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TRENDS IN THE FLOW OF FUNDS

Remarks of

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Board of Governors
of the
Federal Reserve System

at the

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TRENDS IN THE FLOW OF FUNDS

The dominant circumstances surrounding credit market developments this year have been the precipitous drop in private investment from the second half of last year to the second quarter of this year and the abrupt rise in Federal deficit that accompanied the investment drop. The nature of these swings since the middle of 1974 is well known by now and need not be detailed here. At annual rates, the $60 billion decrease in investment from the second half of last year to the second quarter of this year consisted mainly of a shift of inventory investment from a $13 billion accumulation rate to a $31 billion rate of liquidation, while business fixed investment and residential construction each fell by $8 billion. The Federal deficit has been largely a result of and reaction to the private demand collapse, arising from lower tax rates, lower tax bases, and higher transfer payments.

For financial market effects it is nevertheless worthwhile to notice that the Federal deficit in 1975 just about offsets the drop in investment spending as a use of private saving. Total private saving is somewhat high this year, at about 17 per cent of GNP, compared to a 1965-73 average of 16 per cent. 1974 saving, on the other hand, was a little low at 15 per cent of GNP, and saving has increased

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rather steeply from last year to this. We can only speculate on reasons for these movements in saving, such as lagged responses to higher prices and lower taxes and increased demand for assets in an uncertain economy. The shift in uses of saving from last year to this has in any case been much larger than movements in saving relative to trend and the transfer of saving from investment to deficit financing that appears in Chart 1 is basic background to credit flow structures this year.

Private saving will evidently also be high again in 1976, sufficient to maintain the 17 per cent relation that we have had this year. With the recovery in both inventory and fixed investment, however, gross investment should be well above 1975, up considerably more than private saving. There will be some offset to the investment rise in a reduction in Federal deficit from this year but probably equally important will be an improvement in state and local government finances as a result of the New York problem. With poor prospects for borrowing next year, many governments are right now working on cuts in spending that can go far toward improving on their rather deep deficits this year. It begins to look as though the remarkable feature for next year is not the size of investment itself, which will probably remain moderate in 1976 relative to GNP, but its conjunction with the still very sizable Federal deficit. Relative to GNP, 1976 may bear a similarity to 1958, although with somewhat larger amounts for saving and Federal deficit. There would remain the striking difference, however, that 1958 was a

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recession time with negative inventory change over the year while 1976 is expected to be a recovery year with inventories rebuilding.

Chart 2 gives another view of the remarkable shift in structure of flows that began late last year. This chart gives for the three major sectors the excess of all income receipts over all outlays, both current and capital investment. The amounts are strongly positive for households, which always have a large excess flow that goes into financial investment, whereas business net flows have been negative throughout most of the postwar period, reflecting capital outlays that have been filled by external credit and equity flows originating directly or indirectly in the household surplus. The Federal net position is essentially the NIA surplus, which plunged steeply into deficit as we entered 1975.

For financial markets the striking feature of this view is the extent of improvement in net business position this year, following a stretch of years beginning 1971 when the financing gap for business was widening well beyond any previous experience even in relative terms. From the end of 1971, when the recent slide in business cash flows began, the net deficit in Chart 2 went from a reasonable 26 per cent of capital outlays to almost 45 per cent by the middle of 1974, far more than in any of the post war years. The sharp upward shift in net business flows this year was an abrupt correction of that trend. It was also the major offset to the Federal deficit plunge, although the effect of tax rebates are also visible as a second-quarter peak for

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households and a sharp trough for the Government. 1976 will patently be less extreme than these 1975 positions as activity picks up, but business will apparently still be in a better net flow position than before the recession. The 1976 Federal deficit will also be reflected in a somewhat high rate of household saving.

Business Credit Flows. In private credit markets the steep decrease in business investment this year was accompanied by an equally steep decline in net credit demands by business, as illustrated in Chart 3. The drop in net borrowing was almost equal in dollar amount to the fall in investment spending and is one indication of the extent to which earlier borrowing in 1973 and 1974 had generated uncomfortable debt levels for business. To extricate itself from the tight cash flow-to-debt position business had arrived at by the end of last year, virtually all of the improvement in net position went into debt repayment or debt avoidance, and little was spared, at least at first, for liquid asset buildups. With the 1976 recovery in business investment will unquestionably generate renewal of credit demand, but credit flows to business need not reach the 1973-74 rates even with capital spending that goes well above those years in dollar amounts. Better net cash flows next year will be enough to provide a more comfortable margin of internal financing and to avoid the extreme of debt financing preceding the downturn last year.

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Business financing this year has included both a correction of total debt outstanding and a quite considerable restructuring of short-term into funded forms and equities, shown in Chart 4. Equity markets have been only moderately favorable for stock issues this year, and the majority of the equity money raised has gone into public utility issues that to some extent were required by regulatory bodies. The amounts have been sizable, however, and they have been an important alternative to loan credit. Bond issues were more spectacularly large in the first half of the year, however, even though the cost of such money was not much lower than during the 1974 high. The cumulation of borrowing over 1973 and 1974 in short-term forms had resulted in debt structures that were both large in total relative to cash flows and also precariously biased toward short-term debt. Banks, in particular, were becoming nervous about the condition of their customers in these circumstances. The run-off and funding of this short-term debt this year has gone a long way toward correcting the distortion that has been created by the end of 1974.

There has been strong support for the restructuring this year in the demand for corporate bonds from both the insurance industry and individual investors, who have been a principal source for the funds buying those high volumes of offerings last spring. This may have been the result of yet another bad experience in stocks last year, and perhaps partly a reaction to current worries about municipal securities.

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In any case the apparently strong demand by individuals is similar to the 1970 experience. Bond issues will probably fall back to more normal proportions next year as a result of the very sizable restructuring that was accomplished this year.

Thrift Institutions and the Mortgage Market. A major aspect of other credit markets this year and next is the flow of household funds into time and savings accounts. Flows into thrift institutions were sharply up in the first half of the year, reflecting high saving rates by households, low market rates on alternative investments such as short-term Treasuries, and perhaps a need by households to restore real balances that had been eroded by the 1973-74 inflation. These inflows, indicated in Chart 5, came at a time when mortgage lending had been drifting downward over a two-year period from the exceedingly high levels of late 1972 and early 1973. The immediate effect of the deposit flows was to supply funds to the Government securities market, partly through liquidity investments by thrift institutions and partly through repayment of home loan bank debt that enabled the home loan banks to retire their own debt from the market.

Mortgage flows reacted promptly in the second quarter of this year, however, rising more steeply on a net basis than we have seen before. There were apparently further increases in the third quarter in thrift institution lending, but the recent faltering in deposit flows leaves little room for mortgage lending to be much above current levels.

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As the thrifts' inflows come down to meet the rate of their lending, these institutions will be withdrawing from the Governments market and will probably be both selling liquid assets and borrowing to maintain present lending rates.

Chart 6 relates mortgage lending--public and private--to projected levels of residential construction. The lending spurt of the second quarter was far larger than any construction financing requirement and, like the 1972-73 flood of mortgage money, went to a large extent into financing existing-house transactions. This form of financing essentially funds used-house market values into cash in the hands of the sellers and thereby increases liquid asset holdings in the system. Its ultimate effects derive from the many uses sellers put that cash to and cannot be traced in any explicit form. The housing market had not needed such volumes of mortgage flows before the 1972-73 burst, and the presumption is that such heavy borrowing is not implicit in the construction outlook for next year. Hence from here to the end of 1976 mortgage flows should grow considerably less than construction spending, although the gap will by no means reach the amounts that were customary before 1971.

Commercial Bank Credit. Commercial bank business loans were repaid in sizable amounts over the first three quarters of this year, in reflection of both the inventory liquidation in process and of the exposed short-term debt position of business at the end of 1974. With

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consumer credit demand low and a distaste at banks for further real estate lending, total loans at banks have decreased over much of this year. This drop in loans has been accompanied, as Chart 7 indicates, by a roughly comparable decrease in negotiable CD's outstanding and by much reduced borrowing in nondeposit forms. Time deposits other than CD's, in Chart 8, have seen some of the strength shown by thrift institution flows but in diluted form, perhaps because the figures we have on these deposits include a good many large CD's that we don't know about. Total bank credit, also in Chart 8, has thus been without substantial offsets to the run-off of CD's and is very much weaker in total flow than we have become accustomed to. Such flows as the banks have had have gone largely into Government securities (Chart 9), which are providing a much needed restoration to bank liquidity positions.

For 1976 bank loan growth should be more moderate, relatively, than in earlier recoveries, partly because of the better cash flow position projected for business and partly because banks will apparently be applying more stringent quality standards in their lending, especially in the real estate field. Given the flows of non-CD money likely in 1976 and the reasonably adequate liquidity they are establishing this year, banks do not appear to need CD funds from money markets next year to meet their loan demands, and banks will probably remain less important as a source of credit supply than has been usual in recoveries.

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Total Funds Raised and Advanced. Enough major elements of credit demand and supply can be pulled together at this point to summarize the aggregate market flows and where the money is coming from. Major private credit demands are in Chart 10; all of these have been mentioned earlier except consumer credit, which bears a close relation to consumer durables demand. In Chart 11 these are combined with Federal borrowing into a grand total of borrowing by all nonfinancial sectors, a total that sags somewhat in 1975 in spite of the abrupt rise in Federal borrowing. The drop in business borrowing, together with the lapse in consumer credit demand earlier this year, has slightly overweighed Federal needs, even though private saving, back in Chart 1, was slightly buoyed this year by the deficit. Primarily, however, Federal borrowing has served in credit markets the same function as the deficit performed in nonfinancial activity in that it has filled (most of) the gap in total credit flows left by private customers and supported a fairly stable rate of financial asset creation.

The turnaround in private credit flows this year, started by mortgages in the second quarter but continued as we go into 1976 by business credit, combines with a continued high rate of Federal borrowing into what might be a smartly ascending rate of credit demand for the next several months. Appearances can be a little deceiving here though, because the total flow will probably be lower in relation to GNP than the total we experienced in 1972 and again in 1973. While

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the economy is unlikely to achieve high employment in 1976 there is enough inflation in the system to produce something like a 10 per cent increase, IV/75 to IV/76, in current-dollar GNP. In this context, with the moderate credit demands that seem to be arising in business and in the municipal market, the total of debt outstanding at the end of 1976 may very well be lower relative to GNP at the end of 1975 or 1974.

