FOR RELEASE ON DELIVERY
TUESDAY, SEPTEMBER 23, 1975
10:30 A.M. EDT

THREE JOBS FOR THE CAPITAL MARKETS

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the

International Conference

of the

New York Stock Exchange

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The capital markets today confront three big financing jobs that will need to be done. One is the financing of the large balance-of-payments deficits that have been imposed upon many countries by the rise in the price of oil. This job has been going forward for about two years. Another is the restructuring of the finances of corporations, drained of liquidity by many years of inflation, at a time when enormous demands are also being made upon their financial resources by the need to provide for record peacetime government deficits. This job has just gotten under way. The third is to help finance the growing investment needs of the economy as it again approaches full employment, in the face of a threatening capital shortage.

The views expressed herein are my own and do not necessarily reflect those of the Board of Governors or the Board's staff.

International Financing

The international capital markets have functioned well. They have accommodated successfully the demands for credit resulting from the increase in oil prices. They were able to do this at a time when the whole structure of banking markets experienced some tightening after the rapid expansion of recent years.

An important feature of international capital markets is their two centers, the U.S. capital market and the institutions in it, and the Euro-markets, where again American institutions have a leading role. The role of the U.S. capital market has changed from that of being almost the sole source of funds for large international requirements in the postwar years up until the early 1960's to its present status of sharing that role almost equally with the Euro-markets.

The expansion of the Euro-markets was in large part the product of American policies which were aimed at diminishing the outflow of capital from the United States and encouraging the development of other sources of capital for both American companies that were expanding abroad and for foreign borrowers who were relying on the United States as a major source of funds.

The international capital markets are doing a tremendous job in moving large flows of funds across national boundaries, in which most countries appear both as lenders and as borrowers. Looking first at U.S. capital flows, a massive increase in gross flows became visible in 1974 in response mainly to the oil crisis.

The outflow of U.S. private capital jumped to $31 billion from $14 billion in 1973. This included a large increase in outflows by American firms for direct investments abroad and the beginnings of what has turned out to be a major increase in the placement of foreign bond issues in U.S. capital markets. The most dramatic change was an increase in foreign lending by American banks to about $19 billion, far higher than the outflow in any previous year, but matched by corresponding inflows.

The ability of U.S. financial institutions to meet the demand for credit abroad was a major influence in calming what otherwise might have been an undesirable response on the part of countries confronted with enormous demands for funds to pay for oil. At the same time there was a very sizable increase in the flow of foreign capital to the United States. In particular, American banks were able to attract from foreign sources an amount of funds of about the same magnitude as their increase in foreign assets. A change in the opposite direction was the drop of foreign purchases of equity securities from the record levels of previous years when American equity markets were moving upward. So far this year there seems to have been some abatement of international capital flows through the U.S. markets, though they are still very substantial from an historical standpoint.

In addition to these two-way flows of essentially private funds, capital is provided mainly to developing countries by the U.S. Government's financing in the form of grants and credits. Taken together, the U.S. Government provided about $4 billion, net, of foreign financing in 1974. There is also now the very important element of the flow of OPEC funds to the United States. This amounted to something over $10 billion in 1974, though it has diminished greatly this year as the OPEC surplus has dropped off.

Flows through the Euro-markets also took an extraordinary jump last year. Publicly announced Eurocurrency bank credit facilities amounted to $29 billion in 1974 compared to $22 billion the year before. This lending has slowed down to about $10 billion in the first seven months of 1975, which nevertheless is still an extraordinary amount. Placements of bonds in the international markets were relatively moderate in 1974 amounting to about $3.2 billion. This year, however, the international bond markets have been extraordinarily active, with $7-1/2 billion raised outside the United States through August.

The purposes served by international financing are manifold, but one reason for the great recent increase in these flows, as already noted, has been the international payments imbalances caused by the high price of oil. The oil-exporting countries (OPEC) have generated for themselves a huge payments surplus. The oil-importing countries necessarily must, as a group, absorb the corresponding deficit. The incidence of these deficits, however, has been very uneven. A few countries, primarily Germany, the United States, and Japan, have been able for the time being to avoid deficits, partly because of their good export performance and partly because the recession has held down their imports. The deficits have gone, in part to some of the industrial countries such as Canada, the United Kingdom, Italy, and a number of smaller countries, and in part to the developing countries.

