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Statement by

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Member

Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

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I am pleased to appear before this subcommittee today to discuss my views of the current financial condition of our nation's businesses and its relationship to monetary and fiscal policy.

Recent headlines attest to the timeliness of these hearings. Business failures have risen sharply and are now at their highest levels of the postwar period, and several very large firms have filed for bankruptcy in recent weeks. Beset by a very sluggish economy and sharply declining profits and burdened by continuing high interest rates, the financial health of the business community has worsened steadily over recent quarters. Moreover, this has followed a more gradual weakening in financial structure that has accompanied a decade and a half of accelerating inflation. Indeed, growing expectations of inflation encouraged businesses to take risks they might not otherwise have taken, to tolerate unbalanced debt structures, and to accept unwarranted cost increases in hopes that things would work out over time.

At the Federal Reserve we believe that the financial situation of businesses will improve gradually as the economy resumes its growth on a steadier and less inflationary path. There are encouraging signs that significant progress has been made in laying the foundation for such growth. Economic activity should be on a recovery trend later this year and substantial--though still partial--success has been achieved in cooling inflation and inflation expectations. Nevertheless, the current financial difficulties seem likely to persist for a while longer, and they are of very substantial concern.

The Current Environment

The proximate causes of the difficulties that many business firms are now facing are the extremely sluggish performance of the economy and profits over the past several years and the high levels of interest rates that have prevailed during most of that time. Most companies typically experience both declining real sales and a drop in profits during cyclical contractions, as revenues fall off faster than costs can be cut back. But what makes the profit squeeze we are now witnessing more severe is that it comes on the heels of three years of relatively sluggish growth in profits. In addition, the persistence of high interest rates has added to the problems of businesses. In the past, interest rates generally have fallen sharply during periods of economic slack, providing some relief to businesses in meeting their debt obligations and financing activities when sales and revenues were depressed. The downward movement in rates in the current recession has been quite limited thus far, reflecting a variety of factors, including the continued nervous state of credit markets, exceptionally heavy current and prospective federal deficit financing, and the need to keep monetary policy on a steady noninflationary course of moderation.

Continuing high interest rates have had a particularly marked effect on businesses because many firms have come to rely heavily on credit, particularly short-term sources of funds, over the years. At the same time, they have reduced their cushion of liquid assets relative to their liabilities. These trends reflect basic shifts in corporate financing patterns that had been underway for many years--trends fundamentally

related to the long period of substantial and intensifying inflation to which our economy has been subjected.

Background

The years since the mid-1960s have been marked by tremendous changes in financial markets. The major inducement to change has been the shift--albeit a gradual one--from an environment of relatively stable prices to one in which inflation seemed to become a permanent and increasingly pernicious feature of the economic landscape. The most obvious effect of the accelerating price movement was the irregular upward trend in nominal interest rates. With the pace of inflation quickening, lenders required larger premiums to compensate for the anticipated reduction in purchasing power of the funds they would be repaid. Borrowers, of course, were not happy to pay higher rates, but for many years they were willing to do so in the expectation that incomes would rise to equal or exceed the general increase in prices. In addition, higher prices meant that more and more funds were required to finance any particular scale of activities. Since these needs consistently outpaced retained earnings--a residual item in business operations--a large volume of outside funds had to be raised and cost considerations favored doing this in the credit markets.

In an inflationary environment, the attractiveness of debt relative to equity financing is enhanced, in part because tax laws treat interest payments as tax deductible whereas dividend payments are not. Thus, as nominal interest rates rise to reflect inflation expectations, the increased interest payments by corporations are partly offset by lower corporate taxes. In

addition, equity financing becomes less attractive because of the depressing impact of cost-push inflation on corporate profitability and the higher capitalization rates required by investors in translating these profits into stock market values. Since 1972 many stock prices have shown little increase and price-earnings ratios have fallen to historically low levels. Therefore, as chart 1 appended to my statement illustrates, corporations have come to rely more and more heavily on debt in financing their inflated needs.