On the supply side of these credit markets, as in Chart 12, it has become customary to view with alarm a market condition in which a substantial part of the total flow comes directly from private non-financial investors, since these investors are viewed as residual sources that prefer to put their money into financial institutions and let the intermediaries do most of the direct lending. When they come directly into markets, it has been a sign in the past, for example, in 1969 in Chart 12, of tight credit conditions where market yields are well above those offered by intermediaries. The nature of markets has changed in the last five years, though, particularly through the liberalization of rates on bank CD's, and whether the nonfinancial investors are important lenders depends more on the structure of credit demand--that is, whether the demand is for business and real estate credit or for open-market funds. The slack in total credit flows in 1975 has been in bank forms of credit, which have fallen off more than Federal demand has increased, and this appears in Chart 12 as a marked decrease this year in the proportion of credit supplied by private finance as a whole, but without

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the classical crunch conditions in markets that we would have expected in earlier years.

The most active open market this year has been in Federal securities, and Chart 13 shows the two critical suppliers to this market--banks and the nonfinancial group. (The total in this chart is broader than in Chart 11 in that it includes borrowing by sponsored agencies, an intermediary group whose credit demands are left out of the Chart 11 total to avoid double counting.) Bank demand for Governments has been so high this year that, along with the temporary investments by thrift institutions, they have essentially kept nonfinancial investors out of this market for most of the year on an overall net basis.

All of this is presumably in the process of abrupt change as we enter into 1976. Bank demand for liquidity will taper off and thrift institutions will need all of the inflows they can get to handle mortgage flows. Presumably the supply of funds has even now shifted toward the nonfinancial groups, although it will take a little time to see this clearly in the numbers. More plainly, though, in 1976 households in particular but businesses as well will be far more important to Government security flows than they have been this year, and the critical question for next year is whether selling those amounts of securities to the public requires crunch-like market conditions. Any such financial market distress would be the real-world manifestation of the crowding out that has been of such concern this year.

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We haven't the answer to that question, but there are enough new aspects to financial markets these days to make it very far from clear that a classical crunch is part of the 1976 picture. We have, first, Chart 14, which shows for the nonfinancial group the remarkable change in their favor that has occurred in lending-borrowing relationships, giving them a large flow to invest in some form, including Governments. This relation will almost certainly continue into 1976 and will be a strong support for credit market flows.

Second, there is in Chart 15 a different view of nonfinancial investors, giving asset holdings, rather than flows, and putting them relative to GNP. While the scale is compressed, it nevertheless illustrates the persistent trend over many years toward increased holdings of deposits and decreased positions in Government securities. Because of this year's demand by financial institutions for Governments, the trend is hardly affected by the flows we have had this year. And for 1976 the arithmetic of growing GNP and credit flows is such that even if this nonfinancial group were to buy, net, as much as $60 billion of Governments next year--three to four times recent amounts--their holdings at the end of 1976 would not be as high on the chart as in 1970, just five years ago. Demand for a safe financial instrument in a time of uncertainty may well produce a shift back toward such earlier portfolio structures.

In conclusion, two very broad charts on debt and asset positions can help to put the present state of financial markets into perspective.

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Chart 16, on debt trends, gives a view of the business debt problem that gave rise to those steep repayments earlier this year. While household debt leveled off, relatively, in the mid-1960's, businesses continued to build a debt-based balance sheet (with a pause in 1971 and 1972, when there was a flush of equity issues) all the way into last year, when they were caught far out on their debt ratios by a combination of inflation and recession. The prospects for 1976 that I've mentioned are based on the presumption that business will not let that happen again. Avoiding it will produce changes in financial market patterns that will be important both to investors and to policy makers concerned to reestablish the economy on a proper path.

Chart 16 also illustrates the diminishing position that Federal debt has had over the years in the total financial structure. Because the dollar numbers on Federal debt have gone up over most of these years many people have not been aware of this shrinkage in Federal debt relative to GNP. It is related to the decrease, in Chart 15, of private nonfinancial holdings, and it is also related to the growing illiquidity of many of those years in bank liquidity. 1975 stands on the chart as a mild correction of the trend, compensating for the reverse correction in business debt.

"Compensating" private debt movement with Federal debt appears to have some real meaning in Chart 17. This chart compares total debt and total financial assets for the private nonfinancial economy altogether.

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It is yet another view of the reversal and correction that has occurred in 1975 and that will probably be at least sustained next year. The asset total, which has shown no trend at all over the last two decades, is related to the total of debts in Chart 16 in that directly, or indirectly through intermediation, most of those debts are reflected in the asset total. Over the years the asset total has become increasingly based on claims against private borrowers, particularly business claims that are on this chart in the debt total. When private borrowers get into difficulties nowadays it makes investors far more nervous than it might have 10 or 15 years ago, generating discussion about the fragility of the system and about capital shortages that are touching on very real problems. The dip in the private debt total this year, which is replaced in assets by claims on the Federal Government, is a step away from the problems that have produced those worries. It appears now that 1976 will continue the shift we have had toward earlier debt-asset positions for the private nonfinancial sector and that the shift will probably include some sizable buying of Government debt directly by this sector. As the economy works its way upward through 1976 it will be eliminating much of the fragility that has grown into the system and perhaps can later avoid reaching the extremes of 1974 as it approaches high employment.

