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Summary of Remarks by

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Financing the Business Expansion

Summary Statement

The U.S. economy is now entering the second year of rebound following the recession of 1960-61.

To provide opportunities for adequate employment of a growing labor force and adequate utilization of a growing stock of plant and equipment, economic expansion must continue. And to achieve a satisfactory over-all rate of expansion, a significant rise in business outlays appears necessary.

Why is rising business investment so important? Generally, and somewhat paradoxically, a dynamic economy must always be increasing its stock of plant and equipment in order to use more fully the stock it already has. This follows from the dual effect of capital investment; it adds to productive capacity, and it also increases aggregate demand.

Second, as of today a review of the other sectors of our economy reveals limited evidence of the kind of a generative upsurge of demand that is strong enough to have the required over-all booster effect.

Government spending has increased substantially in the past year, contributing importantly to the recovery, but it will be much less of a stimulant to the economy this year.

The outlook for residential construction outlays, which played an important role in earlier cyclical upswings--for example 1954-55 and 1958-59--is uncertain at present. Although there has been some increase in the past year, outlays are no higher than they were three years ago. And because of the age distribution of the population, it will be the mid-sixties before demands for housing reflect the expansive effects of a large increase in the formation of new families.

Consumer purchases of automobiles have been considerably above the depressed levels of a year ago, and this has been an encouraging factor in the over-all business situation. But total retails sales faltered in December and January, and probably in February. Consumer expenditures for all goods and services have increased a little less rapidly than consumer income over the past year. Consistent with this, use of instalment credit by consumers has been moderate. Thus there is as yet no sign of an independent surge in consumer outlays such as the one that sparked the expansion of 1955-57.

The immediate prospects for capital outlays themselves are difficult to assess. These outlays have been relatively low since 1957. In fact the dollar amount of plant and equipment expenditures is only now regaining the 1957 rate, though GNP is more than one-fifth higher than in 1957. These expenditures accounted for a smaller portion of GNP in 1961 (8.9 per cent) than at any time in the postwar period. The peak portion (10.7 per cent) was reached in 1956 and 1957.

Although psychological factors are important in all economic decisions, they are especially so in decisions relating to capital formation. Investment is an act of faith--a commitment of funds, and frequently of reputation, on the basis of expectations regarding future sales, prices, costs, and technology. That is one reason why fixed investment is volatile, swinging more widely through the business cycle than most other components of GNP, and more widely than GNP itself. Yet there have been few, if any, peacetime booms without a high rate of fixed investment; neither have there been periods of high investment without prosperity.

Surveys of businessmen have not yet indicated that business as a whole plans a large increase in capital outlays this year. But such predictions usually fall short in periods of rapid economic expansion, and many observers believe that capital expenditures this year will be significantly larger than suggested by earlier surveys.

One reason for this view is that the growth in output in 1961 reduced excess capacity somewhat and raised profits sharply. In these circumstances, the prospect for further gains in sales and output can induce stepped-up business investment in productive capacity. In addition, the investment tax credit now under consideration in the Congress is designed to provide incentive for a higher rate of capital formation. It is planned to make this tax credit retroactive to the beginning of 1962. Similarly, announcement has been made of revisions in the number of years over which equipment may be depreciated for tax purposes.

Whether or not these various influences have led to plans for larger outlays will be revealed shortly, when the latest survey by the SEC and Commerce Department is released.

As we await this report, it may be useful to look at the other side of the investment picture and to evaluate the outlook for the supply of funds to finance business investment outlays.

The outstanding fact on this score is that corporations in the aggregate are building a potential for investment by generating a cash flow of internal funds larger than their capital outlays. This annual flow consists of about $25 billion of depreciation allowances, which are growing by more than $1 billion per year. Besides this steadily-rising flow, there is a more volatile flow of retained earnings (undistributed profits) that also can be used for investment. Although retained earnings have not been rising secularly, as have depreciation allowances, they tend to rise swiftly when output expands. In the past year, as corporate profits have increased sharply--from a low in the first quarter of $40 billion to a postwar record rate of about $52 billion at the end of 1961--retained earnings have risen even faster.

Together, depreciation allowances and retained earnings were accruing to corporations in late 1961 at a rate of more than $35 billion per year. At the same time corporate outlays for capital goods came to only $31 billion. In periods of high level activity, capital outlays have usually exceeded internal funds by several billion dollars.

Needless to say, not every corporation is experiencing an excess of internal funds over capital outlays. But for corporations as a whole, the excess, plus external long-term financing, has permitted a build-up of inventories and the financing of customer receivables with only a moderate rise in business loans at banks.

From the viewpoint of corporations, therefore, capital outlays are not likely to be limited by a reduction in the internal flow of funds or an unwillingness to seek financing.

What about the viewpoint of lenders and investors in terms of willingness and ability? Two facts stand out: both the banks and the capital markets give every evidence of being receptive to corporate demands for funds; and their ability to be so is enhanced by the fact that the competition from nonbusiness borrowers is not likely to be vigorous.

In the capital markets, investors have shown a far from sated interest in new corporate issues of securities. Except for a few months in the spring of 1961, on the average, the volume of new issues by corporations has been relatively light. Just last month the market absorbed a very large issue with no perceptible impact on yields.

Savings institutions of all kinds experienced large inflows of funds in 1961 and all are continuing to do so, although commercial banks have increased their share of the intake by increasing their interest rates on time and savings deposits. The flow of consumer financial saving through these institutions into the capital markets has not fallen off.

With respect to borrowing other than for business investment, it has already been noted that with the vigor of the demand for housing uncertain, mortgage borrowing is unlikely to be absorbing funds at a sharply increasing rate. Furthermore, as the Federal budget moves toward balance, the Treasury will be reducing its calls on the securities markets for new money. Thus it appears that lenders in capital markets should be able to meet considerably enlarged demands for funds by corporations.

If a substantial increase in capital outlays should materialize, there no doubt would be a spillover of financing needs to commercial banks. This would occur in part because long-term funds now are being used to satisfy short-term needs, such as receivables and inventory financing. As long-term uses of funds increased, greater calls would be made upon banks to finance these short-term needs. In addition, some capital projects would involve bank financing, in the form of term loans.

There is reason to believe that banks are in a position to meet these demands for funds, should they be forthcoming. Ever since it became clear about a year ago that recovery was under way, banks have been prepared for a substantial increase in loans to business. Long-deposit ratios have declined a little further in the past year. Bank liquidity, meanwhile, has risen to quite a high level as the result of large acquisitions of short-term securities in the past 18 months. Finally, monetary policy operations have been adding to bank lending power by supplying reserves. The absence of inflationary or speculative pressures in the present upswing, together with the expected move toward balance in the Federal budget, has extended the period of expansive monetary policy beyond that characteristic of past cyclical expansions.

All in all, I conclude that the supply of funds should be sufficient to enable the attainment of a significantly higher rate of capital formation in the year ahead. Whether or not the rate attained is sufficient to meet the projected goal for the U.S. economy will depend mainly on those factors that influence the demand for capital goods.