As corporations have turned increasingly to debt markets for financing, the types and terms of credit instruments being issued in these markets have been in process of change. For the most part, these changes reflect efforts by both borrowers and lenders to limit their exposure to unexpected shifts in securities prices and interest rates. Investors, threatened by the unanticipated erosion in the capital value of their investments, have become increasingly reluctant to commit funds for long periods. Instead they have preferred short-term instruments in placing their savings, so that returns would closely reflect current interest rates and the risks of depreciation in market values would be largely avoided. Even longer-term securities, as well as term loans and residential mortgage contracts, now often provide for adjustable rates or carry shorter maturities. A major portion of new bond issues coming to market currently have maturities of 15 years or less--a sharp contrast to the 25-year or longer maturities prevalent in earlier years.

The limited supply of funds available for long-term investment has prevented some corporations from funding their short-term liabilities,

while other corporations, concerned about the high rates prevailing in bond markets, have been reluctant to lock themselves into long-term liabilities at these high rates. As seems quite rational, many have preferred instead to finance short-term in the expectation that rates will drop or because they are uncertain about future rate and price movements and wish to maintain some flexibility. To be sure, we have seen some periodic spurts of activity in long-term bond markets, but only when long-term rates have dipped and only because firms anticipated that further reductions were unlikely. Thus, reflecting both investor preference and corporate caution, as Chart 2 illustrates, the emphasis on short-term financing has substantially increased the importance of short-term to total debt in nonfinancial corporations' balance sheets.

It is hard to assess the implications of this development for corporate vulnerability generally. There is no doubt that a high proportion of short-term debt increases a firm's exposure to adverse developments in financial markets since the debt must be rolled over at more frequent intervals. In the past, this could present very serious problems even to highly rated firms during periods of credit stringency because of institutional constraints that reduced the overall availability of credit. In particular, low regulatory ceilings on rates permitted to be paid on time deposits sometimes resulted in disintermediation at banks and other depositary institutions when market interest rates rose; this effectively limited the supply of loanable funds at these institutions. Usury ceilings also acted to constrain lending in some cases.

Such constraints are of much less importance in today's financial markets, however. Banks, for example, are now able to bid competitively for funds through the issuance of large certificates of deposit that pay market rates of interest. This means that these institutional lenders can continue to meet the needs of all business borrowers able and willing to pay the going rate. Many businesses now maintain substantial backup lines of credit with banks, for which they pay a fee and which can be drawn on in times of need. The existence of these lines and the increased confidence by firms that they can borrow quickly if circumstances dictate has led to a reduction in the importance of liquid assets as a cushion against unexpected drains on cash flow. Therefore, the rather pronounced decline in the corporate liquidity ratio shown in Chart 3 does not seem to me as significant as it might appear.

As is illustrated in Chart 4, however, the combination of high interest rates, an increased proportion of debt that can quickly reflect these rates, and a heavier debt burden generally have sharply increased the toll of interest charges on available earnings. For all nonfinancial corporations, the ratio of interest charges to total earnings has risen from less than 10 percent in 1965 to a new high of more than 40 percent in the first quarter of 1982. The peaks in the chart correspond to periods of recession, and the sustained high ratio over the last two years or so importantly reflects the weak profits performance of business generally as well as the further deterioration caused by the recent cyclical decline. Nevertheless, the point is that interest--unlike dividends--must be paid, whether current earnings are sufficient to cover or not. Any sustained

failure to cover interest charges will likely lead over time into bankruptcy.

Thus, one's concern about heavy debt service charges becomes particularly acute when adverse developments affect a firm's product market and threaten its ability to generate profits and cash flow. For such companies, strained liquidity positions and high interest rates are very serious problems--because their ability to service their debt has declined and the longer run outlook for earnings growth becomes more questionable. The problems facing such businesses tend to be cumulative; struggling companies are likely to have their credit ratings lowered, making it more costly and difficult to obtain credit. The greater the extent of their borrowing in short-term markets or through issuance of variable-rate instruments the more rapidly will their costs increase and the greater will be the risk that they will be unable to roll over maturing debt at any reasonable cost.

The denial of credit is a step that institutional lenders generally try to avoid. Banks and other creditors are acutely aware of the problems facing their customers and have a strong interest in the continued operations of firms whose long-term viability appears sound. Concessions by creditors--such as deferrals of interest payments and extensions of maturity dates--have frequently been granted in recent periods in efforts to work with debtors to overcome temporary setbacks, and no doubt will continue to be made for borrowers whose difficulties appear to be transitory.

