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STRUCTURAL CHANGES IN THE BOND MARKET

Remarks by

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

at the

Second Institutional Investor Bond Conference

Waldorf Astoria

New York City

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In recent weeks I have had numerous occasions to listen to bond market people, and their views have given me considerable food for thought. (That, some said, was the only food the market supplied these days.) One school of thought, representing principally buyers, points to the fact that bonds have stood up better than equities and that for the time being debt issues have in fact largely replaced equities. A second school, representing predominatly sellers, points to the advantages that banks have in raising and supplying funds in contrast to the bond market. In effect, it says that bank credit is tending to displace open market borrowing and that commercial bankers are out competing underwriters. Both views, I believe, contain some contemporary truth. In both cases, the underlying cause is inflation. Let me begin by examining what has been going on in the bond market.

The data show that since 1970 the share of total funds raised by nonfinancial borrowers by means of bond issues declined from 21 per cent to 8 per cent (year ending June 1974). Over this time, the share raised by means of stock issues declined from 6 per cent to less than 4 per cent. Meanwhile the share of bank credit rose from less than 7 per cent to 20 per cent. These shifts, substantial as they are, do not go beyond the range of fluctuations experienced in past years. The accompanying circumstances are different, however, and they may indeed alter the case and its significance.

Within the total of recent bond issues, there has been a variety of departures from customary practices, such as

(a) a shortening of the maturity of issues, presumably in order to take advantage of yield relationships and to increase participation by individual investors;

(b) a lengthening of the period of call protection;

(c) a move of some public utilities from competitively bid offerings to negotiated issues.

These shifts have taken place within the context of a downward sloping yield structure. On historical grounds, this too, is no absolute abnormality. In fact, it was more nearly the rule in the bond markets of the 1920's and earlier. The premium that the market places on short-term assets naturally does not make longer term issues easy to sell. At the same time I draw at least this much encouragement from a downward sloping yield structure: it implies that investors have expected inflation to come down over the long run. Present inflation rates have not been fully absorbed into expectations.

One must not forget that bond investors are compelled to look to the very distant future if they want to evaluate rationally the discounted present value of all the payments, including principal, that they will receive on their bonds. In fact, more than one-half of the discounted present value of all future receipts on a 10 per cent, 30-year bond reflects payments due more than 14 years from now. One may wonder how effectively these far distant receipts are translated into present value and whether an excessive weight may not be given to the near-term future and to the possibility that inflation may not come down as rapidly as we would like during that small stretch of the road that we believe we can see.

I might parenthetically extend that comment to the stock market. For a stock with a price/earnings ratio of 10, whose quotation reflects the discounted present value of all future earnings, more than one-half of this value represents earnings expected to accrue after 7 years. Anyone who notes the wide swings that have occurred in the price of many stocks, must wonder whether investors really have so fundamentally changed their mind about events in the American economy after 1981, or whether they are perhaps giving excessive weight to what they think they see ahead for the next year.

A second striking feature of the interest rate scene that has developed of late is, of course, the tiering process. One can only specualte whether it is indeed true that risks have increased so substantially, or whether it is the price of risk, i.e., the risk aversion exhibited by the average investor, that has risen. The fact remains that high risk premia today greatly increase the cost of capital and ultimately the price of everything produced with the aid of capital. Furthermore, it has become evident that there is no truly riskless asset left in our economy, if we take into account the increasingly severe price level risk that affects even highly liquid short-term assets. This is of importance not only to the devotees of the beta factor, the underlying theory of which demands the existence of riskless asset. Far more important is the impact of this circumstance upon the many people in our economy who need the financial and emotional security that a riskless asset can provide. I need hardly add that this is another of the fruits of inflation.

Innovations

The bond market has responded to the travails of inflation with a variety of interesting technical innovations. It would be far preferable, of course, if an ending of inflation made many of these expedients unnecessary. Meanwhile, however, the market has demonstrated an ability to defend itself.