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Chart 1

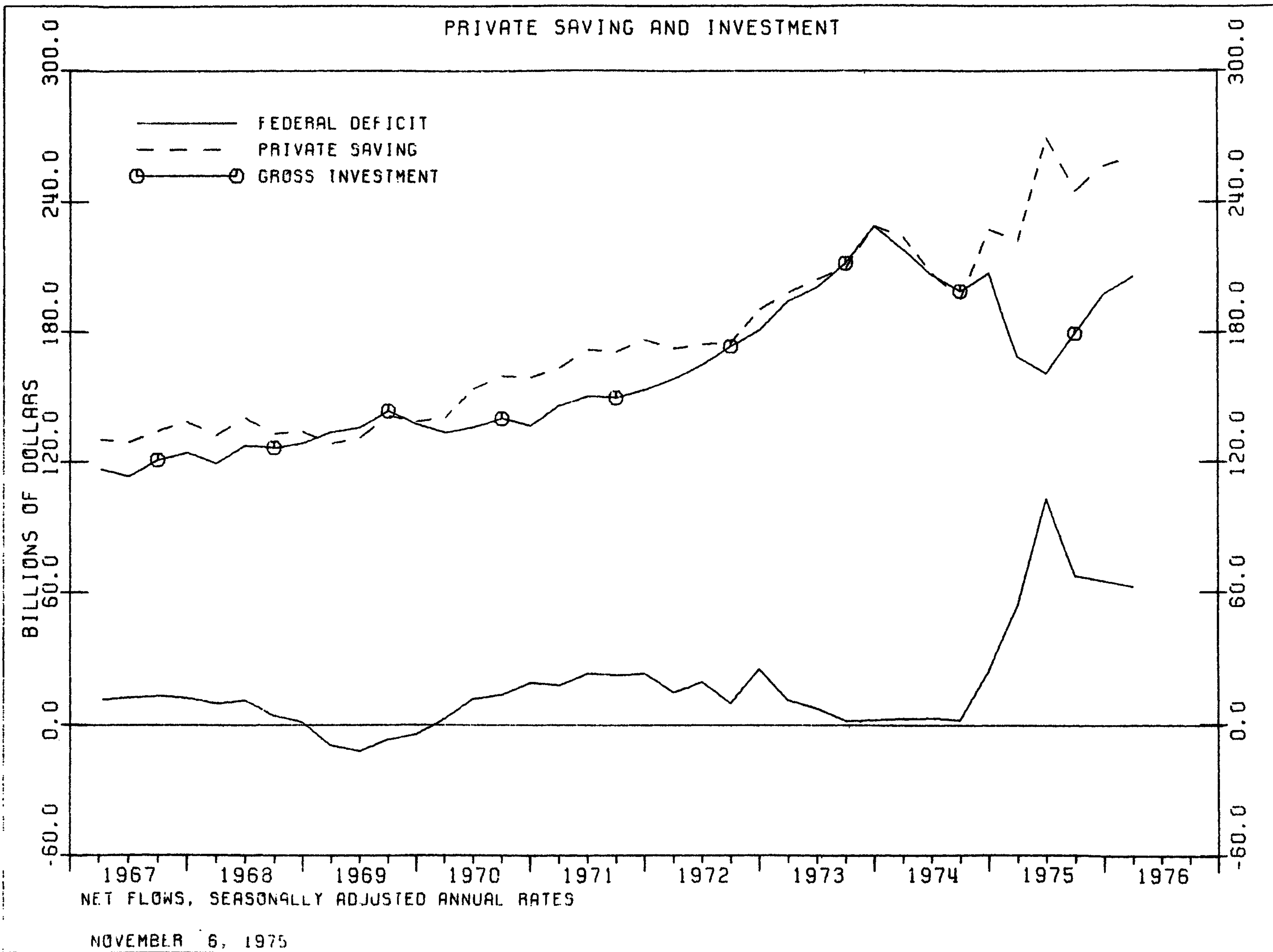

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Chart 2

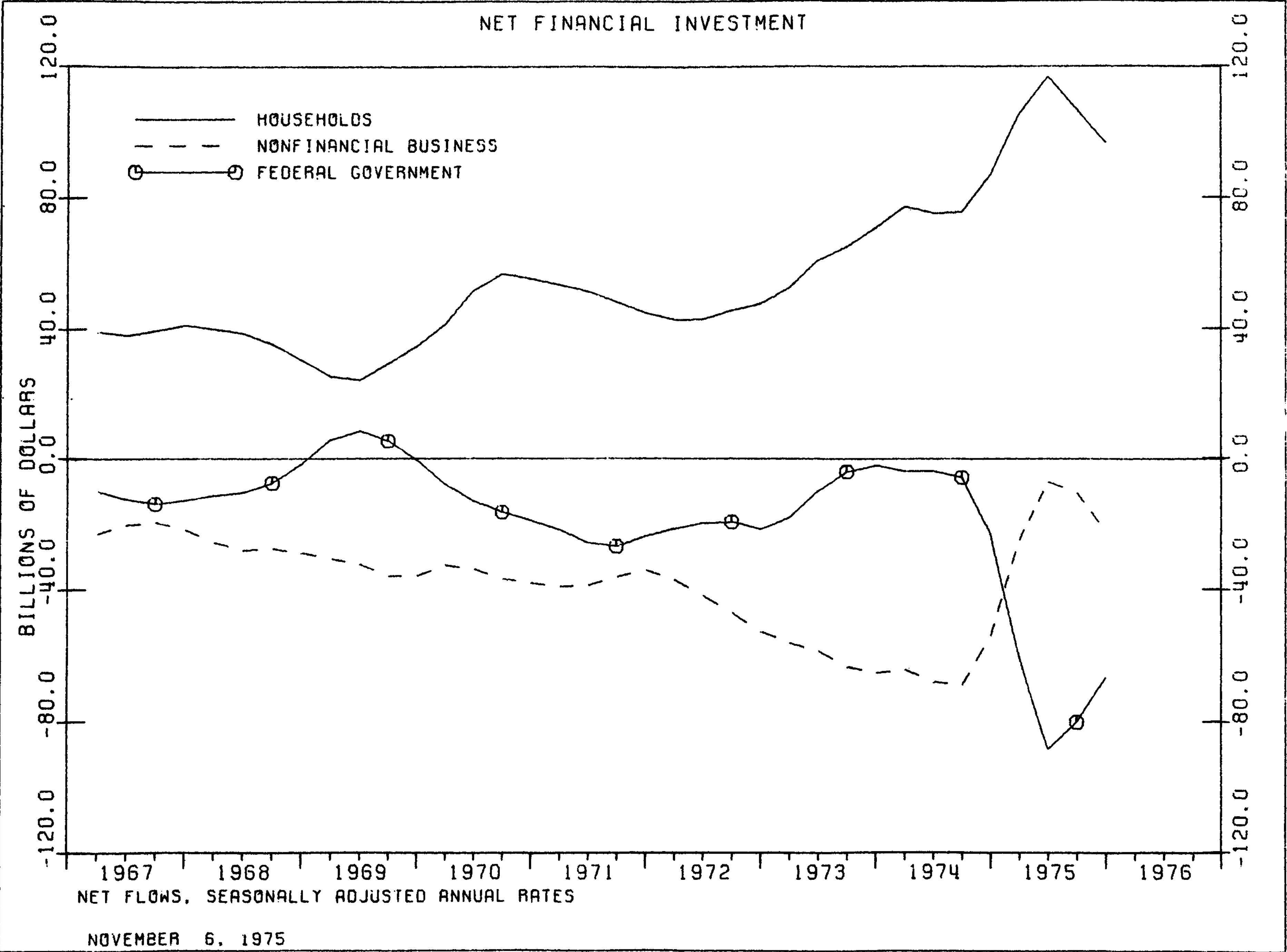

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Chart 3

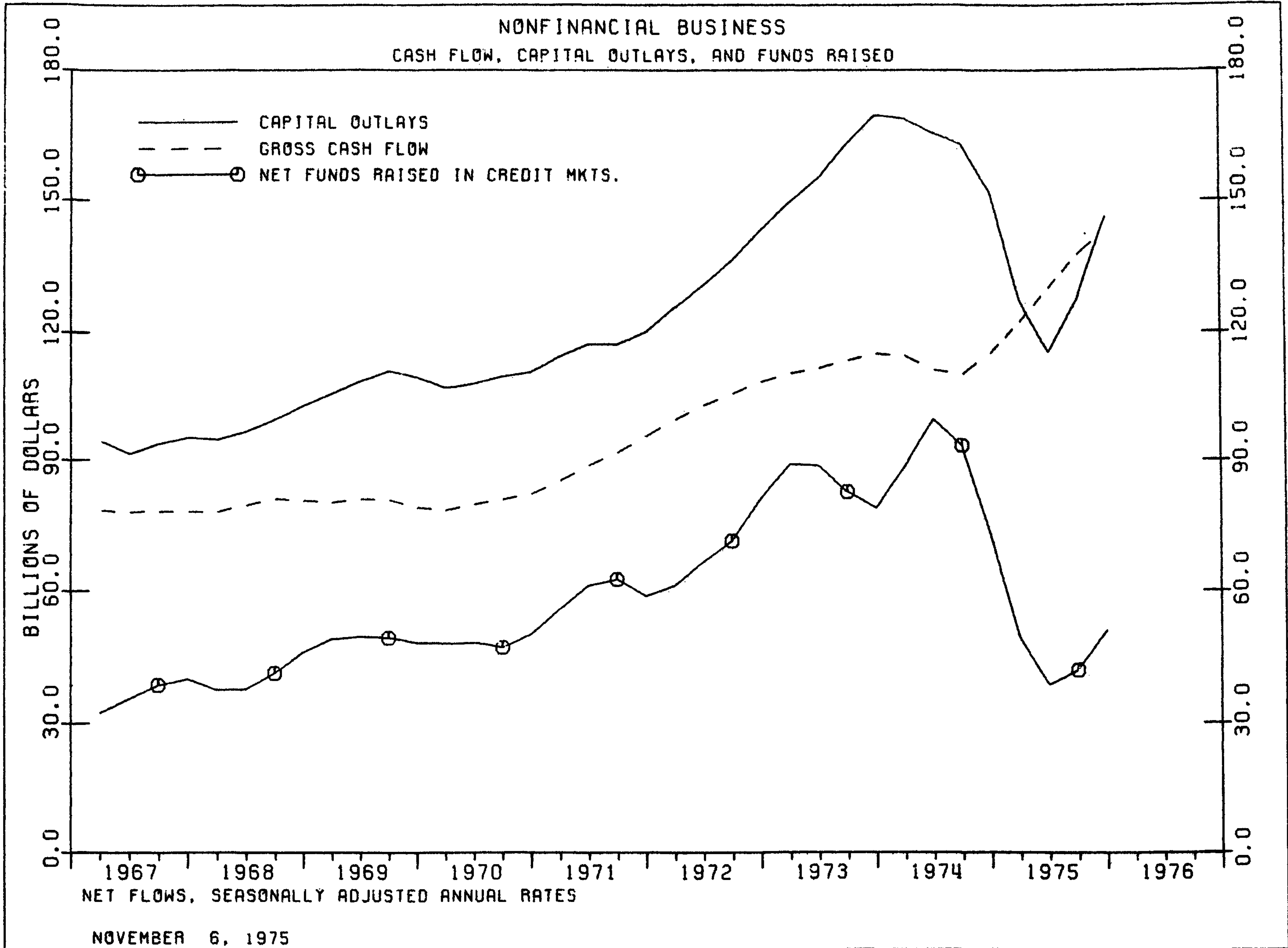

