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CAPITAL FORMATION IN AN UNCERTAIN FINANCIAL ENVIRONMENT

Remarks of

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Capital Formation in an Uncertain Financial Environment

In keeping with the forward look of the theme of this Convention, my comments will focus upon the financial environment of the future and the uncertainties we face in meeting the capital requirements of this nation. The starting point will be a review of demand and supply in several different contexts. Following this, I shall look at the principal factors that will affect capital markets over the next quarter century. Of course, I speak only for myself not the Federal Reserve or my associates at the Board.

It almost seems unnecessary to say that the capital requirements of the world over the remainder of the Twentieth Century are staggering. The needs and expectations of the developing nations alone will require capital infusions on a massive scale if they are to realize a significant improvement in standards of living. Similarly, the high technology race underway in the industrial nations will continue to require heavy capital expenditures to provide the plant and equipment to maintain the technological substitution of equipment for labor and the increasing efficiencies of modern methods of production.

It may seem somewhat strange to a few of you that I have started with the global demands for credit, but I do so, not only because capital markets are worldwide and often interchangeable, but because there are some lessons to be drawn from foreign experience. With many foreign nations competing for capital in the U.S. market, both by direct issues and by borrowing from financial institutions, the worldwide demand for capital is of importance to the industries of the United States. Just in the first seven months of 1976 bond issues of foreign entities in the U.S. market have totaled $5.5 billion or more than 10 percent of total capital issues in our market. There have been $1.3 billion of new issues marketed in the United States by international financing institutions such as the World Bank, Asian Development Bank, and the Inter-American Development Bank. Moreover, estimated foreign lending by U.S. banks has risen $10 billion thus far in 1976.

It seems clear from the foregoing that U.S. capital markets have been a major source of financing for other nations and foreign businesses. It is also true that U.S. enterprises have obtained financing abroad, both by Eurodollar loans and Eurobond issues and U.S. banks have drawn sizable amounts of new funds from foreign sources, especially the OPEC nations. Moreover, foreign governments and nationals have purchased sizable amounts of U.S. Treasury issues in all maturity ranges as well as stocks of U.S.

corporations. Foreign official institutions hold almost a fifth of total U.S. Government debt in the hands of private investors. The net effect of capital exports and imports and security investments here and abroad appear to reflect a continuing export of capital to other nations, especially when new plant construction and expansion abroad by U.S. firms are taken into account. One important feature of our international relationships in the capital area is the high volatility, at the margin, in the demand and supply of funds flowing in both directions.

The demand for capital abroad is quite large, particularly from the less-developed nations. But some of these very nations are ones where effective demand may be questionable. First, the LDC's who must import oil, generally have had a significant increase in balance of payments deficits and have borrowed heavily to meet such deficits. As a group, the non-oil LDC's have borrowed more than $65 billion in the past two years and debt burdens for some have reached a problem level. For a few such nations, credit-worthiness has been impaired and future borrowings will be costly and difficult to obtain unless adequate stabilization policies are in force.

Secondly, for a few countries, recent nationalizations have dampened capital inflows and reduced effective demand in world markets. Political shifts have made some countries less acceptable risks in the U.S. capital market, and a few have boycott, human rights, or debt arrearage problems.

Thirdly, for certain industries, capital expansion is unlikely due to heavy overhangs of unutilized capacity, weak demand, low prices and generally poor prospects for profit. Shifts in labor costs, higher taxes, restrictions on currency conversion of profits, and directed priority capital controls have reduced the effective demand for some industries.

Finally, in a number of less-developed and even developed countries, the inflation rate is steadily eroding their capacity to borrow in the world markets. A few nations attempt to balance their international accounts by sequential devaluations designed to neutralize the affect of domestic price increases on their position against foreign currencies. Others have attempted to hold their exchange rate relationships but mount increasing borrowings to make up for the higher costs of imports and development at home. For both types, the fundamental problem is the inflation rate and its impact on domestic and international financial positions and capacity to borrow.