The floating interest rate has been one such development. It seems to have been generated in the Euro bond market some four years ago, and has featured in a considerable number of issues of Euro bonds. It has not protected that market against the ravages of two-digit inflation, unless one were to assume that the virtual cessation of its new issue activity was the result exclusively of the ending of our interest equalization tax. Meanwhile the floating rate principle has leaped across the Atlantic and found embodiment, with the addition of a put feature, in such issues as the Citicorp note. The floating rate poses some very interesting problems for borrowers and lenders and also for the monetary authority.

For the borrower the floating rate implies an increase in one form of risk and a reduction in another. A borrower who must raise long-term money in order to finance an investment project with a given rate of return incurs the risk that the rate on his obligation may rise above that rate of return. This is a very serious risk, for instance, for utilities, and for many manufacturing firms. It makes calculation of the cost of capital impossible. The borrower, to be sure, is better off than he would be if he had to finance his project with short-term money in the hope of rolling over. He has long-term money (unless he has given a put), but at a short-term rate, depending on what kind of rate the interest on his obligation is pegged to -- the London interbank rate, the Treasury bill rate, the commercial paper rate, or whatever. A utility, and many types of manufacturing or mining companies, might find this kind of financing very hard to accept. A government, which has control over taxes and money, or a financial institution, which can adjust the interest rate it charges to those it has to pay, might find the risk very acceptable. A financial institution making long-term commitments, such as a thrift institution writing mortgages, could, of course, use a floating rate for its liabilities only if there were flexibility also in the mortgage rate.

Another aspect of the borrower's risk, however, is reduced by a floating rate. That is the risk that his timing in issuing a long-term obligation might be bad and that he might find himself caught with a rate higher than that paid by his competitors until the obligation matures, or at least to the call date.

With a floating rate, the borrower always pays what others pay who borrow in similar form. Of course, a difference might still develop between him and a competitor who borrowed on a regular long-term bond. But if the short-long rate relationship returned to its predominant upward-sloping form, the spread would still work out in favor of the floating rate borrower.

It is the reduction of the timing risk that creates a problem for the monetary authority. Monetary restraint in part at least works through the hesitancy that a borrower must feel if he has to commit himself to a high rate for a long time if he finances during a period of restraint. If that concern is lifted from the borrower, he may be willing to finance even at very high rates, knowing that he will not be penalized for that decision when rates come down. Floating rates may weaken the effectiveness of monetary policy, or at least require policymakers to increase the degree of restraint in order to achieve the same effect.

To conclude this subject, I would point out that a floating rate obligation is the nearest thing we have today to an indexed bond.

Bond insurance is another innovation, discussion of which has gained relevance in the present state of the bond market. It is not a completely new feature, because the market has produced its own institutions to perform that function at least for municipal bonds. Evidently the innovators had diagnosed a market need, where particular borrowers were so little known, or restricted by other circumstances in their access to the open capital market, as to be able to benefit from insurance.

Today, bond insurance is beind discussed, not in relation to small or relatively weak borrowers, but in the context of the sudden dramatic borrowing difficulties of some very well known enterprises which have long had unquestioned access to the bond market -- principally enterprises in the utilities industry. It has been proposed to provide government-sponsored bond insurance, financed by premium payments of the insured but ultimately backstopped by government money, in order to restore adequate borrowing power to these enterprises at a cost that would avoid the risk premium imposed by the market.

The proposal has characteristics that make it worth study even though one may well find that its negative features outweigh the positive. Insurance in the form of a pooling of risks generally is more efficient than self-insurance which takes the form of a risk premium charged to each particular borrower. But that is the case only when the risk to be insured involved a substantial random factor. When there is a common risk affecting the entire group of insurance buyers, pooling that risk does not help. The premium rate required to cover the risk for all will be no smaller than the premium rate required to cover an average single insurance buyer. This might well be the case of the utilities industry.

This reasoning leads to the conclusion that the proposed kind of bond insurance would have to charge a very high premium if that premium is to cover the risk adequately, or else would have to rely importantly on an ultimate backing by government. The latter possibility in turn lends strength to the concern that a government guarantee might be only a first step on the road to greater government involvement in private industry than one would like to see.