It is depressing to see that a good part of this capital which is moving among countries and which could serve to create more production, more jobs, and higher living standards in fact is being used only to sustain consumption. Few countries whose international indebtedness is growing are successfully matching it by additional domestic capital formation. To be able to borrow part or all of the increased cost of oil imports can be an advantage. It means the ability to postpone the real resource transfer required to pay for the oil. But this will not long remain an advantage if the funds are not used for investment. Future debt service may then come on top of the high price of oil as a depressant of living standards once the period of borrowing comes to an end.

A return of the world economy to full activity will probably change the present distribution of the OPEC-induced deficits. In particular it will very likely reduce the deficits of many developing countries. Where these deficits will then be shifted cannot be foreseen. They would come to an end only if the OPEC countries as a group cease to run surpluses. Since some of these countries, however, owing to their limited absorptive capacity, are very likely to be in surplus indefinitely if the price of oil stays up, some other OPEC countries would have to go into substantial deficit to balance the accounts for OPEC as a whole. Unless that were to happen, an aggregate OPEC surplus of some size, and a corresponding deficit for the rest of the world, would remain for a long time.

Some concerned observers believe to have noted a parallel between the present accumulation of international debt and the state of the world just before the Great Depression of the 1930's. Then as now, international borrowing was heavy. In particular the United States had been a large international lender to European countries as well as to the developing world. On top of this debt structure there rested the burden of German reparations owed principally to England and France and of interallied war debts owed mainly by those countries to the United States, representing essentially unproductive debt. When the Great Depression struck, much of this debt structure went into default, although most of the defaults not related to World War I were eventually remedied.

I believe that this supposed parallel goes astray in more directions than one. First of all, during the depression of the 1930's, present day methods of reducing the depth and shortening the duration of economic fluctuations were largely unknown. Imperfect as our techniques are, they have exhibited some effectiveness. Thus the recession of the 1930's was a great deal more severe than our present one.

Second, many countries during the 1930's tried to improve their condition by restricting trade and competitively devaluing their currencies. This severely reduced the volume of world trade. The normal transfer of debt service through the international movement of goods became very difficult. At the present time, the volume of world trade has been quite well maintained and promises to continue its remarkable expansion as the world economy recovers.

Third, some countries during the 1930's introduced controls over international payments in order to avoid an unintended depreciation of their currencies. They thus interfered with private debt service. Today, most of the major currencies are floating. This makes payments restrictions unnecessary and permits the free movement of capital and debt service.

Fourth, of the indebtedness of the 1930's, a substantial part consisted of bond issues floated by underwriters and bought by investors with what seems to have been a very inadequate understanding of the risks involved. Today the great bulk of private international lending takes the form of bank credit. The banks, rather than individual investors, take the risk; they stay with their credits, and they have every reason to be circumspect in granting them and to watch them once granted. Much of the lending to weaker risks today is being done by governments and international lending institutions like the World Bank and the International Monetary Fund. Fifth, a "safety net," in the form of the Financial Support Fund, is in the making, and central banks are aware of their lender-of-last resort responsibilities. These are all significant differences that make analogies with the past misleading.

Restructuring Corporate Balance Sheets

A second large job that financial markets must accomplish is a rebuilding of the badly warped capital structure of many American corporations. Several factors have contributed to this condition. For many years, the tax structure has injected into corporate financing a bias toward debt. More recently, the erosion of profit margins which, as we discovered belatedly, had been going on since the middle 1960's, has reduced the internal creation of savings. Inflation has intensified both effects, by raising interest rates on new debt, by further squeezing correctly computed profit margins and by imposing additional tax burdens on fictitious inflation profits. Both inventory profits, only imperfectly mitigated by LIFO accounting, and underdepreciation, resulting from original cost depreciation,have played a role in this distortion of the profit picture.

High interest rates resulting from inflation have also deteriorated the quality of credit. They have made it increasingly difficult to achieve the multiple coverage of interest payments which prudent investors must expect. Increased risk premia have ensued.

The overall trend in corporate capital structure has been a shift toward debt, relative to equity, and within the structure of total debt a shift toward the short-term end. Liquidity thus has been adversely affected by developments on the liability side of the balance sheet, while low cash flow was hurting it on the asset side. The deteriorating financial structure has made new financing increasingly difficult.

