

## Recent Capital Market Developments in the United States

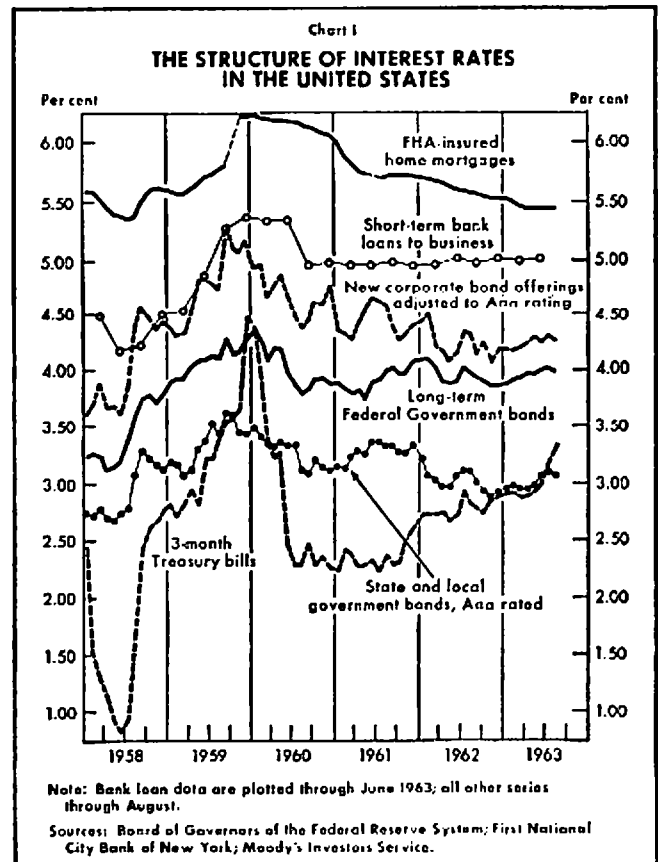
Although 1963 appears to be shaping up as another year of heavy over-all demand for funds in the financial markets, supplies have again been ample so that, with the exception of yields on short-term open market instruments, interest rate movements have been mixed and quite narrow. Thus, despite growing business activity and a somewhat less easy monetary policy, yields on long-term obligations of corporations and governments have edged up only slightly this year and are still below early-1962 levels. Moreover, home mortgage rates have actually declined, while rates charged by commercial banks on short-term loans to businesses have remained stable (see Chart I). The commercial banking system has continued to play an important part in financing heavy demands for credit without sharp advances in interest rates. Growth in total bank credit has again been rapid, with little convincing evidence of any significant slowdown from the high rate of increase experienced in 1962. As in that year, the most rapid gains have been in bank acquisitions of state and local government securities and in real estate loans, while growth in business loans has continued slow.