But in the current environment, as economic activity has remained weak and interest rates high, the problems of a good many firms have come to seem too great to treat as a temporary setback. The rising number of bankruptcies, as shown in chart 5, are evidence of this, though it should be noted

that the rate of bankruptcy has risen less sharply, since there has been a very considerable growth in the total population of business firms over the years. Of course many firms facing difficulties today have suffered from critical errors in planning or from domestic and international competition that have increased their vulnerability to adverse conditions. Nevertheless, in this environment there is a danger that loss of confidence in the ability of business to grow and thrive could have a seriously depressing effect on investment and threaten the economy's future performance. These are matters that should and do greatly concern the Federal Reserve Board and others in policymaking positions.

Policy Implications

Let me, therefore, turn now to the implications of these developments for economic policy. In this regard you have asked me to address specifically two questions: First, how has the increase in corporate use of short-term credit affected the growth of the monetary aggregates and what has this meant for policy? Second, looking ahead, what monetary or fiscal policy actions should be taken to reduce the likelihood of a further deterioration in corporate financial strength?

With regard to the first question, the shift in business credit demands to short-term credit markets has not been a significant problem for the implementation of monetary policy. As you know, the Federal Reserve formulates its monetary policy in terms of target ranges for the growth rates of various measures of money over one-year spans. We also specify a range for bank credit growth that seems consistent with money growth objec-

tives; this measure of course contains as a principal component the business loans outstanding at commercial banks. For 1982, we have indicated our expectation that M1 would grow toward the upper end of a 2-1/2 to 5-1/2 percent range, M2 within a 6 to 9 percent range, M3 in a 6-1/2 to 9-1/2 percent range, and aggregate bank credit between 6 and 9 percent. Business demands on banks for credit would seem likely to have very little, if any, direct effect on M1, a narrowly defined aggregate that comprises only transactions balances. The public's holdings of such balances depend primarily on the level of nominal spending, on precautionary attitudes, and on the opportunity cost of holding assets that bear no or only a modest interest return; because of this externally determined nature of the deposit balances that are a part of M1, banks cannot use them as a flexible source of funds to meet business credit needs. The broader aggregates, however, are affected by the shifting composition of debt instruments. M3 in particular might be expected to show the effects of greater short-term borrowing by business firms because it includes large certificates of deposit and other market instruments, which are sold more or less aggressively by banks to finance credit demands exceeding core deposit growth. Both M2 and M3 include the shares of the rapidly growing money market mutual funds, which invest considerable amounts in commercial paper and bank CDs, but these balances are thought to represent mainly funds that otherwise would have been placed directly in M2- or M3-type deposit forms.

While we pay careful attention to developments in bank credit and the broad M3 monetary aggregate, however, I think it is fair to say that the

Federal Reserve typically places a good deal more emphasis on the behavior of M1 and M2, both in operations and in policy determination. This is so because these variables are more susceptible to monetary control and also because they have exhibited a more dependable historical relationship with ultimate target variables--prices and output.