The second question that must be raised about any bond insurance scheme concerns its effect on the allocation of capital. If a scheme could be developed to make bonds free from credit risk and therefore virtually as good as government bonds, what would be the results? Yield differentials among bonds would largely disappear, and so would the effect of these differentials in steering capital into the most productive uses. Perhaps a complicated scheme of gearing the insurance premia to be paid by borrowers to each borrower's individual risk might be designed to help offset this effect. In any event, the volume of bond issues might greatly increase, thereby possibly displacing other borrowers from the market. I see no need to pursue hypothetical speculations about this intriguing subject any further, but I hope that I have said enought to indicate that bond insurance raises many fundamental questions that should give pause to its advocates.

Bonds and Banks

The innovative thinking in the bond market that I have examined may help the bond market in defending its share of total financing against the competition of bank credit. The banks certainly have been highly innovative competitors of late. Underwriters to whom I have listened seem to think that big banks have a built-in advantage in providing credit because it is easier to use one's own money than to find money from other people. In the present situation they may have a point although it needs to be remembered that banks, too, use other people's money. In an age of liability management they have to go out to find it rather than wait for it to come.

Underwriters also seem to think that the banks have a special advantage by virtue of the Federal Reserve role as a lender of last resort. It needs to be remembered that the Federal Reserve's role is concerned with safeguarding the market and the depositor, not the management and the shareholder.

The issue of bond versus bank financing is essentially the issue of intermediated (indirect) versus direct financing. The advantages of intermediation are well known -- risk pooling, expertise in financing, economies of scale, and the possibility of maturity transformation, i.e., the conversion of short-term money into longer term money. These advantages, however, have never been sufficiently decisive to tilt the balance very far in favor of term lending by banks as against bonds. The individual bond buyer for a while had largely vanished from the markets, but he has returned. Even in the short-term market direct financing in the form of commercial paper in recent years has competed with successfully against intermediated credit.

I find it hard to believe that a balance that has been maintained for such a long time, between bank financing and bond financing, even though with very substantial fluctuations, should become permanently disturbed. There are financial systems in which the great preponderance of financing has been through the banking system and where the bond market has played only a modest role, such as that of Japan. It is my understanding, however, that the Japanese authorities, who are very deliberate about the structure of their financial markets and institutions, do not regard that situation as optimal. A good bond market is a major asset for an economy.

I think we can look with a fair amount of pride at the workings of our markets in a time of rate structure, competition for funds and uncertainties such as it has never seen before during the lifetime of anyone presently in the market. The bond market, in my judgment has responded to this time of unprecedented difficulties with courage, vitality and intelligence.

There is a heavy bond calendar ahead. That is to say, our money market has not clammed shut in the face of current high interest rates as has the Eurodollar market. The fact that a strong crop of issues is coming to market indicates that money managers share my view that the market has the vitality to continue to function despite the heights to which it must currently climb on the rate structure to obtain funds.

This is not merely an expression of sentiment on my part. These indications of doggedness and vitality in the money market are heartening, for they suggest that the forecasts one hears of imminent collapse of the financial system are highly premature. The fact that the market has continued to function, and even to do so with a certain degree of grace under pressure, has been a major factor in shaping my conviction that our financial system--far from approaching a state of collapse--has reserves of strength and resourcefulness left, and that no collapse is either imminent or likely. In my view, the fact that the market is continuing to schedule a large amount of offerings is further evidence that the financial doomsayers among us are wrong.

I think, further, that the market has moved intelligently along the precipices it has had to traverse in recent times. As I have indicated, it has responded with innovations, new or borrowed, but innovations that have tended to meet the prevailing uncertainties and unprecedented conditions in mature and thoughtful ways.

A case in point, and a case very much to the point at the moment, is the market's response to the recent decline of short-term rates. There have been many who interpreted this as evidence that the Federal Reserve had let go, and reversed direction, moving away from the policy of careful restraint of the past year and more. The bond market, I think, has reacted much more rationally. If it had joined in interpreting the slight relaxation of recent weeks as an abandonment by the Federal Reserve of its fight against inflation, and if there had been an expectation of sharply increasing supplies of credit in relation to demand, the reaction in the money market could have been very pronounced. No such reaction has taken place. No such reaction should have taken place. In this, as in many other instances during the season of stress the market has had to endure, I think it has shown a high degree of commendable caution and realism.