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Address

by

Manuel H. Johnson

Vice Chairman

Board of Governors of the Federal Reserve System

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How Much Debt, How Much Equity?

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The Growth of Corporate Debt: Implications and Policy Response

It is a pleasure for me to be here and address this group today. The topic of debt and its economic implications is an important one and the list of conference participants is--as I am sure you agree--very impressive. To join our latest Nobel Prize winner--James Buchanan--on the program is a special honor.

Apprehensions about debt and its growth pertain to both the public and private sectors of the economy. Problems associated with public sector debt growth were discussed this morning. While I certainly share some of the concerns held regarding the growth of public debt, I will focus my attention on a component of private sector debt, namely corporate debt, and its growth.

The rapid rise of corporate debt is of great interest to the Federal Reserve for several reasons. First, a debt buildup has the potential to inhibit future business spending on plant and equipment. Secondly, increased corporate leverage may lead to an increase in the number of corporate failures. Thirdly, the greater likelihood of defaults suggests that financial institutions may be assuming greater risks in their loan portfolios. Since this may contribute to making the financial system less stable and, therefore, to making the economy more vulnerable to unanticipated economic shocks, it is of particular importance to the Federal Reserve. Finally, some argue that because of increased leverage of the corporate sector, the Federal Reserve will be more reluctant to tighten when necessary, thereby introducing an inflationary bias to monetary policy.

The growth of corporate debt in the current economic expansion has been noteworthy not only because it has been rapid, but also because it has persisted for an extended period. While the pace of corporate debt growth has slowed considerably since early 1984, it still remains about 5 percentage points faster than growth rates of value-added in the corporate sector or in the economy as a whole. As a consequence, the level of corporate debt relative to corporate product has risen to a succession of new post-World War II peaks, though the ratio remains well below those typical earlier in the century.

This debt expansion has been unusual in that a significant portion of the rapid growth of corporate debt is attributable not to normal borrowing for new investment goods, or to desperation borrowing by failing firms, but rather to the restructuring of healthy and previously stable firms. Some of the restructuring has stemmed from the financing of mergers or leveraged buyouts, and some has occurred through share repurchases for the explicit purpose of increasing leverage. The distinction is insignificant since some share repurchases were designed to fend off mergers and some mergers occurred primarily because the target firms were not heavily leveraged. For all nonfinancial firms, these largely debt-financed stock purchases have retired more than $300 billion of equity in the past three years.

Both increased debt and decreased equity have dramatically affected debt-equity ratios. With asset values adjusted to reflect replacement costs, the aggregate debt-equity ratio of nonfinancial corporations has risen to a post-World War II record of 50 percent, up from 37 percent at the end of 1983. This has happened despite strong growth in retained earnings and a relatively robust pace of new stock offerings.

While there clearly are risks involved for the individual firms that have restructured, many firms have been able to increase the combined market value of their outstanding securities by increasing the proportion of debt. Consequently, the attraction of leverage must be hard to ignore.

There are a number of reasons why investors like leverage. A principal one is the tax advantage. Returns from capital passed through to investors as interest on debt are not taxed at the firm level, whereas those passed through as dividends on shares are. Also, leverage (up to a point) can improve capital market efficiency by providing a wider choice of securities to investors with differing needs and tastes, thereby facilitating the channeling of risk toward the investors best able and most willing to accept it.

Recently, attention has focused more on the idea that leverage enhances control of management by investors because it reduces the choices available to managers in allocating funds. Managers are proscribed from misguided capital expenditure decisions if revenues in excess of labor and materials costs are committed to pay interest on heavy loads of debt, especially if leverage is so high that lenders would be reluctant to lend more.

Why leveraging has been so widespread recently is not as apparent, but a number of developments have augmented the more enduring advantages of leverage. The restructuring of balance sheets has been concentrated among firms in a few industries where the leveraging may represent an adaptation to new circumstances. As examples, one could include sharply changing investment opportunities in petroelum production and a new regulatory environment taking a more open-minded view of mergers in broadcasting. In the petroleum case, investors may have raised their preference for leverage, while in the broadcasting case, leverage may be largely a short-term byproduct of mergers that may be partly offset over time by greater earnings retention.

Three factors that have probably increased preferences for debt have done so largely by reducing the risks entailed. Over the past five years, interest rates paid by firms on new debt have decreased substantially, falling by almost half on long-term bonds and by about two-thirds on short-term paper or loans. The lower rates combined with the recovery in corporate cash flow during the business expansion have actually reduced the share of cash flow needed to service debt in recent years, despite the huge growth in the amount of debt on which interest is being paid.

At the same time, stock prices have soared and are now 2 to 2-1/2 times the lows of four years ago, on average. This makes restructuring more expensive for firms, as it raises the cost of the shares purchased. But it may also make borrowing safer and more attractive to investors. To the extent that the discrepancy between balance sheet values and the true earning power of assets has grown, the increase in balance sheet debt-equity ratios is illusory. Indeed, measured at their market values, the aggregate ratio of debt to equity has been roughly stable over the past four years--lower than during the middle and late 1970s, though higher than in the 1950s and 1960s.

Over the past few years, many firms have also benefited from improved access to credit markets. In some respects, this has lessened the risk of being unable to borrow at times of credit stringency. Deregulation of financial markets and the growth of loan commitments have helped ensure the access of healthy firms to loan credit, regardless of changes in credit conditions. In other respects, access to new borrowing markets have become possible for many firms because of the increased use and acceptance of techniques such as interest rate and currency swaps, third party guarantees, and the new-issue market for low-rated bonds, among others. In short, some increase in debt may reflect not only technological advances in information processing and therefore risk evaluation, but also financial innovations that ensure firms ready access to credit markets when they may have had more difficulty in the past.