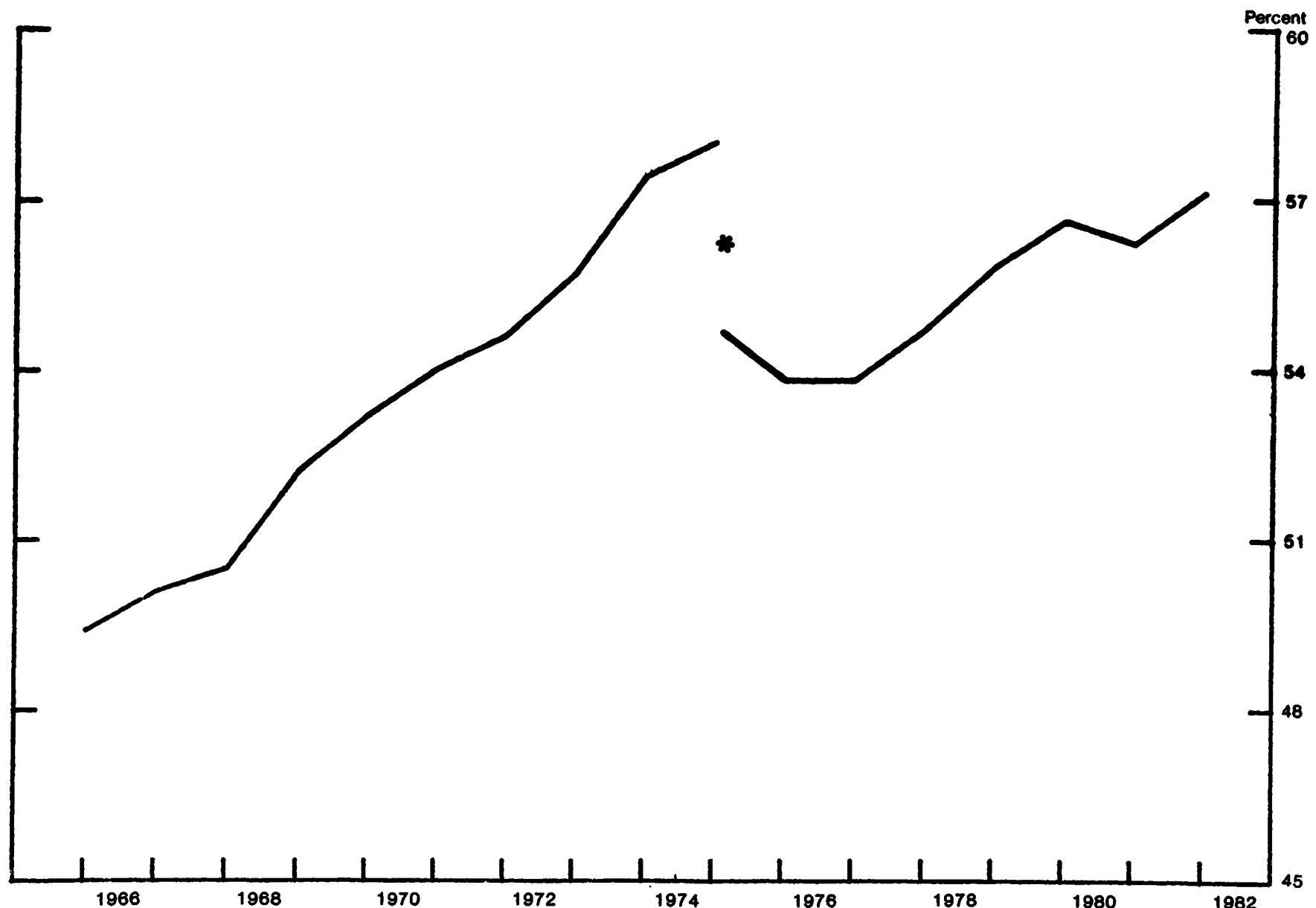
I would like to turn now to the more basic question of whether there is any change in the role that monetary policy should play to reduce the likelihood of a further deterioration in corporate liquidity. In my view, two lessons stand out plainly from the experience of the past 15 years. First, it has become abundantly clear that we must conduct our affairs so as to bring inflation under control. Only then are interest rates likely to move to permanently lower levels, and only then will we see lasting improvement in the financial health of the business community as a whole. The rise of inflation, and the uncertainties and distortions that accompanied it, were important factors that induced firms to structure their financing in ways that made them more vulnerable to economic setbacks. Absent substantial progress on reducing inflation I fear that we will see further gradual erosion of financial strength. Second, success in achieving this objective requires systematic restraint in the growth of money and credit; inflation may originate from many causes, but it can flourish over an extended period only to the extent that it is accommodated by excessive monetary expansion. Thus, the Federal Reserve has been and continues to be committed to a program of moderation in the growth of money and credit as we work to restore an environment conducive to non-inflationary growth.

Recently there have been encouraging signs that the national effort to slow inflation is bearing fruit. Price increases at both the consumer

and producer levels have been much reduced of late, and there has been heartening--though still only partial--progress in reducing the strong upward trend in wages and other costs. Inflation expectations are far from broken, however, as is reflected in the failure of nominal interest rates to follow the inflation rate down. Market perceptions that the Federal Reserve was backing away from its commitment to financial discipline could quickly undermine the progress that has been achieved to date.

My final point concerns fiscal policy. Monetary restraint, especially when operating in isolation, falls unevenly on different sectors of the economy depending on their sensitivity to credit conditions. In recent months it has become apparent to me that a major cause of taut conditions in financial markets, and especially the high level of long-term interest rates, is the current budget impasse. It is therefore crucial that an accord be reached on the budget and, if it is to bring significant improvement in financial conditions, that accord must offer specific and credible reductions in Federal deficits to take the place of the large year-by-year increases now in prospect. Once this has been accomplished, I think we will have demonstrated convincingly to the financial markets the government's resolve to continue on with the fight against inflation. Though I normally do not engage in interest rate forecasts, I would venture to say that this outcome should produce handsome dividends in the form of lower levels of interest and restoration of a financial environment much more conducive to the revitalization of American business.