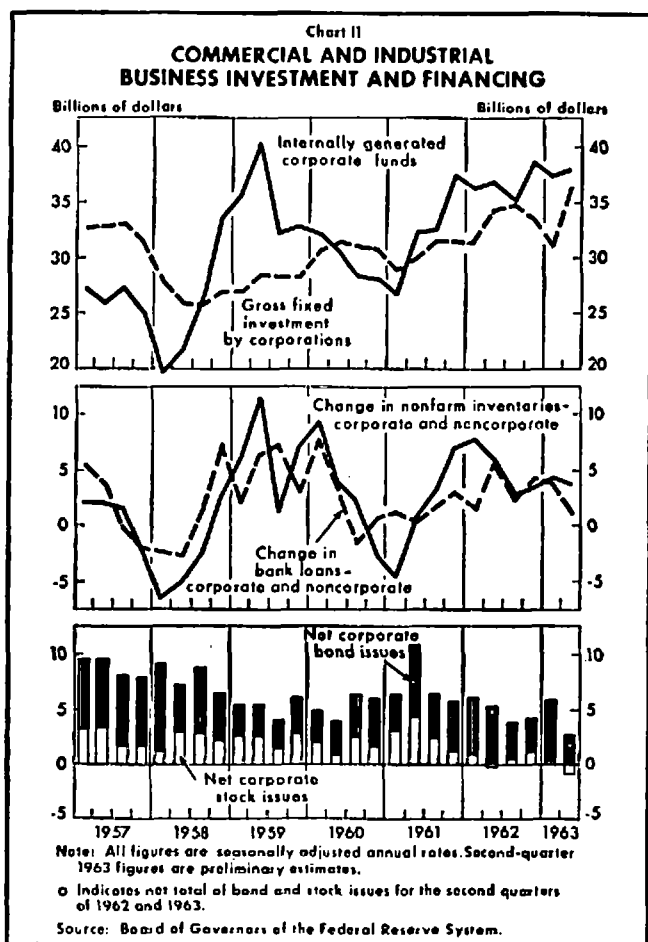
### BUSINESS CREDIT DEMANDS

Businesses experienced record sales in the first half of 1963, and their spending on new plant and equipment for the six-month period as a whole was not far below the all-time high set in the second half of 1962. Nevertheless, demands for additional debt and equity funds have continued to be relatively low. The volume of net long-term business capital raised by nonfinancial corporations through sales of securities during the first half of this year was below that raised in the first half of 1962. It remained considerably under the record amounts raised in early 1957 when, despite the smaller size of the economy, fixed investment was running only slightly below current levels (see Chart II).

The demand for outside capital has remained light in recent years, primarily because businesses have been able to finance an enlarged part of their investment expenditures through internally generated funds—that is, retained earnings plus depreciation and other amortizations. In

contrast to the general pattern of earlier years, these corporate flows of funds actually exceeded corporate fixed investment during most of the period from late 1958 through 1962. The estimated excess of internally generated funds over fixed investment expenditures for nonfinancial corporations was nearly \$4 billion during the first half of 1963, at a seasonally adjusted annual rate (see Chart II). While fixed investment by these corporations during the period was running only 3 per cent above the rate in the first half of 1957, internally generated funds available for financing these expenditures were more than 40 per cent larger than in the earlier year.





The ability of corporations to generate funds internally was given a significant boost by the 1962 tax changes, permitting businesses to charge off the cost of machinery and equipment over a shorter number of years and to deduct from current profit tax liability up to 7 per cent of the cost of certain types of capital equipment. The Department of Commerce estimates that these changes, which were effective from the beginning of 1962, reduced corporate tax liabilities by about \$2.3 billion in that year. At the current rate of capital expenditures and with perhaps more widespread use of the shortened depreciation schedules, the 1963 tax saving may well be running somewhat larger.

The reduced need for external financing by nonfinancial corporations is particularly reflected in their flotations of new corporate stock issues. Such flotations actually fell short of company repurchases of outstanding stock in the first half of 1963 after allowing for seasonal influences. Thus, larger internal flows of funds appear to have sub-

stituted much more extensively for external equity financing than for debt financing. This decline in stock issues relative to bond issues, however, is probably also due in part to the lack of market interest in the speculative new issues of small companies—a market attitude that has been in evidence ever since the sharp break in stock prices in the spring of 1962. Prior to that decline, such new issues accounted for an important part of total stock offerings. They have not yet regained that position, even though stock price averages recovered about two thirds of the 1962 decline by the end of the year and have reached new highs in 1963.

Although net offerings of new corporate bonds in the first six months of this year remained below the peak levels of 1957-58, they were substantially above the low amounts recorded in the last half of 1962, after allowing for seasonal factors. Despite this recent increase in supply, offering yields on these securities have shown only a minor increase this year, paralleling a similar small rise in yields on long-term Treasury bonds. The yield spread between new corporate and lower risk long-term Treasury obligations continues to be quite narrow, compared with earlier years, indicating that institutional demand for new corporate bond issues remains an important force in this market.

Demands for short- and intermediate-term credit by nonfinancial firms have also been light this year relative to the level and growth of economic activity. To some extent, this development may also be related to the trend toward a lessened need for long-term funds from outside sources. For many companies, increased flows of internally generated funds may have resulted in a build-up of liquid resources beyond desired levels, owing to the temporary lack of offsetting increases either in capital expenditures or in dividends. Such firms are able to apply these liquid resources to uses that would otherwise call for short-term borrowing, particularly from banks. Further, because interest rates on short-term bank loans have recently exceeded long-term market rates by a wide margin, even the use of new funds obtained through additional long-term borrowing may represent an alternative to bank financing of inventory increases—particularly when the higher inventory level is expected to be permanent. But, although a substitution of long- for short-term financing may be an element in the slow demand for bank loans, the relatively small total need for funds to finance the currently moderate rate of inventory growth is a more important factor. The relationship between changes in inventories and changes in bank loans has been rather close in the past (see Chart II), because inventory build-ups are conventionally financed in the first instance by short-term bank loans.

### GOVERNMENT FINANCE

State and local governments made heavy demands on the capital markets during the first half of 1963, with net borrowings apparently amounting to a near record. Favorable borrowing conditions and the continuation of the postwar trend toward expanded government services at the state and local levels contributed to this large volume of new debt offerings. Reflecting the substantial new supplies of state and local obligations, market yields have moved up somewhat more rapidly than interest rates on corporate and long-term Treasury issues. This greater rise in yields, however, may also have been related to the prospect of a reduction in Federal income taxes, a development that would reduce the relative advantage to the investor of the tax-exempt status of state and local securities.