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Chart 4

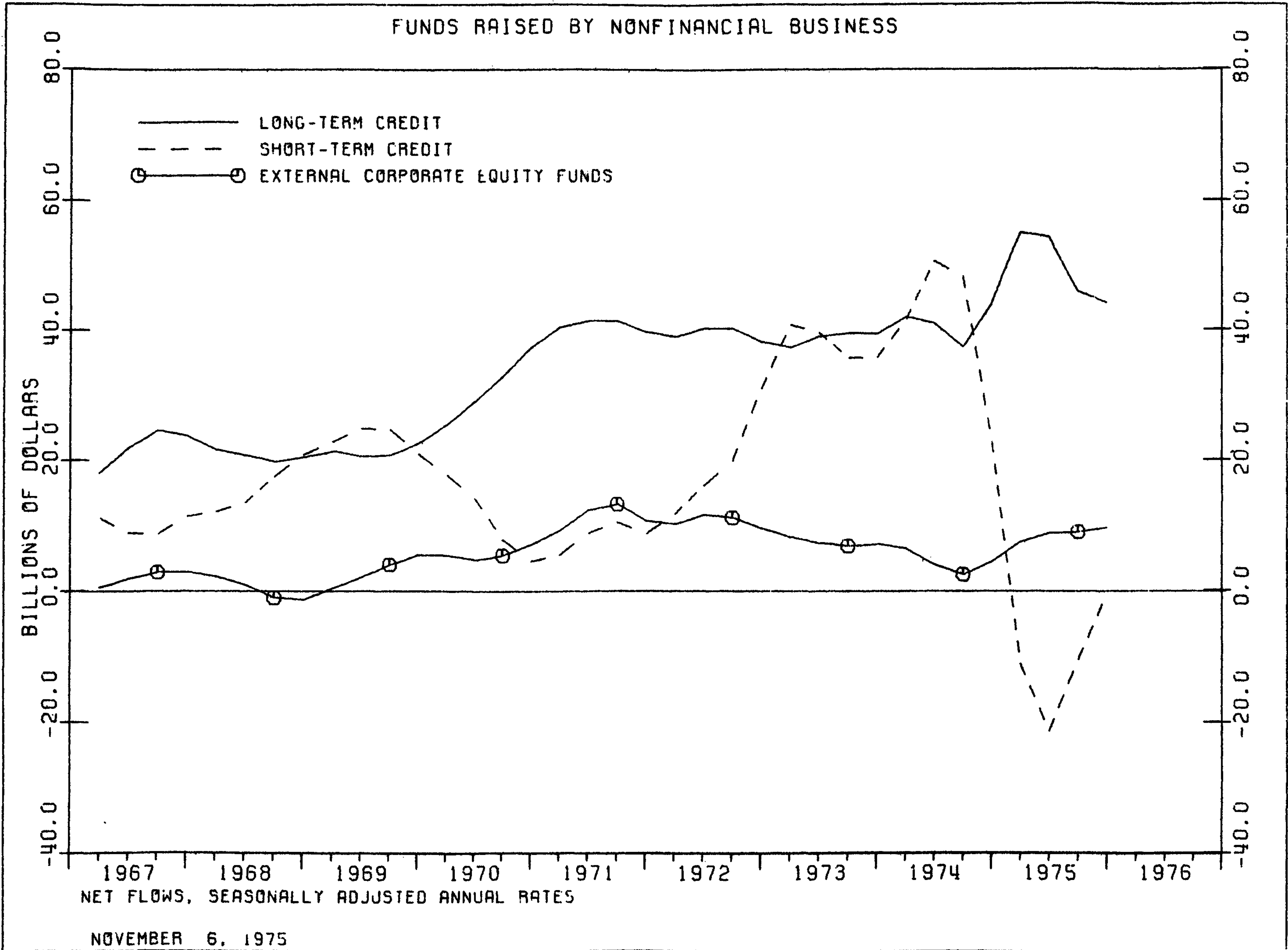

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Chart 5

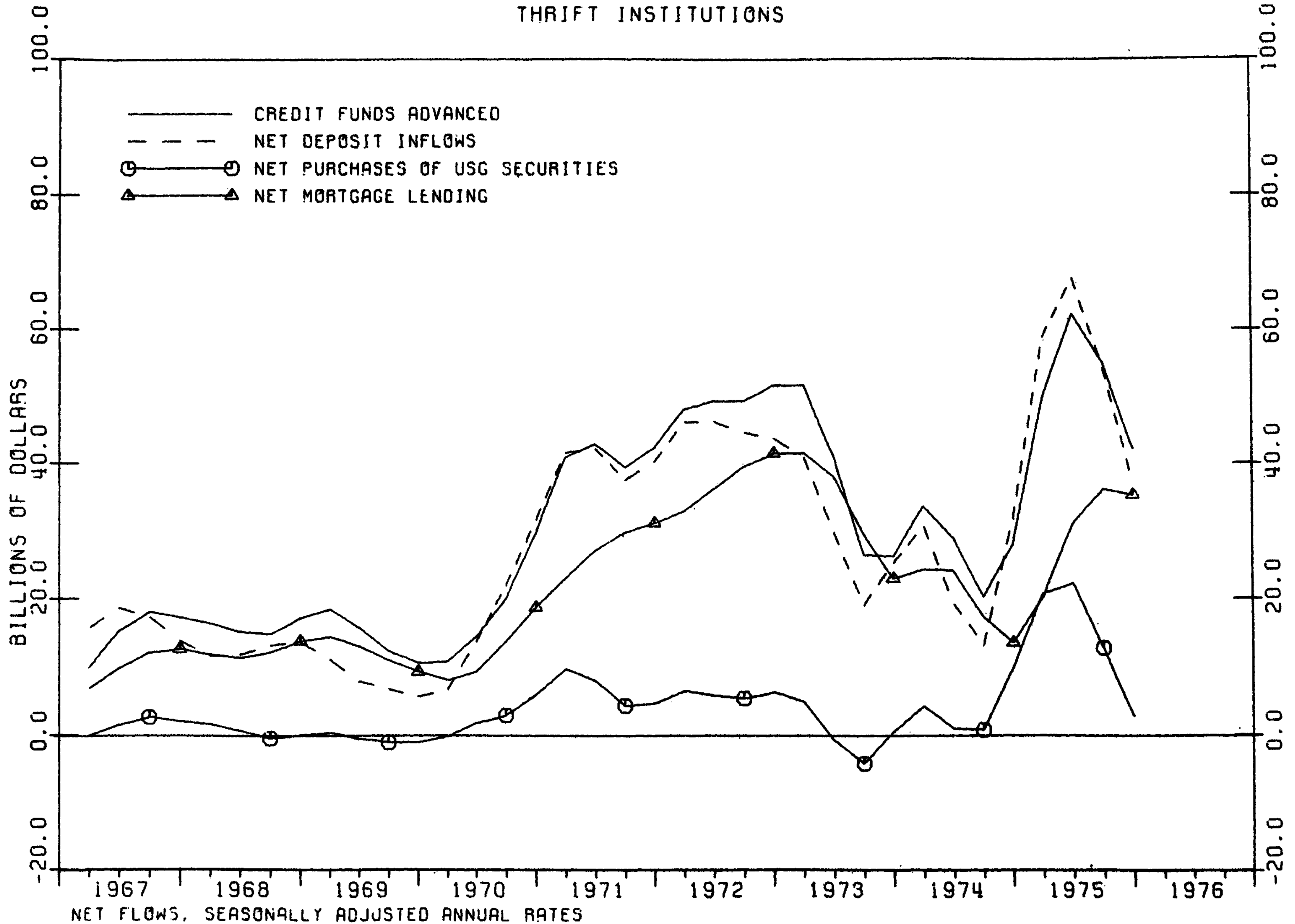

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Chart 6

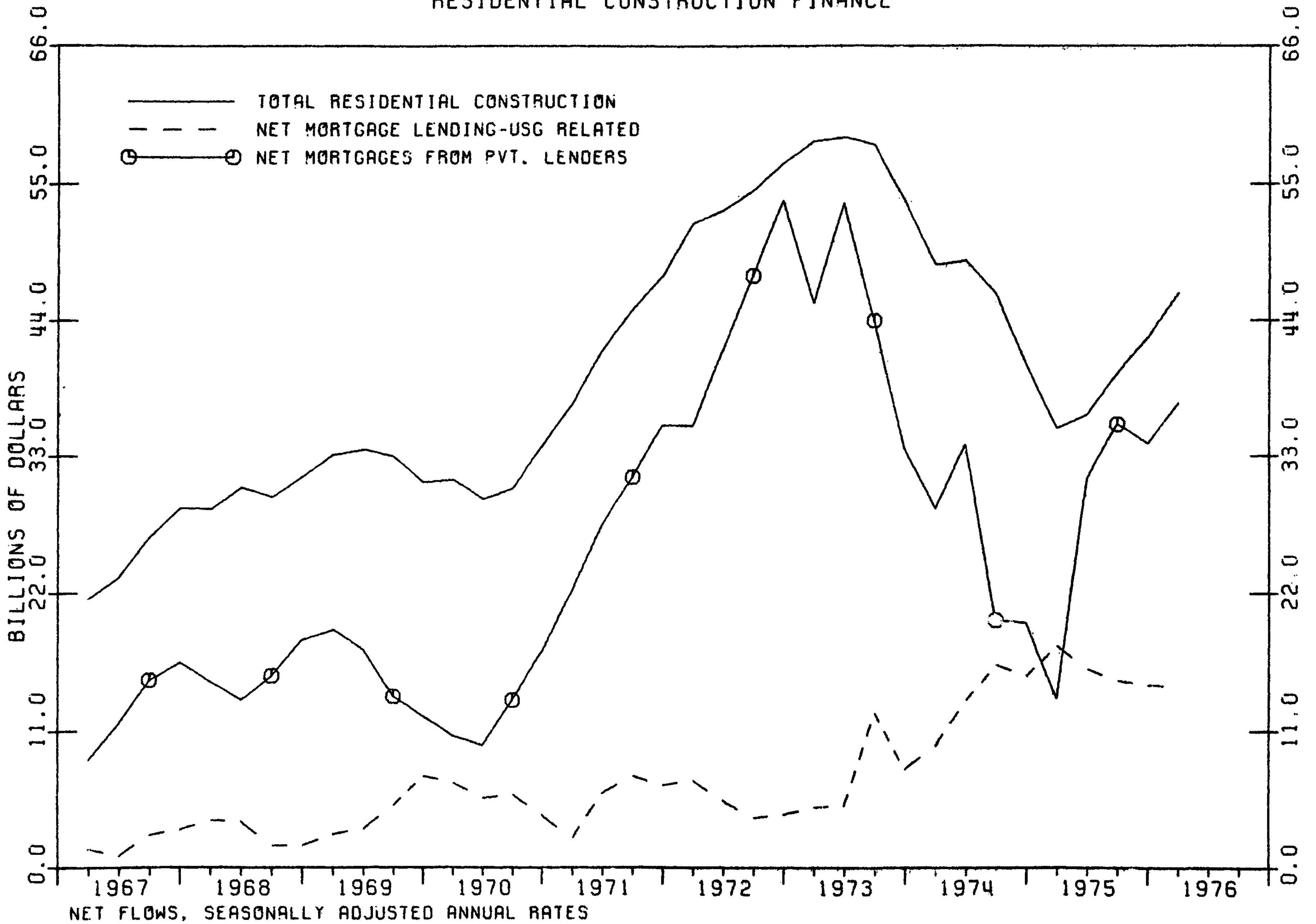

