would be complete and the expansion in the broader aggregates and bank credit would not quickly be reversed.

But the rise in demands for money and credit caused by bank-financed merger loans could evaporate even before the original merger loans were paid off. If the former owners of the acquired firm preferred to hold claims other than bank liabilities—Treasury securities, for example—CD rates would have to rise in relation to those on Treasury issues, as the banking system tried to issue more certificates to a public which had no greater desire to hold them. Under these circumstances, with the relative returns on Treasury securities falling, the banks might choose to reduce their reliance on CDs, instead selling Treasury securities to continue the funding of their expanded loan portfolios. The merger financing would have had only transitory effects on the demands for the broader aggregates and bank credit. But the bank credit aggregate would include a higher proportion of loans and a correspondingly smaller proportion of securities.

It is likely, then, that bank lending for merger activi-

[3] Transitory increases in M-1B might occur, however, as buying firms move funds into demand deposits when checks to the former shareholders of the acquired firm are presented for payment

[4] To the extent that shares were held by pension funds or other institutions, so that individuals did not perceive an increase in spendable wealth, aggregate consumption spending probably would not be affected very much, if at all

ties would cause at least a transitory rise in the demands for the broader aggregates and bank credit. If acquiring firms found no preferable funding sources, and if banks did not sell off securities, the increase in bank credit demands would persist.[5] It is also possible that the rise in the demands for the broader aggregates would be lasting.

Policy implications

It is important to realize that potential increases in the demands for money and credit that have been discussed here are merely reflections of portfolio rearrangements. A variety of factors—the relationship of market value to replacement cost, antitrust policy, and others—may continue to encourage corporate merger activity. In executing these transactions, corporate officials again might decide to increase, at least temporarily, their reliance on bank borrowing. In the first instance, this increase in borrowing would not increase the aggregate demand for goods and services and would not add to inflationary pressures.

Any stimulus to economic activity that occurred subsequently, however, would be the result of investors' spending the proceeds of their stock sales[6] and would be virtually indistinguishable from other forces affecting spending in the economy. In turn, increased levels of spending would tend to raise the demand for M-1B. But, with an unchanged target for this aggregate, interest rate pressures would tend to counter the stimulus to spending. Hence, it would be consistent with unchanged policy goals for the Federal Reserve to pursue unchanged targets for the narrower aggregate. An adjustment of this target would be in order, however, if spending pressures from whatever sources led to inflation that ran persistently above goals.

The broader aggregates (M-2, M-3, and L) might be somewhat higher than they would have been without the flurry of merger lending. Banks would be able to support larger loan portfolios with the liabilities included in these aggregates, without having to bid up the rates on these claims as much as they would otherwise. As a result, the rates at which credit could be made available for other purposes would be little affected.

In the period immediately following the merger transactions, two distinct factors might impose upward pressure on interest rates. To the extent that expansionary pressures increased in the economy as a whole, any associated increase in borrowing demands would tend to raise rates. Moreover, the cost of bank loans might be particularly affected in the short run, since the funding of larger portfolios might strain banks' ability to raise funds at prevailing rates. The rise in interest rates would tend to counter the general increase in spending; it would not reduce the volume of funds available for lending to individuals or small businesses.

If the Federal Reserve were not willing to accept more rapid growth of bank credit and the broader aggregates, some other credit demands might be crowded out by merger financing, in the sense that the entire economy would be subjected to higher interest rates and some prospective borrowers would be forced to delay or cancel their plans. This restraint would exist even in the absence of a stimulus to spending from the wealth effects discussed above. In this case, concerns about the effects of merger lending on the borrowing opportunities of households and small businesses would have substance. These problems would arise, however, not from the merger financing itself, but from an unwillingness to tolerate deviations from the growth targets for the money and credit aggregates.

A summary

The current rise in corporate merger activity reflects a desire on the part of the managers and shareholders of corporations to reallocate the ownership of corporate assets Although it has attracted much attention, the recent spate of lending activity involving the chemical and energy industries seems small in relation to the size of total loan holdings of the banking system These financings, however, raised the question of how monetary policy should respond to a continuation of large-scale merger lending.

The financial transactions associated with a continuation of such lending should cause only small and transitory increases in the demands for M-1B. Their impact on the demands for the broader monetary aggregates and bank credit, however, could be more significant. To the extent that the pickup in the growth of the broader monetary aggregates and bank credit reflected the portfolio adjustments arising from the merger financing rather than intentions to spend, it would not represent additional inflationary pressures. Accordingly, largely accepting the resulting run-up in the broader aggregates would not seem inappropriate.

Merger activity raises public policy questions concerning the organization of American business. For the financial markets, however, the issue of immediate concern is not whether such activity is healthy or unhealthy, but what monetary policy would be appropriate to the pursuit of unchanged economic goals.

[5] Again, however, the net impact of accounting decisions by banks with foreign branches could distort the statistical results See footnote 1

[6] Such spending might be encouraged by the increased liquidity of the former shareholders' portfolios See footnote 4