The rise in yields on tax-exempt issues would almost certainly have been greater had there not been a heavy demand for these securities by commercial banks. Bank acquisitions of state and local bonds normally decline during periods of economic expansion. This year, however, the slow demand for business loans and the continuing need to obtain high-yielding assets in the face of increased interest costs on time and savings deposits have pushed these acquisitions to record levels. In the first half of this year, commercial bank purchases of state and local bonds apparently exceeded 80 per cent of the net new supply of these securities.

In contrast to state and local governments, the financial requirements of the Federal Government have applied little upward pressure on capital market yields so far in 1963. The Treasury's total outstanding marketable debt was about unchanged over the first seven months of the year. Furthermore, the average maturity of the debt was about the same in August as at the end of last year.<sup>1</sup> The Treasury has, however, maintained a high level of outstanding conventional money market instruments (i.e., bills and certificates). This factor and a further movement toward less ease in monetary policy—marked by the July rise from 3 to 3½ per cent in the discount rate of the Federal Reserve Banks—resulted in a substantial increase in rates on Treasury bills and other money market instruments. At the same time, the Treasury made extensive use of the advance refunding technique: the swapping of new long-term issues for shorter term outstanding

issues.<sup>2</sup> The use of this technique helped moderate interest rate increases in the capital markets by avoiding the more direct impact of cash sales of long-term issues that would otherwise have been needed to achieve a comparable effect on the maturity structure of the debt. Partially as a result of these various policy moves, the spread between average yields on long-term Government bonds and three-month Treasury bills narrowed further, from 95 basis points at the end of 1962 to 67 basis points at the end of September 1963.

### DEMAND FOR CREDIT BY INDIVIDUALS

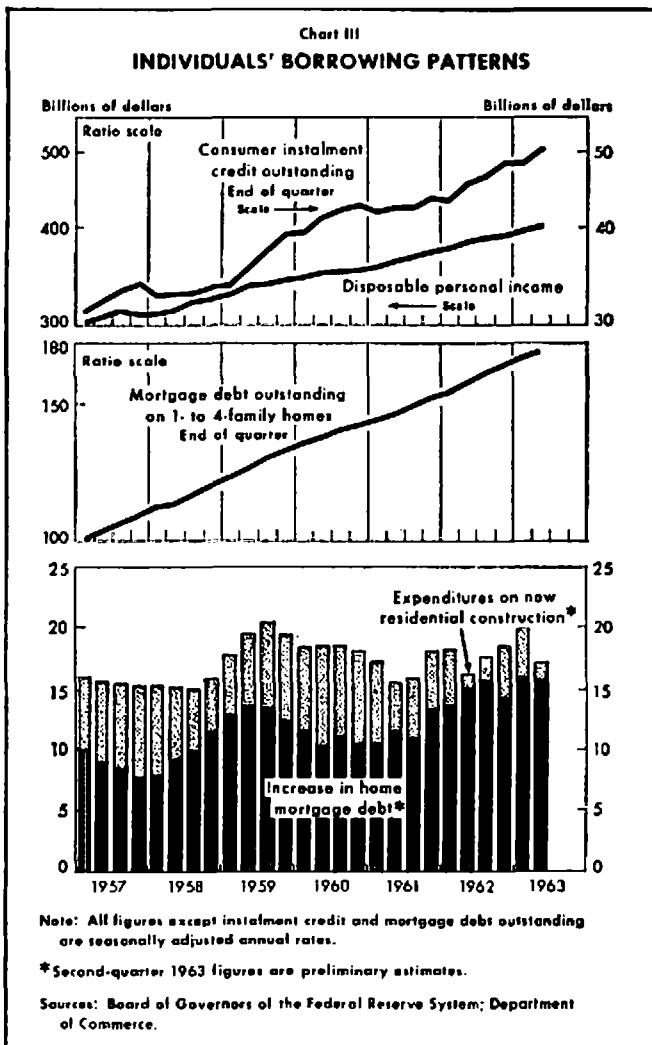
Individuals expanded their holdings of financial assets at a very high rate in the first six months of 1963, but they also added to their debts at a record pace. In fact, increases in financial assets and in debt obligations have both outpaced the growth of personal disposable income over the past two years or so. The increase in financial assets has been strongly concentrated in one particular area—interest-bearing deposits—while the growth in individuals' total borrowing has been reflected throughout all of the various media of personal credit, including consumer instalment credit, securities credit, and home mortgage loans.