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Chart 7

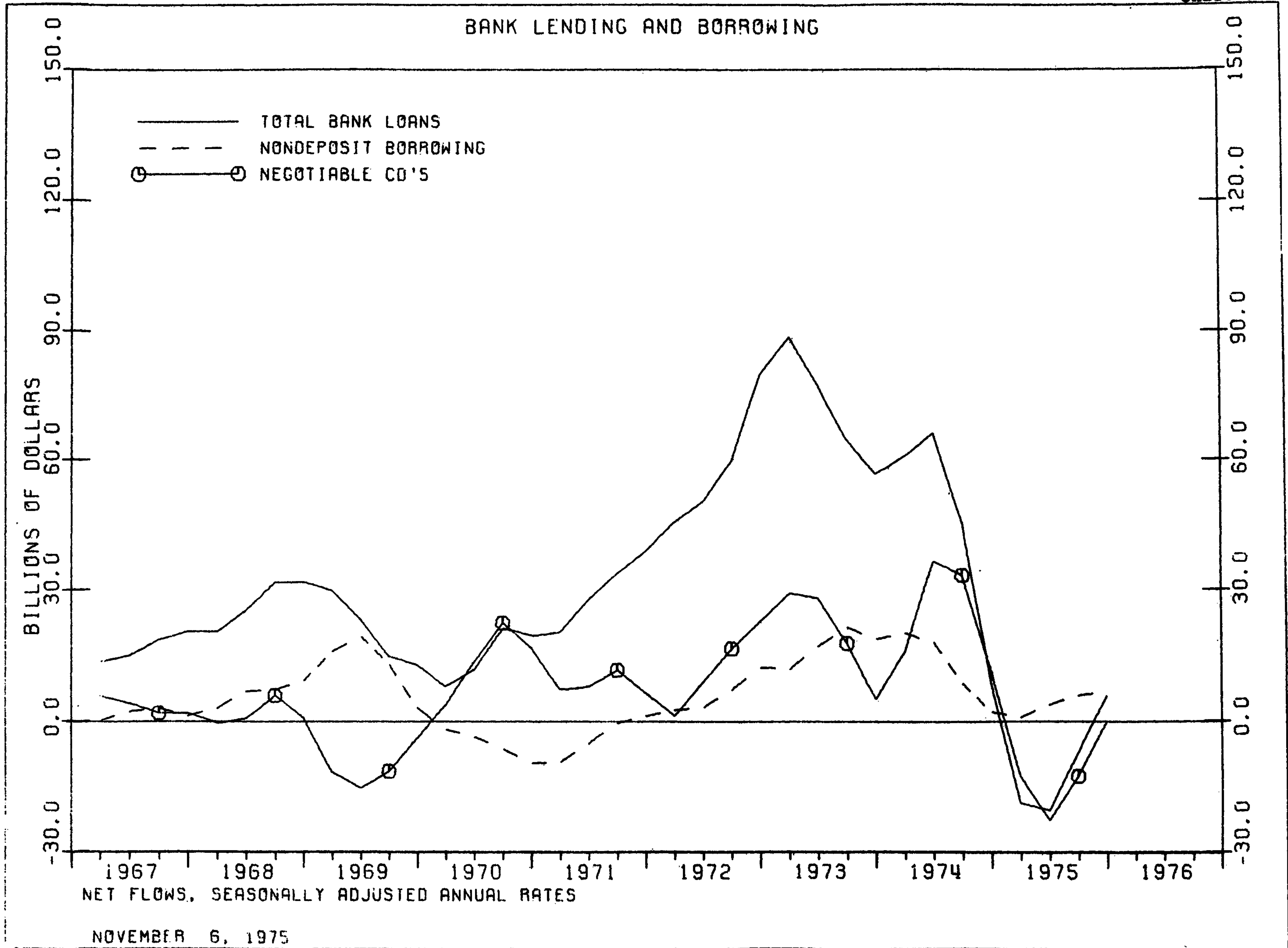

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Chart 8

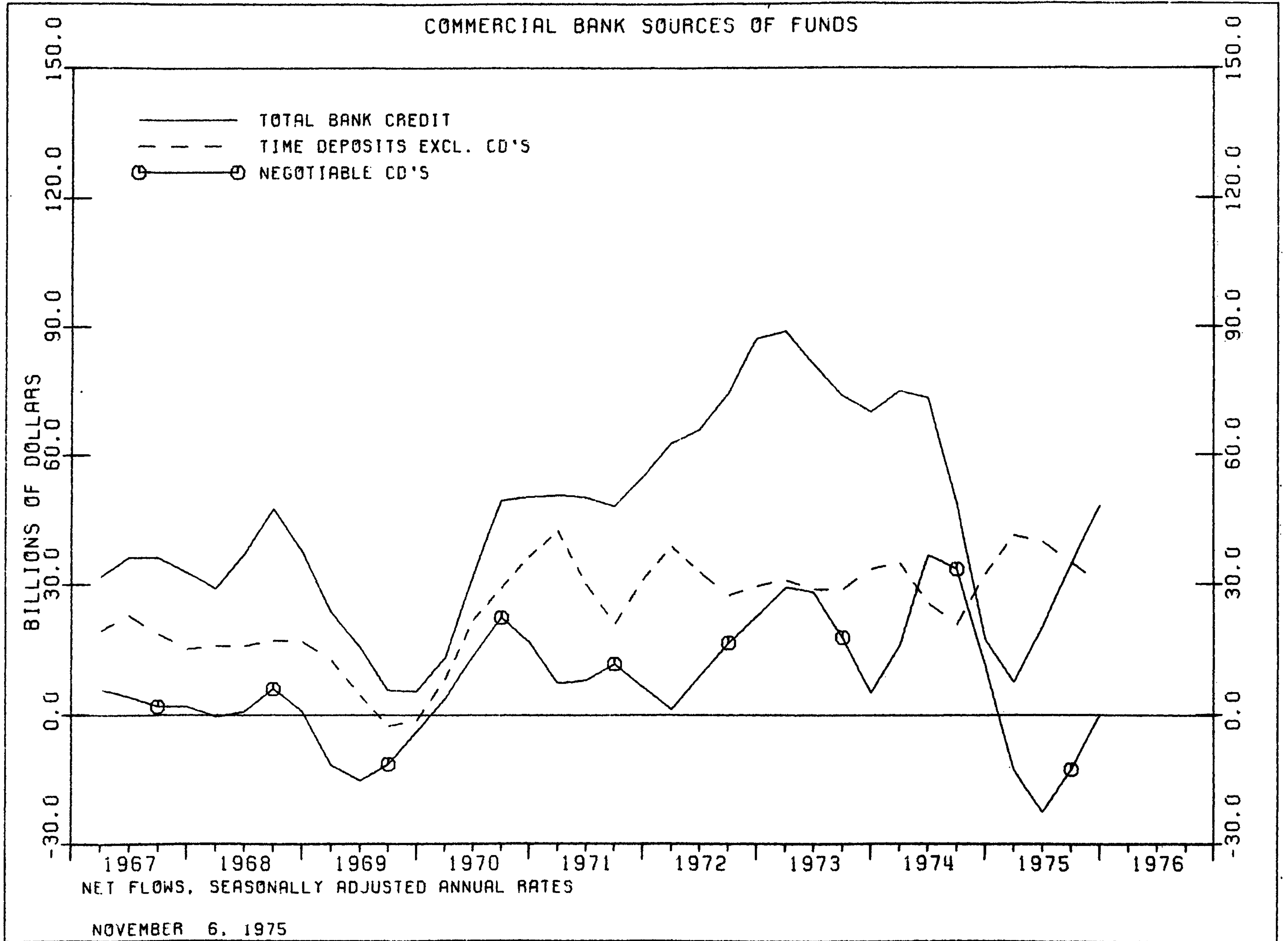

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Chart 9