Evidence of a deteriorating capital structure is provided by the increase in the debt/equity ratio of domestic nonfinancial corporations from 0.85 in 1960 to 1.29 in 1974. That rise does not, however, tell the full story. It employs equity at book value. A more realistic evaluation, which to some extent no doubt is being applied by the market, requires us to take equity at market value. For most of the period before 1974, this procedure would have improved the debt/equity ratio, since market values on average were above book values. In 1974, however, market values of equity declined sharply below book. This happened despite the fact that book values were becoming increasingly understated in economic terms, owing to the rise in replacement cost over original cost. In other words, at recent low stock market values, the debt/equity ratio based on market values has been above that based on book values. The ability to finance no doubt has been adversely affected by this circumstance.

There remains to be mentioned a factor that is considered important by economists although for some reason it does not seem to be stressed much by businessmen or securities analysts. This is the difference between the nominal and the real rate of interest, i.e., the rate of interest minus the rate of inflation. While the real rate depends on individual expectations of future inflation and in that sense is not precisely defined, there can be little doubt that today it is low. Some degree of future inflation seems to be widely expected. Interest rates clearly appear to contain an allowance for this. Moreover, corporations can deduct the inflation premium from taxable income as part of their total interest deduction. For an enterprise for which the value of sales and the replacement cost of assets keeps pace with inflation, the real interest rate, therefore, should be quite modest. An economist would say that in the longer run this fact should have an influence upon the decisions of businessmen, whether they are conscious of the underlying theory or not. But I have heard few comments to that effect by businessmen, or by homeowners, who find themselves in a similar situation.

The implications of the distorted capital structure of corporate business is evident: short-term debt must be converted into long-term debt, and debt as a whole must be converted into equity, until more acceptable relationships are attained. At the same time, of course, a very large volume of new financing of all kinds must be done to enable business to put in place the plant and equipment that will be needed to provide production, jobs, and higher living standards. This will not be easy to do because each component of the financing mechanism today operates under some kind of restraint.

The capital markets seem to have become increasingly risk conscious, with the result that borrowers with lesser ratings have less ready access to the market than they had in the past. The banks, to which many of these borrowers may be looking, in turn find themselves constrained by thinned capital ratios, heavy reliance on borrowed funds, and in some cases a weakening of asset quality. The Federal Government meanwhile is making enormous demands upon the capital market. Monetary policy, in order to avoid a return to high rates of inflation, is constrained to moderate the growth of the monetary aggregates. All this suggests that progress in improving the capital structure of corporations will have to be gradual and will have to extend over a considerable period of time. It would be very unfortunate if the ongoing expansion of economic activity should cause the need for this restructuring to be de-emphasized.

Constructive tax legislation undoubtedly can help a great deal in this process. Various suggestions have been made which would reduce the overall tax burden, by making dividends partly or wholly tax deductible, by increasing the investment tax credit, and in other ways. I have repeatedly argued that there is an alternative way of promoting a better capital structure, even without a reduction in the overall burden of corporate taxation, desirable as that may be. This alternative would spread the burden of the existing tax evenly over the three component streams of corporate income: interest, dividends, and retained profits. The same amount of revenue could then be raised with a lower rate, and the bias in favor of debt financing would disappear. Such a restructuring of the corporate tax could be phased in gradually, in order not to burden excessively firms now relying heavily on debt. It would in no way be inconsistent with a lowering of the overall corporate tax burden, if the political climate should make that possible.

In addition, it seems to me that the time has come to face the issue of replacement cost depreciation squarely. At present we are trying to deal with the inadequacy of cost-based depreciation allowances in various unsystematic ways, such as by accelerated depreciation, the investment tax credit, and a shortening of useful lives. These techniques are becoming increasingly inadequate in the face of inflated replacement costs. Moreover, they convey the erroneous impression of special favors being granted to business when in fact they constitute at best an inadequate compensation for the underdepreciation imposed by the tax law.

If business were to try to overcome this underdepreciation by increasing its profit margins, criticism would very likely be encountered. The standard arguments against replacement cost depreciation, centering on the difficulty of defining replacement cost, are increasingly invalidated by the massive increase in these costs which make arguments about a few percentage points irrelevant. A concern on the side of business that replacement cost depreciation might reduce stated profits and hurt stock market quotations, is, I believe, largely misplaced. The resulting tax saving, the improved cash flow, and the better quality of earnings would be observed by the market and should benefit corporations.

A Capital Shortage?

My remarks so far have dealt with potential obstacles to corporate financing. Such obstacles, resulting from the warped structure of corporate capitalization, from reduced liquidity, and from constraints on the financial markets, do not of themselves signify a capital shortage. Capital, in the sense of a flow of savings generated by the economy, may be available, especially once the economy returns to full employment. Important groups of borrowers, however, may be unable to tap the flow to the extent they would like. The much-discussed thesis of an impending capital shortage questions the adequacy of the full employment flow of savings to meet the investment requirements of the economy, even if obstacles to financing can be removed.