Although repayments on instalment loans climbed to a record 13.6 per cent of disposable income in the first half of the year, consumers have continued to add to their instalment debts at a substantial rate—coinciding with a strong demand for durable consumer goods, particularly automobiles. At the same time, large flows of savings into certain types of financial institutions granting consumer loans, notably commercial banks, have kept up the supply of this type of credit and the trend toward easier consumer instalment lending terms appears to have continued.

One particularly striking aspect of recent consumer financial behavior has been the sharp increase in borrowing on homes. Unlike the pattern of earlier years, mortgage debt has recently been expanding relative to outlays on new houses (see Chart III). Part of this relatively greater rise in mortgage debt is explained by the postwar inflation in real estate values, which causes a rise in mortgage debt as old homes change hands. But the available evidence also suggests that part of the explanation lies in the in-

<sup>1</sup> The average maturity of the Federal debt was lengthened in September through a refunding operation that is described in another article in this Review (see "The Money Market in September", pp. 160-63).

<sup>2</sup> 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.



mortgages declined in 1963 while other interest rates generally firmed. The explanation for the large supplies, in turn, is to be found in the pattern of individuals' investment in financial assets. Individuals, who supply the bulk of the funds made available in the financial markets, have persistently shown a strong preference for interest-bearing deposits at banks and other savings institutions. These deposits absorbed more than 50 per cent of consumer financial savings in the first half of 1963. The institutions receiving these deposits thus continue to have substantial resources to channel into their traditionally favored investments, including mortgages.

The high rate of accumulation of savings deposits is especially noteworthy, because consumers ordinarily shift more toward direct holdings of credit and equity market instruments as cyclical expansions develop. In the first half of this year, however, additions to consumer holdings of these instruments absorbed less than 5 per cent of new financial savings. In the 1958-60 upswing, by contrast, acquisitions of credit and equity market instruments ranged as high as 38 per cent of such savings.

**THE ROLE OF THE BANKING SYSTEM**

A sector-by-sector analysis of the capital markets suggests that commercial banks have played an important role in meeting stepped-up demands for funds in the financial markets with little or no advance in interest rates other than those on short-term open market instruments. The recent heavy bank participation in supplying funds to state and local governments by investing in their securities has already been noted. Commercial banks have been of similar importance in the mortgage market. Bank holdings of real estate loans rose at a seasonally adjusted annual rate of 12.9 per cent through August of this year, equal to the record gain of 1962 and more than double the 1961 increase. Shorter term bank lending to consumers, moreover, has advanced so far this year at an 11.5 per cent annual rate, the most rapid growth since 1959. The 5.0 per cent annual rate of increase in business loans, on the other hand, compares unfavorably with last year's 8.6 per cent growth—which was in fact only moderate for a period of economic expansion. This slow growth, however, appears to reflect mainly the special business demand factors noted earlier rather than a change in bank lending resources or preferences.

A key factor in shaping bank lending and investment practices has been the continuing rapid growth of time and savings deposits. The growth of these deposits, although somewhat slower this year than in the first half of 1962, has been at a rapid 14.2 per cent annual rate,

creasing use of mortgage borrowing to finance nonhousing expenditures. In a number of instances, large current financial needs—such as those for college educations and major medical expenses—can be met most easily through mortgage borrowing, which makes possible longer repayment terms and lower interest rates for the borrower. Moreover, the unusually high current level of consumer instalment debt may be resulting in a need for sources of less burdensome credit, while the pressure of large supplies of funds seeking an outlet in the mortgage markets is encouraging aggressive "selling" of this form of credit by financial institutions.

Despite this additional demand for home mortgage credit, supplies of funds have continued to be more than adequate, with the result that rates charged on home

about equal to the rate of increase in the last half of 1962. Further impetus to the growth of time deposits and negotiable time certificates of deposit was given by the July increase to 4 per cent in the maximum rate banks are permitted to pay on such deposits and certificates under the Board of Governors' Regulation Q. The new maximum of 4 per cent for 90-day to one-year maturities compares with the previous limits of 2½ per cent for 90 days to six months and 3½ per cent for six months to one year.

These increases in the limits on shorter term time deposit rates permitted commercial banks to continue to compete strongly for short-term funds and thus played a part in the recent upward trend of money market yields.

Moreover, because banks must relend these funds at interest rates exceeding the rate paid the depositor, they have tended to invest them in longer term credit instruments. This transfer of funds from the short- to the longer term financial markets has contributed to the reduced spread between short- and long-term interest rates. Indeed, in view of the substantial expansion of bank credit this year and its increased concentration in capital market instruments, it may well be that such advances as have taken place in long-term rates over the past nine months have been more a reflection of expectational factors than of any real change in the availability of long-term credit relative to demand.