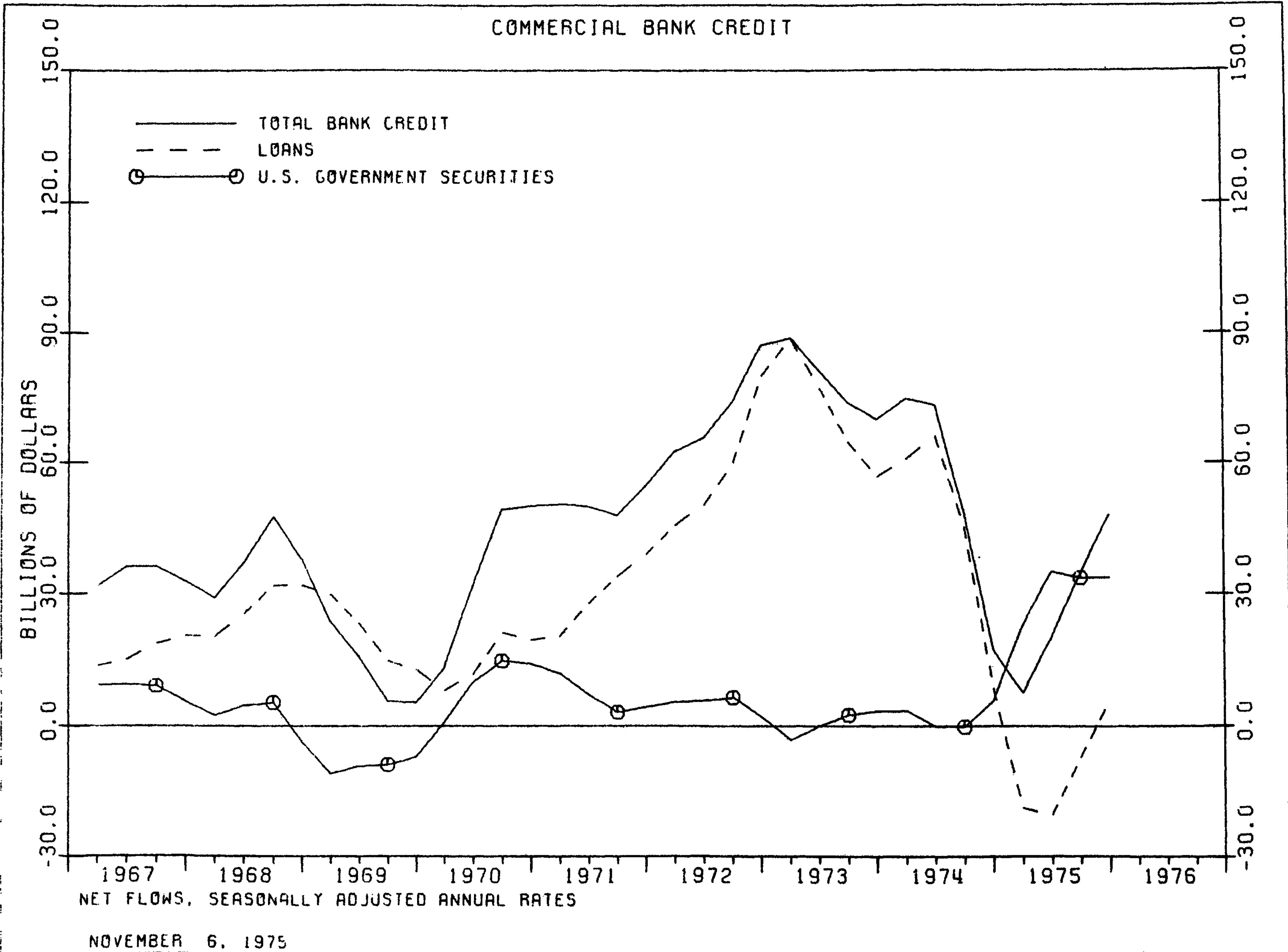

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Chart 10

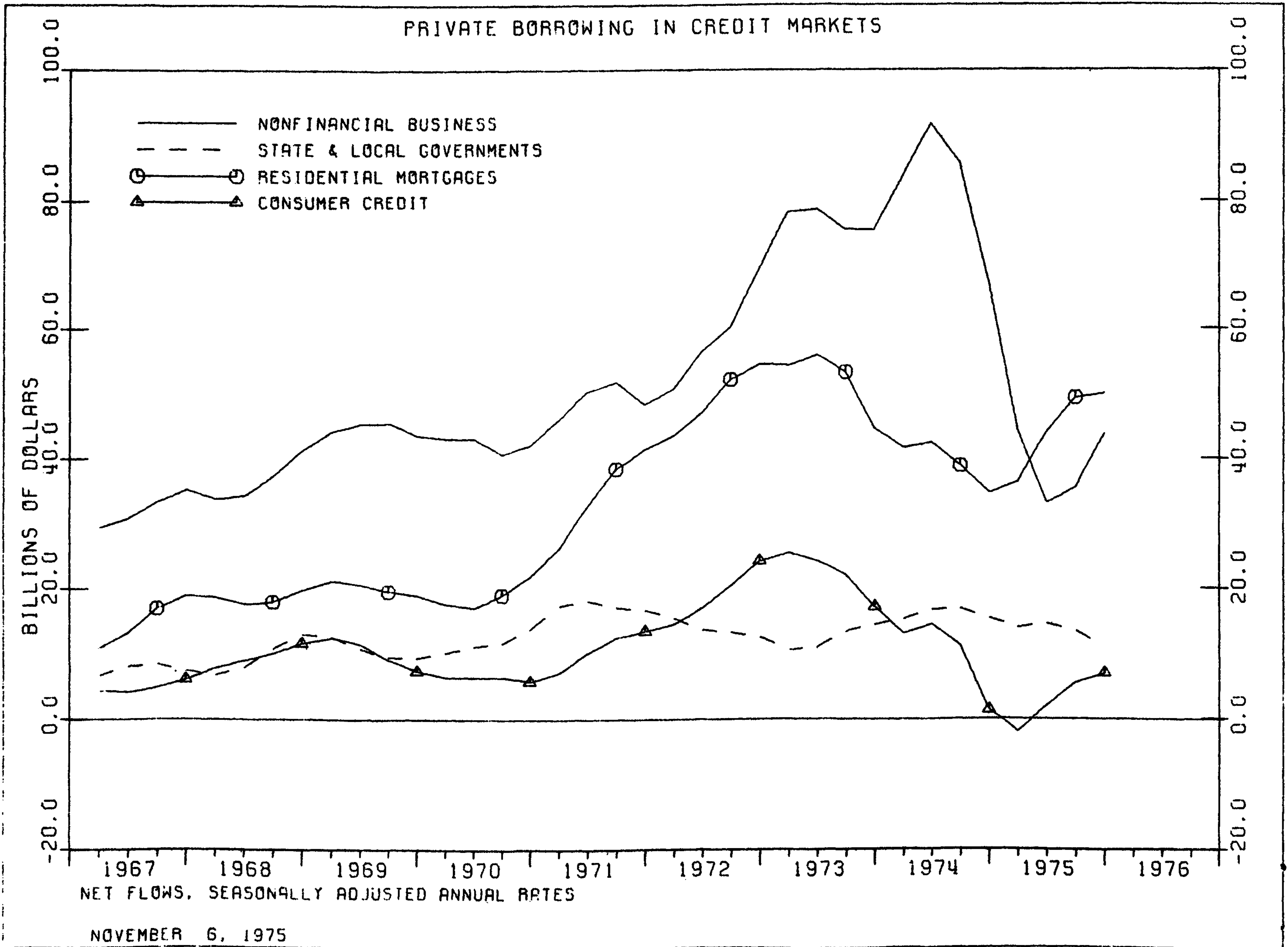

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Chart 11

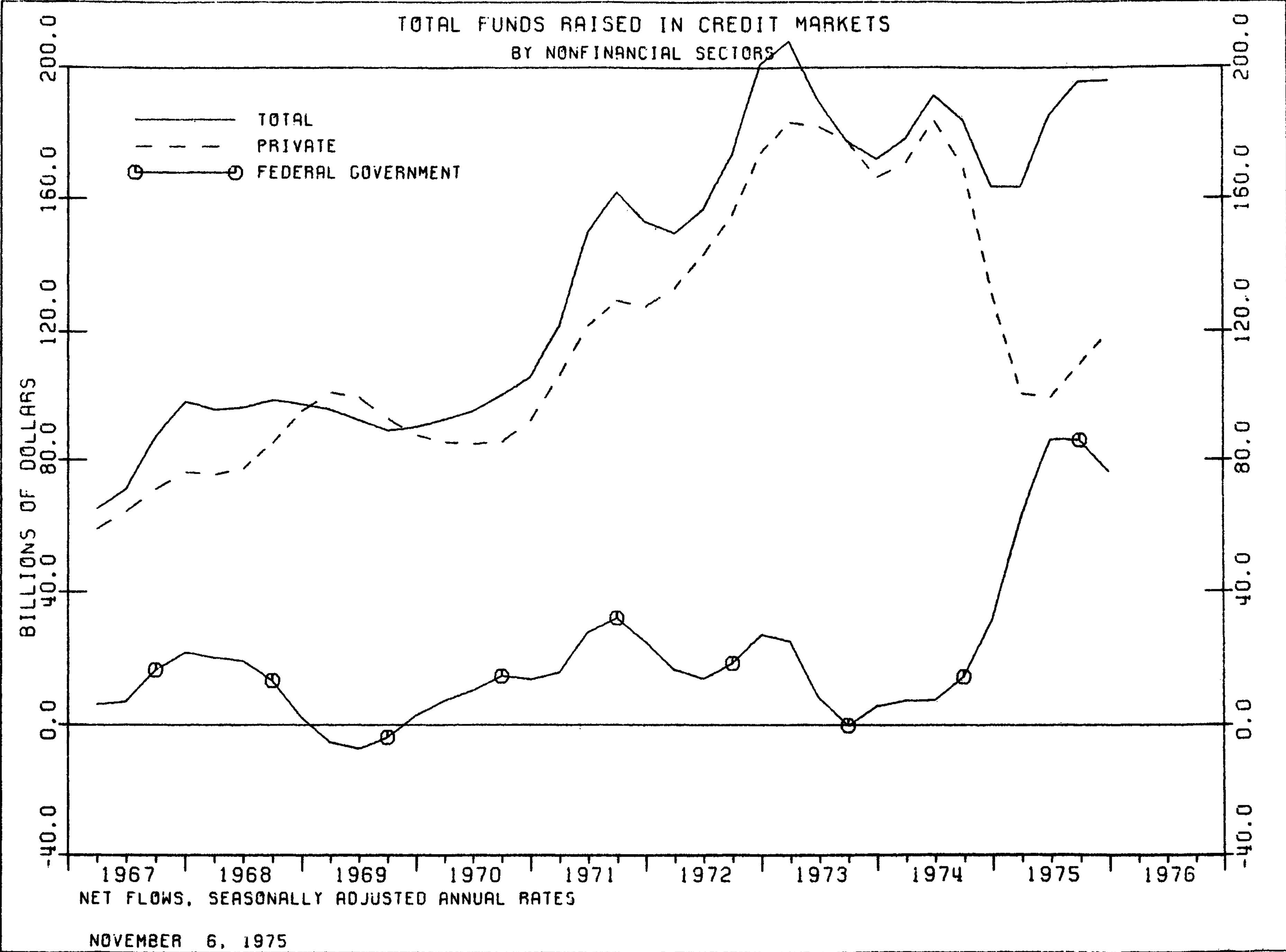

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Chart 12