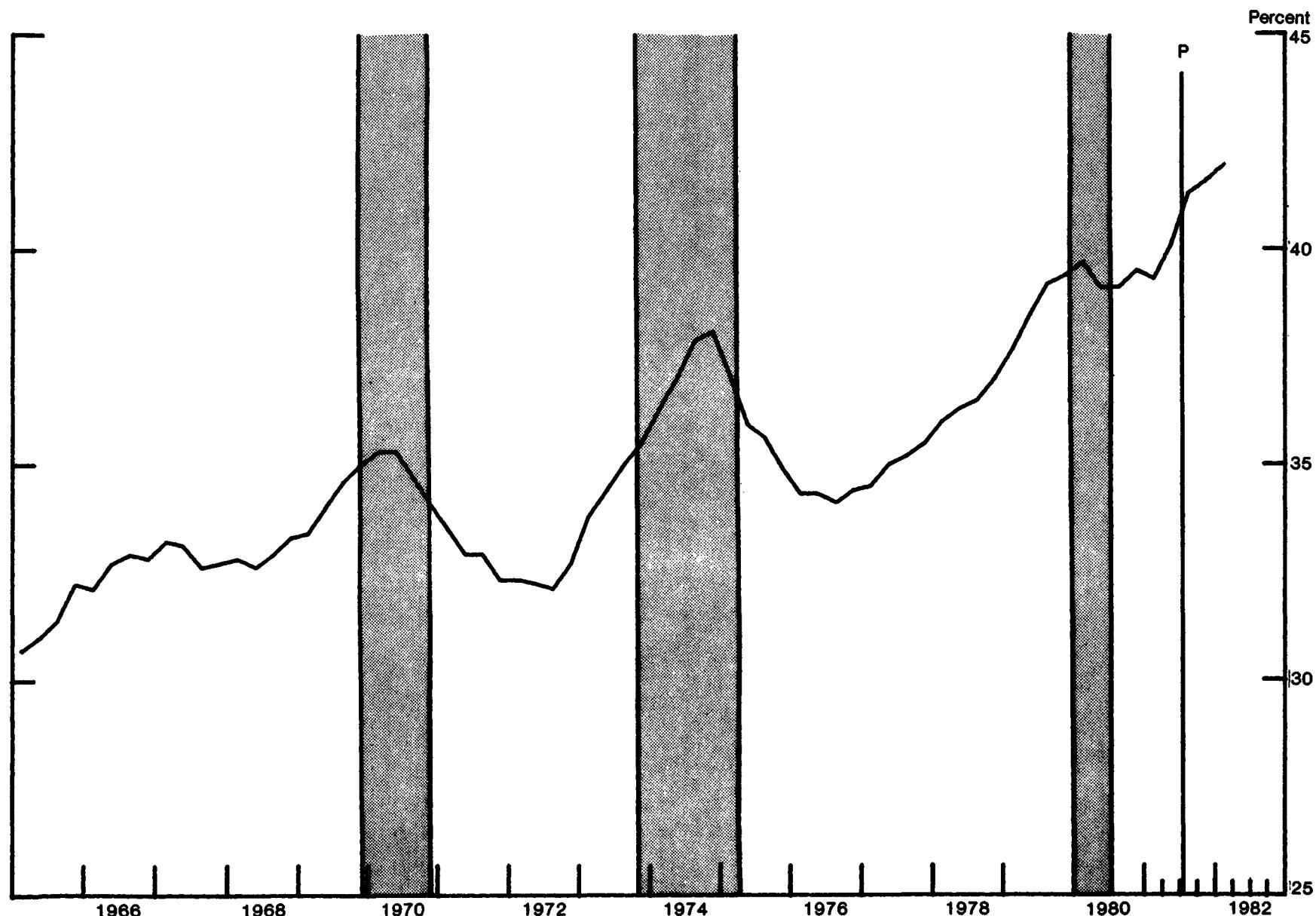
Chart 1
Ratio of Liabilities to Total Assets
Nonfinancial Corporations



* Break in series.