The upshot of the capital shortage discussion that to me appears to emerge is that over the next five years our investment needs are likely to increase only moderately in proportion to GNP. Increases made necessary by energy requirements and environmental needs will be offset, at least in part, by reductions in housing requirements stemming from demographic changes and by declining inventory needs resulting from better management. A shortage nevertheless threatens in the private sector. It arises from an inadequacy in the supply of savings. This supply has been gravely weakened at the corporate level for reasons I have already discussed. Crucial to the adequacy of overall savings will be the Federal budget. If the Federal Government runs deficits as the economy approaches full employment, as it has done so often in the past, it will be absorbing some of the scarce available savings. It will then be aggravating the capital shortage in the private sector. If the government manages to run a sizable surplus at full employment, the expected shortage in the private sector can be compensated.

Today, at the beginning of a recovery, the Federal budget obviously cannot and should not produce a surplus. That surplus will be needed only as the economy approaches full employment. But it is not too early to begin planning for a surplus. The structure of the Federal budget cannot be changed quickly. Taxes and expenditures can be adjusted substantially only over considerable periods of time. Present calculations of the familiar full employment budget show that, given the present tax and expenditure structure, we would in fact have a deficit at full employment. At a time of serious recession, justification can be found for a fiscal policy that shifts flexibly from full employment surplus to full employment deficit. But the shift back to full employment surplus clearly must be made, through a rise in tax rates or, preferably, a slowing of expenditure trends, as the recovery progresses. These shifts will have to be built into the planning for the Federal budget of the next few years.

Are there other sources of savings that could be tapped, apart from a Federal budget surplus? Personal savings in our economy have historically been quite stable. I would not preclude that incentives offered to personal savers might produce some results, but I would not be optimistic about the magnitude of the response. Any tax incentive to saving, moreover, that would reduce Treasury revenue tends to have a self-defeating character. At the corporate level, considerable flexibility in saving potential has historically prevailed. Retained profits and depreciation allowances both are capable of rising substantially, given favorable circumstances. Again it must be noted, however, that corporate savings resulting from a reduction in the tax burden increase the financial needs of the Treasury and thus may have no net effect on the overall supply of saving.

There remains the possibility of attracting capital from abroad. This brings me back to the subject of international capital flows which I discussed at the beginning of this paper. Historically, the United States has been a capital exporter. This seems an appropriate stance for the world's richest economy. It is nevertheless true that, among industrial countries, the United States ranks at the lower end of the scale as regards the ratio of savings to GNP. The fact that almost all industrial countries save a higher proportion than we do has become pretty well known and accepted.

What would be the circumstances and the mechanisms through which the United States could become a net capital importer? Certainly it would not require a cessation of capital exports. As I said earlier, the gross flows of capital into and out of the United States are very large relative to the net balance. It is the net balance that determines whether a country is a net exporter or importer of capital. Among the methods by which foreign private investment in the United States could be stimulated are attractive rates of return, favorable treatment with respect to withholding business and estate taxes, assurance against invasions of privacy and confidentiality, constructive treatment by regulatory authorities, and aggressive selling of American securities, outstanding and newly issued, to foreigners. If interest rates abroad should be lower than in the United States, borrowing by foreigners as well as by U.S. borrowers would tend to be turned toward foreign capital markets. In this way, a capital shortage in the United States could be mitigated by international capital flows, provided the rest of the world does not simultaneously experience a similar shortage.

We should be aware, however, of the implications of net capital imports upon our trade balance. Capital can ultimately be transferred from one country to another only by a flow of goods. If the United States were to become a net capital importer, it would necessarily have to develop a trade deficit, even after the present period of OPEC-induced trade deficits had come to an end. The exchange rate of the dollar, under these conditions, would probably be high, as foreign currencies were sold to acquire dollars for investment in the United States. Foreign competition in our domestic and export markets would mount, and protectionist pressures might revive. Developments such as these would have to be considered as the potential costs of becoming a capital importer, and they should not be viewed lightly. On the whole, it seems preferable by far to resolve our capital needs by means of a Federal budget surplus. Failing that, however, market forces would probably work in the direction of net capital imports by the United States. I believe that we have a strong interest in not being pushed to that solution.

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