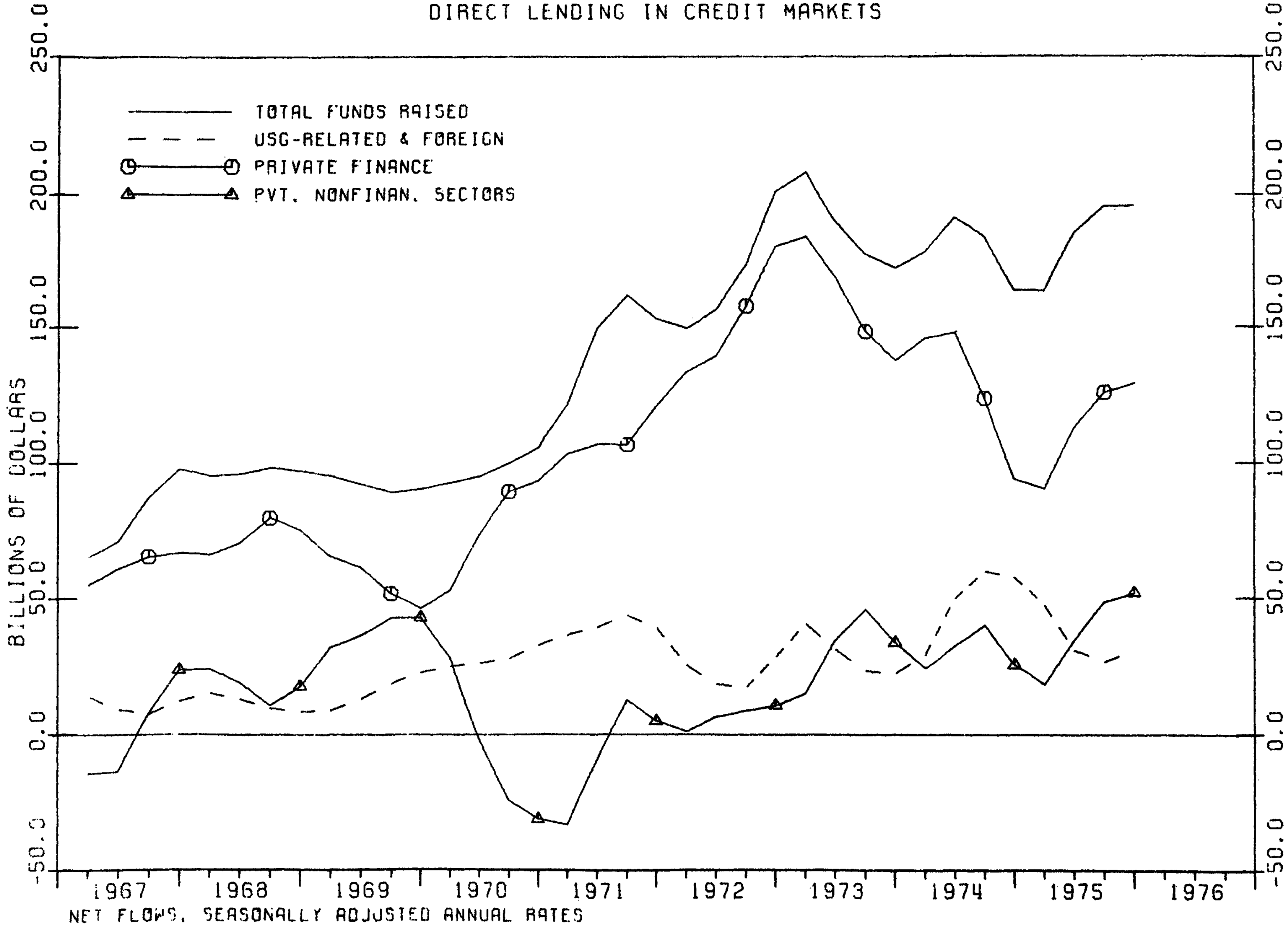

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Chart 13

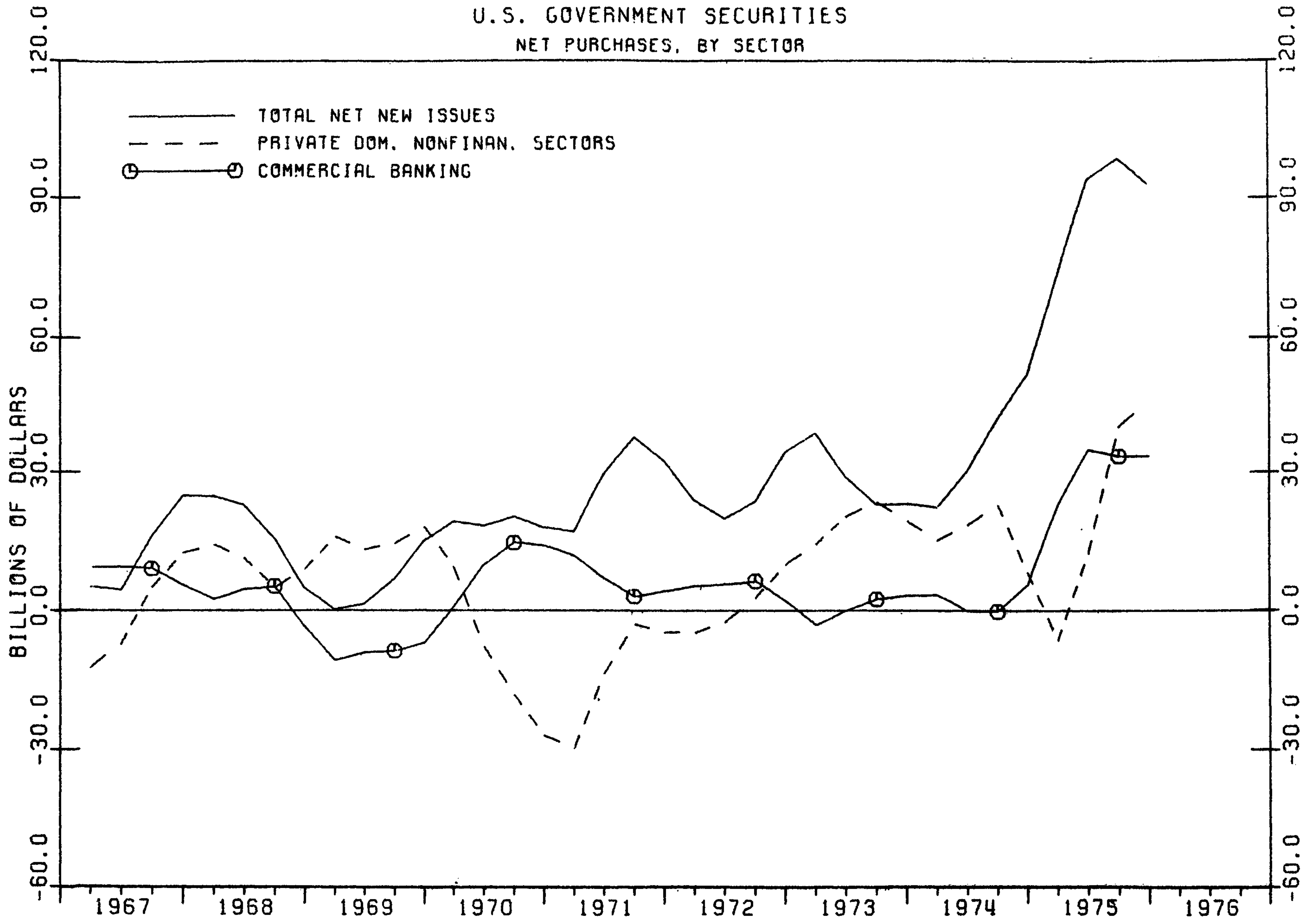

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Chart 14

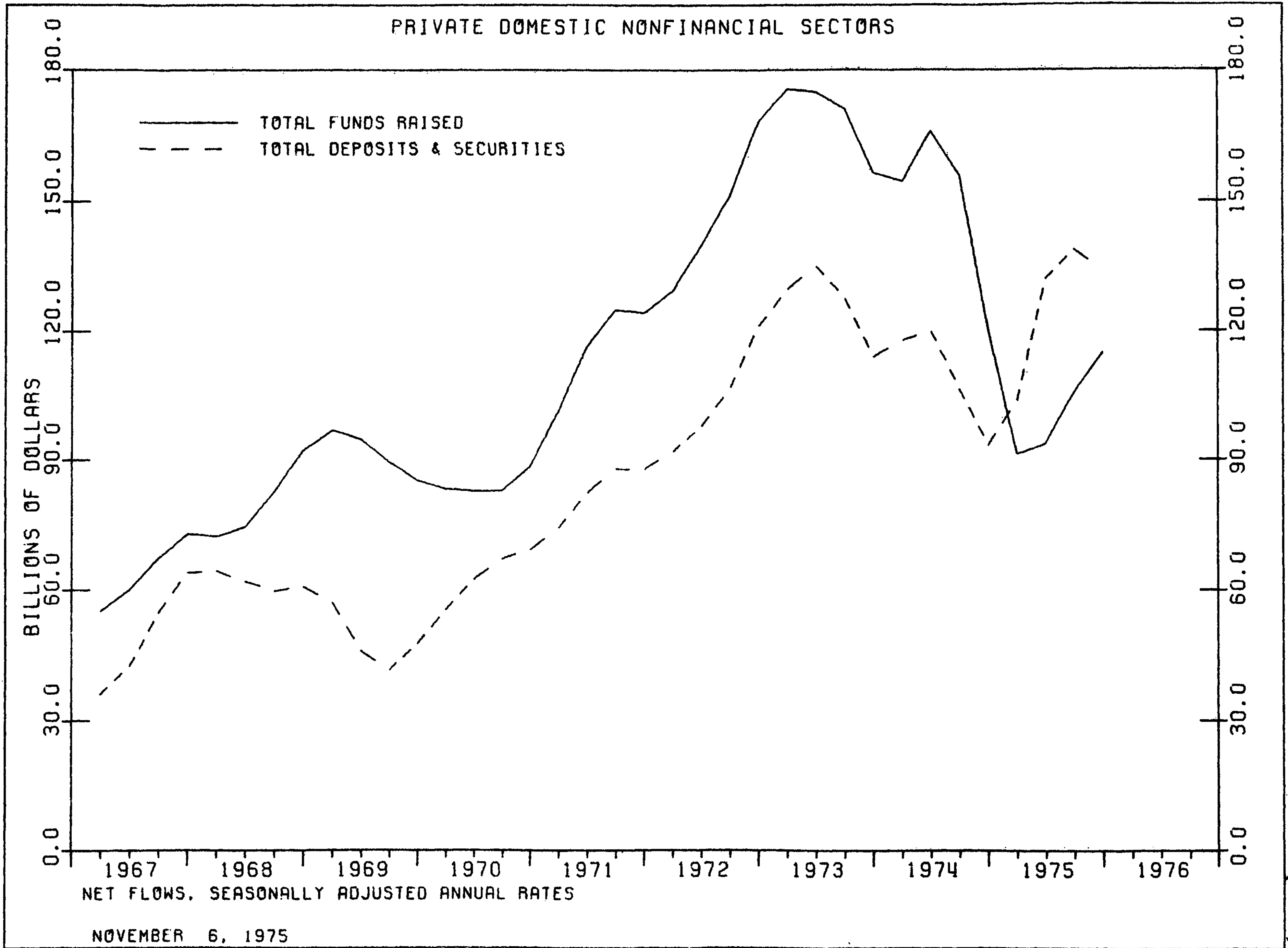

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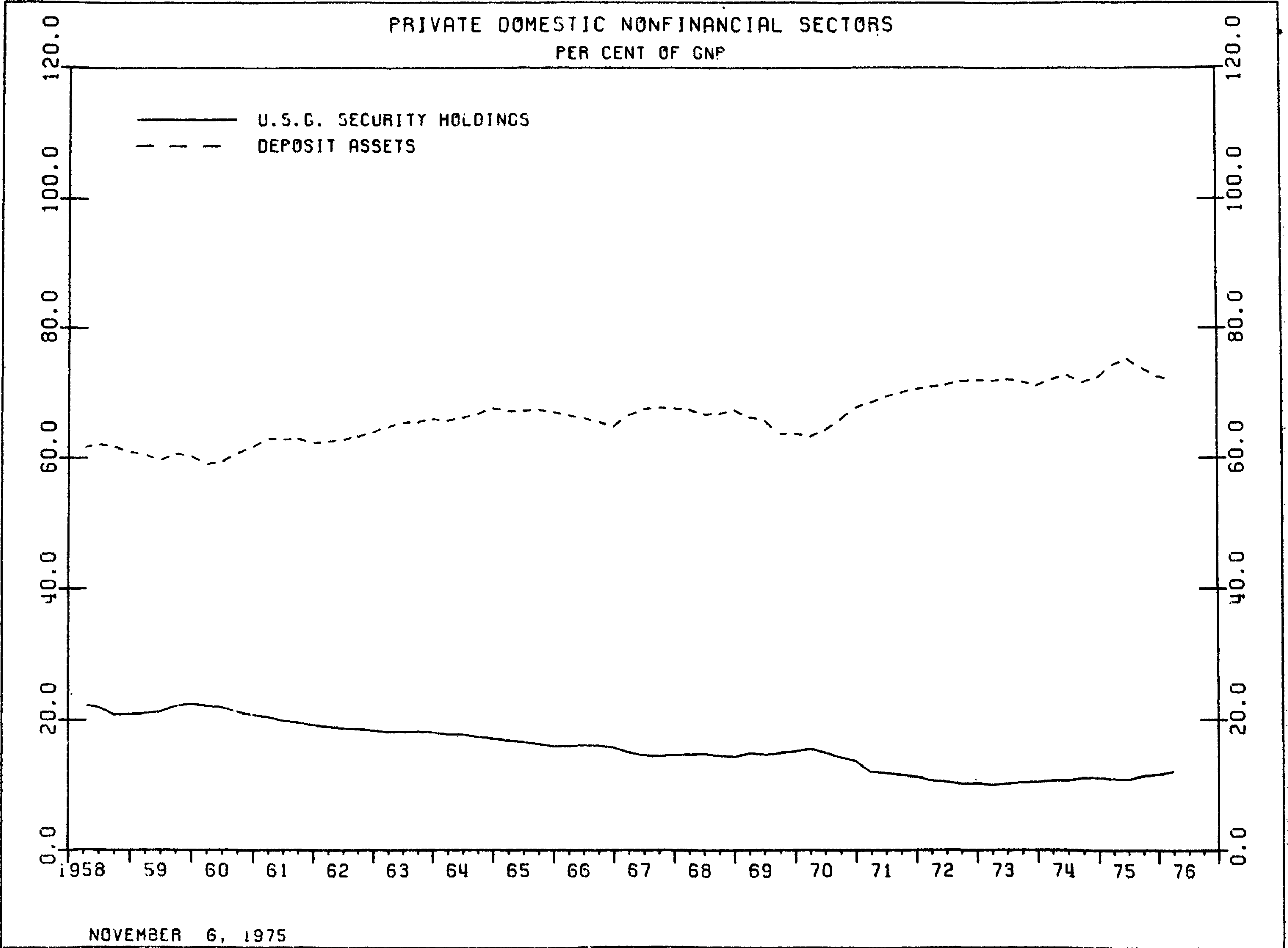