Flow of Funds, year-end data. Values of assets and liabilities are based on historical costs.

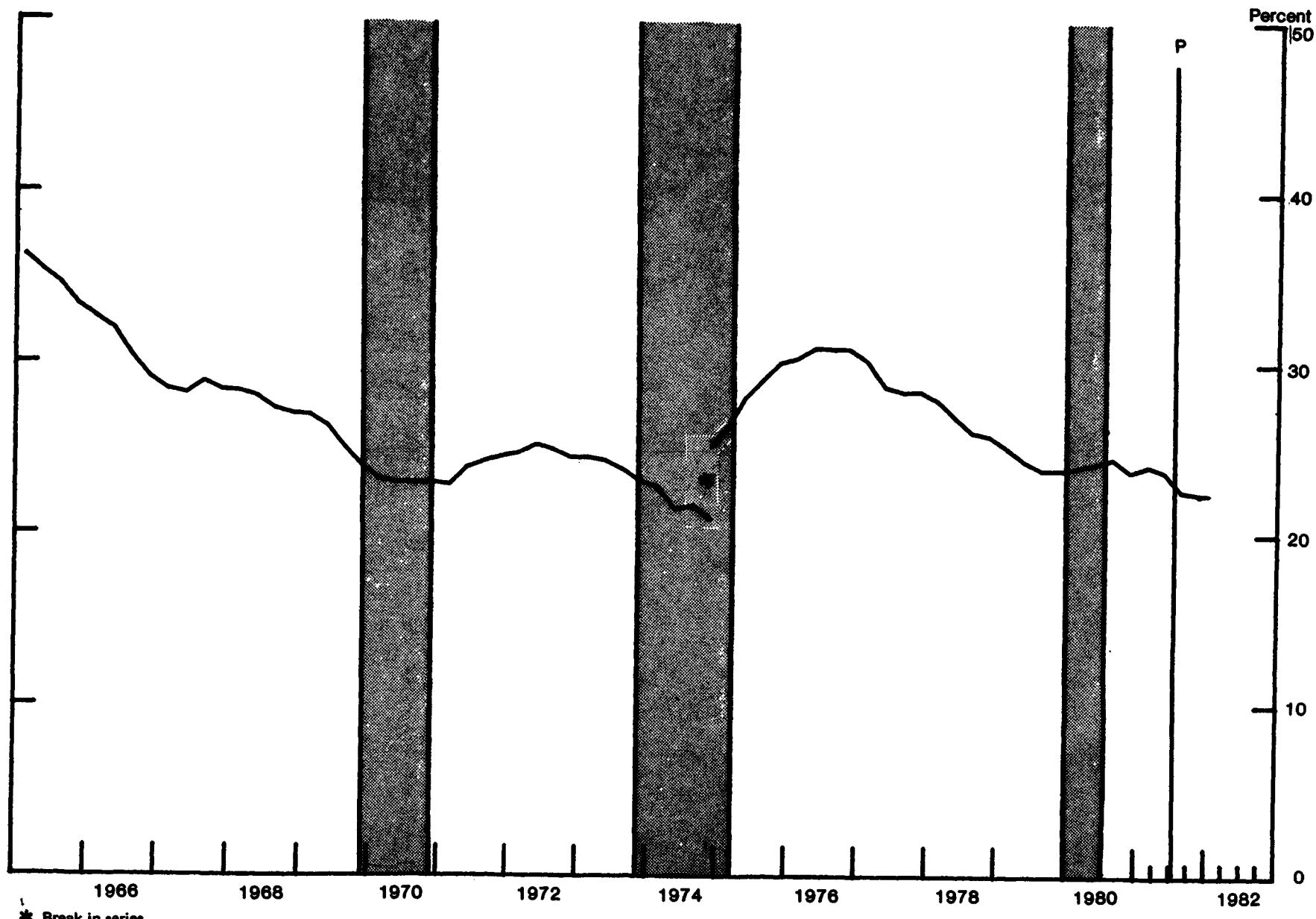
Chart 2
Short-term Debt as a Percent of Total Debt
Nonfinancial Corporations



Flow of Funds, quarterly data at seasonally adjusted annual rates.

Data for 1982-Q1 are preliminary.