Domestic demand for capital in the U.S. has been estimated in the trillions of dollars over the coming years to the turn of the century. One scarcely knows where to start to describe the capital needs of the U.S. public and private sectors. We know that our Federal Government has required $68 billion in new financing just to meet its deficit of the past fiscal year, but more than that, Federal Government needs for financing capital expansion of its physical plant and equipment represent an enormous drain on the capital markets. Just to finance a new bomber program, the Department of Defense needs more than a billion dollars.

The state and local government demands for capital to finance new streets, schools, industrial parks, recreation facilities, and the host of other needs, continues to draw upon the available supply of credit. Just in the first half of 1976, the state and local governments have issued $17.3 billion of new long-term debt instruments. As our population has concentrated into the larger urban areas, the pressure for increased facilities is mounting, while such facilities in the rural areas become increasingly underutilized, if not abandoned. The massive population move over the past 35 years from farm to city has clearly brought new financing pressures on the city and state governments. It is, of course, questionable whether or not such population concentration will persist over the coming 25 years. The problems of big city living are well known and may be enough to at least dampen the rural to urban move with important consequences for our capital stock.

The private sectors of our economy have equally strong capital needs. The destructive inflation and subsequent recession in this country has greatly expanded the needs for protective capital in many firms, especially financial institutions. With heavy losses from defaulted loans impacting on reserves and profits, accompanied by the sharp expansion of assets over the past five years, and pressures from regulatory authorities, the financial institutions have fallen behind in their capital coverage. Capital markets in the past few years have been noticeably unreceptive to new issues from banks and only recently have liquidity and profit positions permitted a return to the market.

While the trials and tribulations of financial institutions may be of only passing interest to you, in some ways their problems have a significant bearing upon the availability of bank credit and the tone and feel of all financial markets. Thus to an important degree, the health of the nation's financial institutions should be of considerable interest to all borrowers.

Nevertheless, the massive capital needs of other businesses may constitute your primary competition for capital financing over the coming years. It is useless for me to try to spell out for this audience the capital needs of energy companies. Your own association's estimate of a nearly $67 billion capital need over the next decade at current prices and a nearly $92 billion capital need with a six percent inflation rate dramatically shows your requirements and the effects of inflation. Suffice it for me to say that competition for capital funds over the next 25 years will be intense even if some foreign borrowers are less-effective demanders of credit.

The supply of investment capital depends upon savings of our people and this is probably one of the happier features of my comments today. With personal incomes advancing and now moving up faster than inflation, savings have increased and supplies of new capital funds are rising. Simultaneously, the cash flows of many firms have strengthened materially, so that internal generation of funds for debt service, additions to liquid assets, or even capital expansion is becoming a steadily greater portion of total sources of funds. Corporate profits have increased sharply and with cautious inventory policies many firms have been able to reduce business loan demands at banks, thus increasing their credit-line availability. Even the investment tax credits have encouraged a few firms to increase capital spending with the prospect of an earlier write-off.

In a longer time frame, the availability of capital funds will depend heavily upon government action to encourage earnings, reduce government competition for funds, improve the tax climate, and permit profit incentives to work on both investors and borrowers by maintaining a certainty of returns and safety and soundness of credit. All of these are important objectives, but all are difficult to achieve and will require dedicated efforts. Unless these objectives are met, the environment for capital formation will suffer and government competition for funds will be stronger. Moreover, unless government deficits can be reduced, the nation will face continued inflationary pressures. To me the greatest uncertainty confronting the natural gas industry or any industry in planning for future capital formation, is the rate of general price increase in the economy.

If inflation can be reduced to pre-1965 levels and, held there long enough to reestablish confidence in currency values, industry can plan its capital expansion with assurance of a reasonably steady value of the dollar.

Beyond the stability of dollar values, slower rates of inflation would have the salutary effect of reducing interest rates, especially for long maturity borrowings. It is well recognized that an inflation premium is built into interest rates and these in turn inflate the costs of doing business. Perhaps of almost equal importance, a slower rate of inflation could provide the incentive to investors to place their funds into equities where returns are likely to be commensurate with basic risks.