Chart 15



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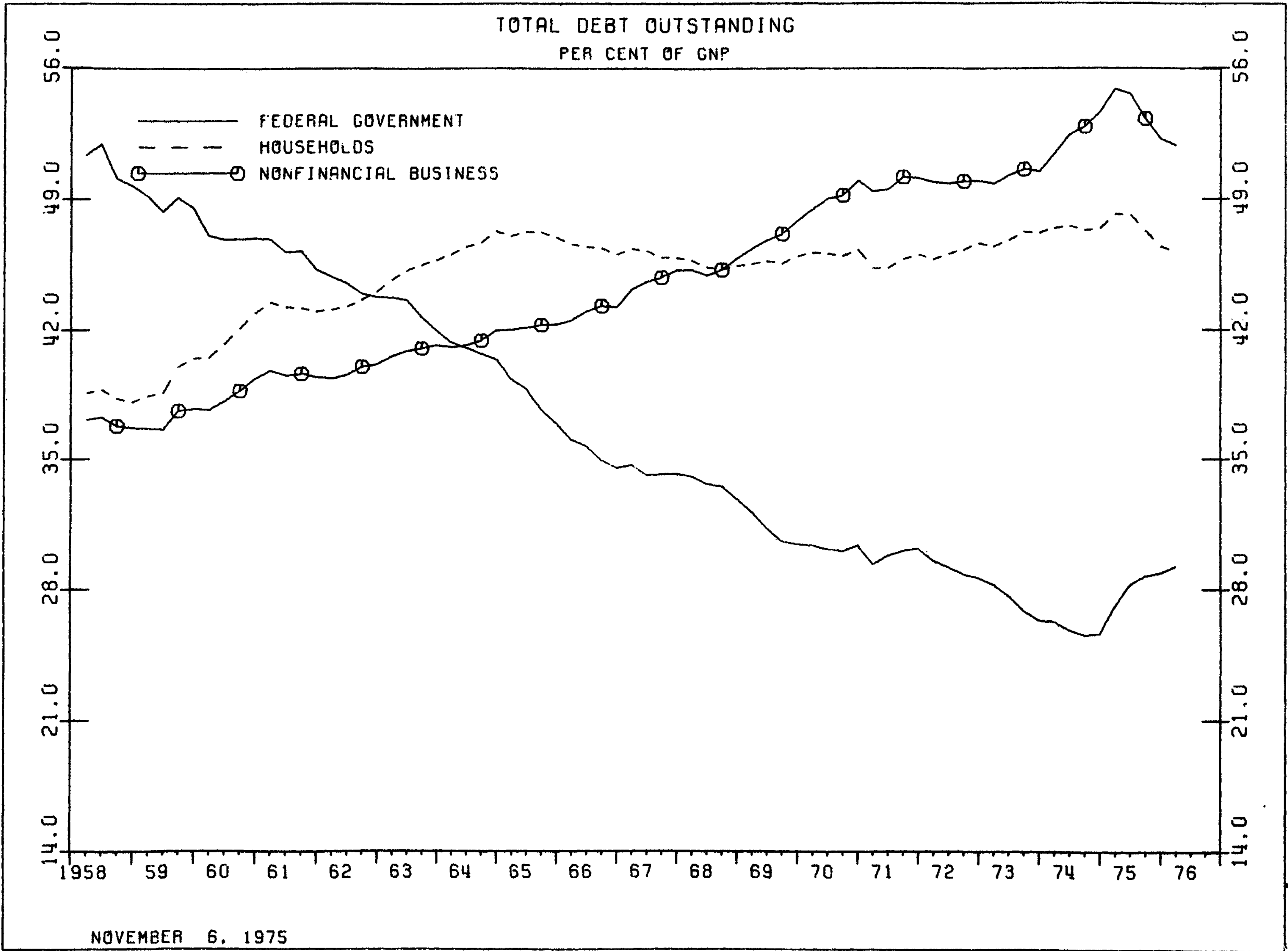

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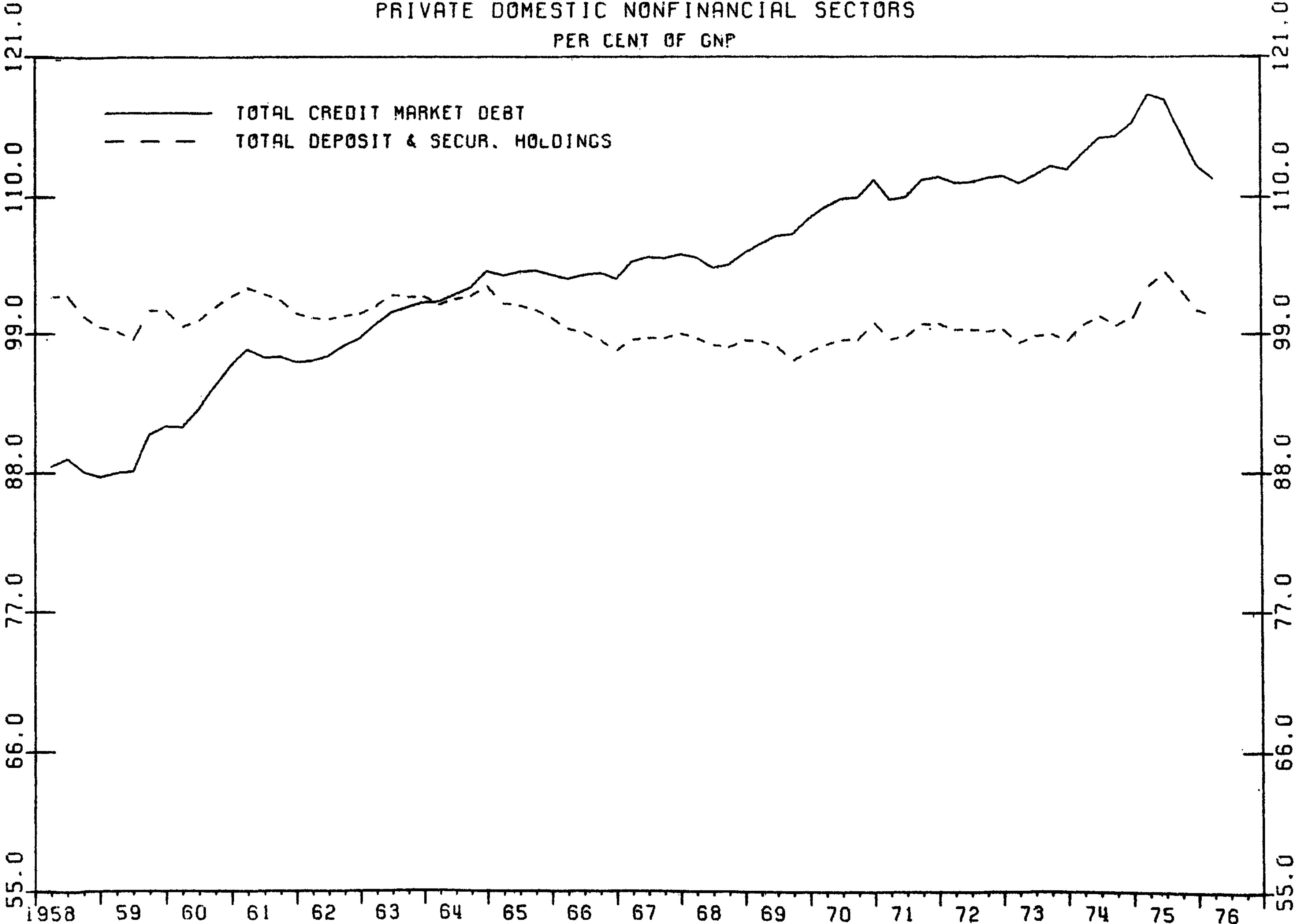
Chart 17



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