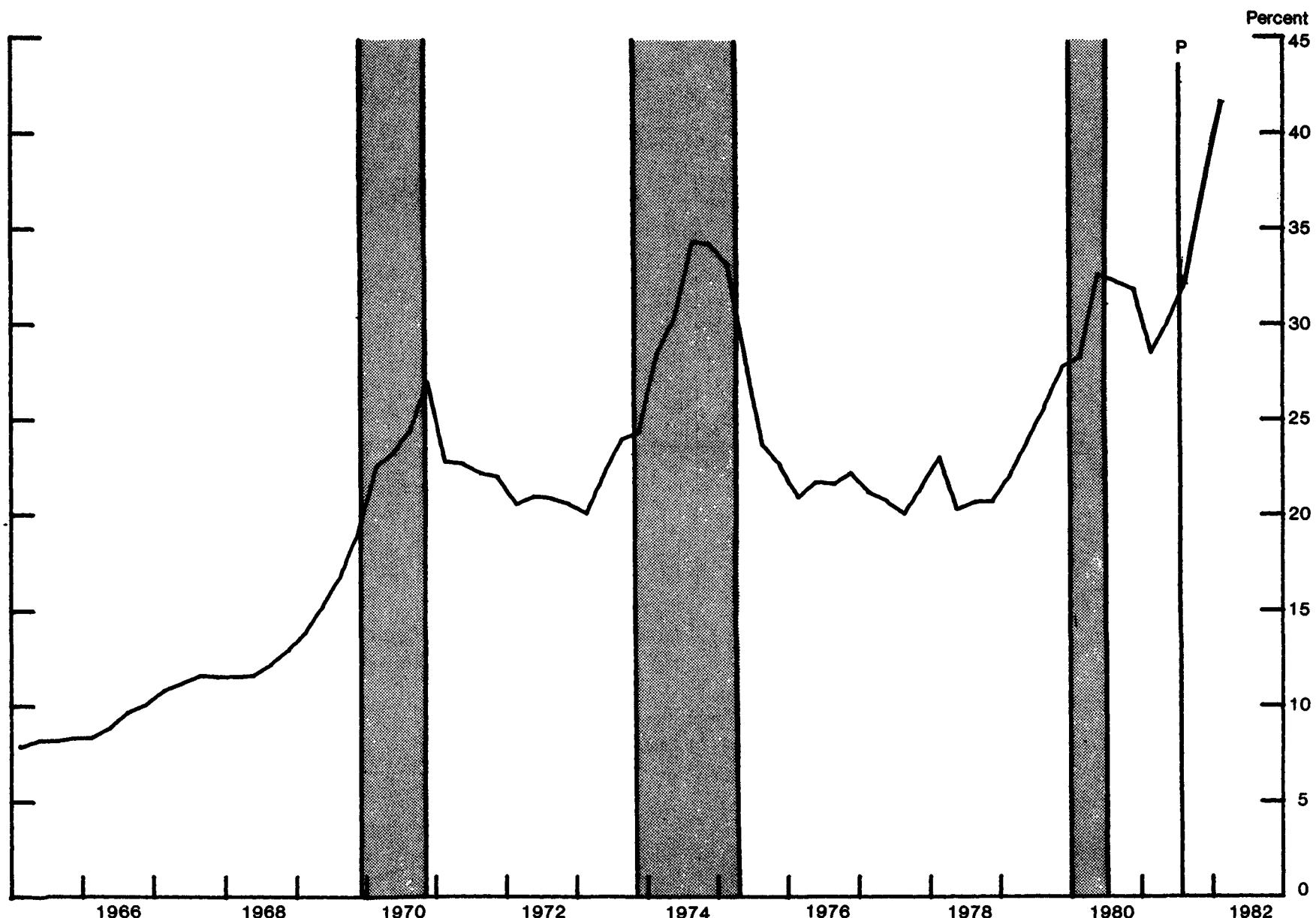
Chart 3
Liquid Assets as a Percent of Current Liabilities
Nonfinancial Corporations



Flow of Funds, quarterly data for nonfinancial corporations at seasonally adjusted annual rates. Data for 1982-Q1 are preliminary.

Note: Shaded areas denote recessions as defined by NBER.

Chart 4
Net Interest Payments as a Percent of Capital Income*
 Nonfinancial Corporations



* Capital income is economic profits before tax plus net interest payments.

Department of Commerce, National Income and Product Accounts, quarterly data at seasonally adjusted annual rates.