Taken together, these credit market developments are encouraging in that they suggest that some increase in debt does not necessarily reflect a desire to take on more risk, but rather reflects the fact that many corporations are now better able to cope with debt.

Nevertheless, while higher leverage may be somewhat safer now than it was some years ago, the corporate sector and especially some individual firms may be more vulnerable to unanticipated shocks, whether specific to particular industries or to the macro-economy as a whole. A sharp rise in interest rates for example, could produce adverse consequences. The latter contingency is especially worrisome in view of the high ratios of short-term to long-term debt that firms have maintained in recent years--though in the aggregate this ratio has not worsened over the past three years of rapid debt growth. The complicating effects of leverage are already visible in the recent problems suffered in the energy, agriculture, real estate, and steel industries. Although highly leveraged balance sheets were not the fundamental cause of problems facing these industries, high leverage contributed to the failure of some firms.

Substitution of debt for equity, while it may raise risks for the individual firms, does not necessarily increase the potential for financial market instability. If, for example, a firm capitalized solely with equity exchanges newly created debt for some of the equity of existing shareholders, and those same shareholders keep the new debt along with the remaining equity, then risks to investors are little changed. The same investors hold the same total claims on the firm's cash flow and the same expected variability of total returns.

If these investors then sell the debt to well-capitalized, well-diversified investors, the risks remain small. Such debtholders can presumably absorb a substantial loss in one of their many investments. But to the extent that the debt is purchased by thinly capitalized financial institutions in concentrated doses; problems can arise. A critical danger from debt, then, may not be the risks taken by the firms that become more leveraged, but rather the risks created by the deterioration in the soundness of lenders.

So far, there have not been many serious problems with the firms that have restructured most dramatically. Of greater immediate concern is the impact of agriculture, energy and real estate lending on many banks and thrift institutions.

In light of these circumstances, some additional supervisory steps have already been taken. Examination staffs of bank supervisors have been improved recently, capital adequacy requirements for both banks and thrifts have been strengthened, and we have proposed a risk-based capital requirement. We continue to urge banks to exercise prudent lending standards, especially in regard to highly leveraged firms.

It is true that leverage ratios of some firms have risen sharply and that, in the aggregate, debt of nonfinancial firms has risen sharply. But debt growth and increased leverage are not necessarily bad; for some companies, changed industry conditions, higher stock prices, and lower interest rates may justify higher debt loads. Indeed, the positive or negative effects of debt growth depend critically on how the borrowed funds are employed. If increased debt is used in ways that promote capital market efficiency, it may actually stimulate economic growth and enhance stability rather than impair it. Even debt used in corporate takeovers and spinoffs may work to improve the allocation of capital in the corporate sector and help stimulate competition. Broad rules run the risk of restricting many desirable loans to stop a few bad ones. We cannot place ourselves in the business of dictating leverage ratios or making individual loan decisions.

We cannot, however, rest easy. Potential problems of a more highly leveraged corporate sector do exist. And it should be noted that current tax laws may well foster some of this increased leverage and facilitate or subsidize more risk taking than would otherwise be the case. There are any number of possible public and private policy responses to the likelihood of increased economic vulnerability arising from the greater leverage that we have observed in recent years. Many of these policies relate to functions of the Federal Reserve; namely, to monetary policy, to central banking, and to the regulation of financial institutions. In discussing policy responses, then, I will focus on those relevant to the Federal Reserve.

Many debt problems that we have experienced in recent years stem from the inflation of the 1970s. Inflationary psychology often encourages the assumption of additional high-yield debt since borrowers anticipate that they will repay such debt with money that will be worth less in real terms. The unanticipated cessation of inflation increases real debt burdens and sometimes leads to severe problems for borrowers who expected the continuation of rising prices in their industries. Recent history suggests that sectors which benefited from inflation in the 1970s are the very industries having some of the worst problems today. Agriculture, energy, and some real estate and commodity-based industries serve as examples of this phenomenon.

Accordingly, monetary policy can make an important contribution to minimizing potential problems associated with an increasingly leveraged corporate sector. It can do this by promoting price stability. A stable price environment avoids creating those incentives which often promote the rapid buildup of speculative debt. The promotion and maintenance of price stability is a fundamental objective of monetary policy today. And it will continue to be in the future. The Federal Reserve recognizes that attempts to employ inflation as a remedy to debt problems will likely only create the type of problems it was intended to solve.

In addition to pursuing price stability and ensuring the system's liquidity in times of crisis, the Federal Reserve can adopt additional policies to promote a stable, healthy financial system. Specifically, the Federal Reserve has responsibilities for the supervision and regulation of certain financial institutions including bank holding companies. In carrying out this function, it can create incentives to discourage excessive risk taking, thereby promoting a more stable financial system. While the current system certainly remains very healthy, there is always room for improvement in the regulatory area. For example, in the process of attempting to promote a safe and sound financial system, risk is unwittingly subsidized through deposit insurance and discount window borrowing. Because of this potential problem, we are seeking to institute a new risk related capital reserve standard that helps internalize to banks the cost of risky activities. This is consistent with the objective that market discipline should be encouraged wherever it is feasible.

Of course, the macroeconomic concerns relating to debt growth are far broader than the corporate sector focus I have been asked to take this afternoon. As we know all too well, reduction or control of federal government borrowing must play an important role in any overall macroeconomic policy response to the problem of the rapid growth of debt. As with corporate borrowing, not all government borrowing is bad. But to the extent that public debt is used for less productive purposes, federal government spending growth should be restrained so that more productive private sector activity can be financed. If such action is taken, it should help in ameliorating the trade deficit as well.