Thus even after the demand and supply curves are analyzed and various options considered, the fundamental variable is the rate of inflation. It is this problem I would like to address for the remainder of my remarks. The recent inflationary chaos and resulting recession may have sufficiently impressed our business and consumer population of the disruptive effects of inflation, whether demand or cost induced. But has the experience of the past decade sufficiently impressed government to force a change in spending habits? On this question, the verdict is still out, though there are some encouraging signs. At least Congress is largely following its own budget reform procedures and there are hopeful indications of recognition of the problem.

Similarly, there is an increasing awareness of the ties between wage increases and price advances on the part of workers and their leaders. Average wage settlements thus far in 1976 show some moderation of the front end cost and a continued willingness to sign three-year agreements. It should be noted, however, that more and more settlements contain cost-of-living escalation clauses without a cap. In other words, more workers have their wages indexed to changes in the cost-of-living. This alone makes it imperative that our inflation rate be curtailed before we build such a base of indexed costs that inflation feeds upon itself.

Another important feature of cost inflation is the raw material prices of primary products and energy. While we in the United States were largely self-sufficient in our early years, the Bicentennial finds us heavily dependent upon foreign sources for many of the primary raw materials and now too for a heavy share of our oil and gas energy supplies. We have already seen the damaging and disruptive results of such dependence, and the inflationary costs it can produce. I suspect that very few of us believe the U.S. can reverse the course and become self-sufficient again without some sacrifice in our standard-of-living; yet the threat of the present degree of dependency is unacceptable to many of us. Thus, it seems to me that some compromise is likely--giving up some of the frills in our usual living arrangements to pay for less dependency, particularly in energy sources. But the degree of payment again depends upon the rate of price change and here we are presently unable to entirely control our own destiny.

Among the very dangerous trends of recent years, has been the formation of producer cartels to dictate terms of availability and price. The success of the OPEC cartel has already encouraged other nations to seek similar restrictive agreements but, so far, without much success. If the trend toward cartels should take hold, the world could break into small groups of nations and world trade will be more difficult, even to the establishment of barter systems. Personally, I doubt the long-range effectiveness of such cartels, but they can be quite disruptive in the short-run.

Cost pressures in the past few years have indeed been a major source of world-wide inflation, but these have been aided and abetted by demand pressures and made effective by too easy fiscal and monetary policies. The pressures of a growing and more demanding population have pushed governments into greater borrowings to raise standards of living. To a considerable extent, these demand pressures have been responsible for loose fiscal policies and these in turn have created financial market competition, conducive to easier monetary policies. If fiscal policies can be tightened to reduce deficit financing, then monetary creation can be slowed.

As I survey the damage of the inflationary pressures over the world and even in the United States, I am even more determined that the causes of inflation should be corrected and that our policies should be dedicated to reducing the inflationary rate in coming years. Monetary policy can and should do its share in eliminating this crippling disease but if not helped by appropriate fiscal, labor, and business policies, our efforts will not likely be successful. It is easy to say that a strict monetary policy aimed at a low rate of money supply creation will eventually restrict growth so that only a part of our needs are financed. But it is clear to me that such a single-minded statistical approach to monetary policy runs undue risks of an unacceptably high rate of unemployment and an equally unacceptably low rate of growth. Thus, a balanced approach to monetary policy seems needed, giving weight both to the long-run needs for funds to finance a non-inflationary growth and to the short-run cyclical swings in the economy. For the latter, monetary policy should recognize the need to stimulate growth in periods of rising unemployment and slow consumer demand or to dampen growth when business inventory or spending plans and short labor supplies threaten price stability. To me this balanced policy approach is our only responsible course.

In summary, I believe the capital formation needs of American business can best be met in a non-inflationary environment which will develop only if government, labor, business, and consumers give it high priority in their decision-making and implementations. I see no insuperable bar to the financing of capital needs of American business nor to a continued growth in our standard-of-living through the next quarter century.

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