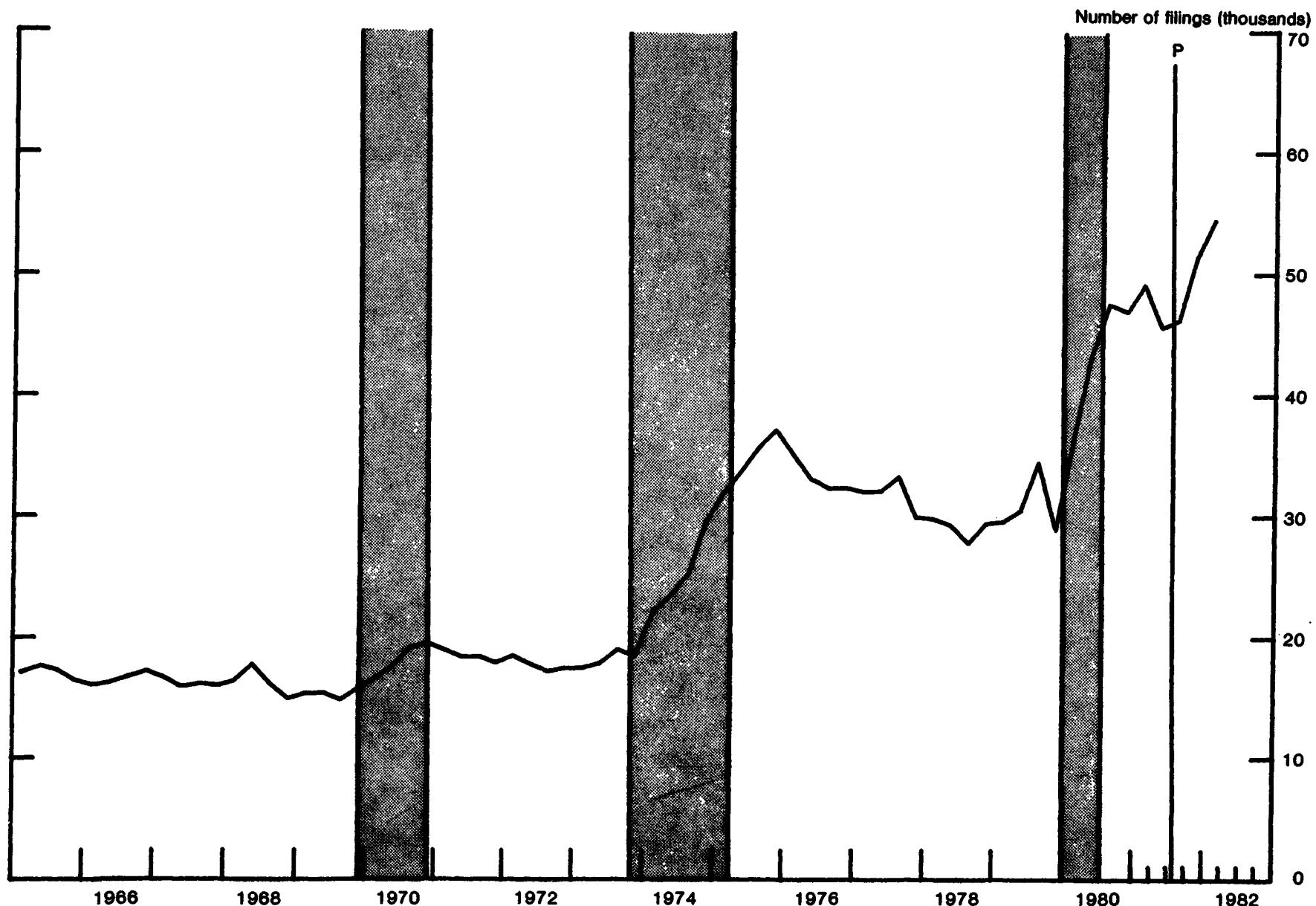
Data for 1982-Q1 are preliminary and based on estimates of net interest payments by the Federal Reserve Board staff.

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Note: Shaded areas denote recessions as defined by NBER.

Chart 5
Business Bankruptcies*



*Nonpersonal filings with U.S. Courts. Quarterly data at annual rates, seasonally adjusted by Federal Reserve.

Latest data are for 1982 - Q 1