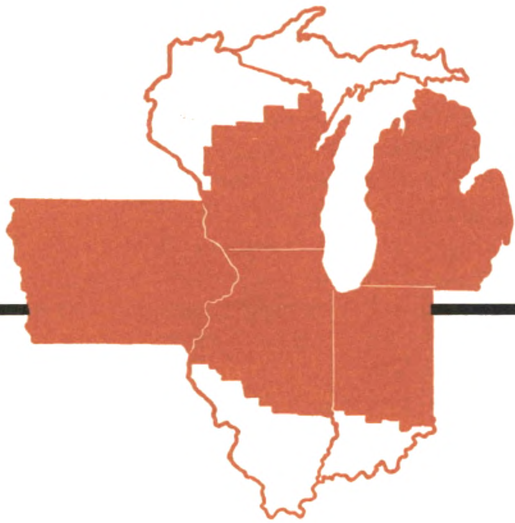
A review by the **Federal Reserve Bank of Chicago**

Business Conditions



1969 November

Contents

THE Trend OF BUSINESS

Another 1966 for homebuilding?

Is 1969 a replay of 1966 in residential construction? Through most of the first three quarters it certainly seemed to be. But a rise in housing starts in September, coupled with an upward revision of the August figures, ended, at least temporarily, the succession of month-to-month declines that began in February. Yet, to judge from the continued slide in building permits and extreme tightness in the mortgage market, prospects are dim for any real resurgence in the final months of the year or early 1970.

Even with the downtrend in 1969 starts, it appears that the total for the year will be close to 1.5 million, or about the same as in 1968. This would substantially exceed the 1.2 and 1.3 million totals for 1966 and 1967. One reason, of course, was the high level of activity early in the year when the decline started. Seasonally adjusted annual starts for January were 1.9 million and it was not until June that they slipped below the 1.5 million rate. For the first nine months of 1969, starts were 1.7 percent greater than in the same period a year earlier.

Apartments strong in early 1969

The uptrend in building of apartments that began in late 1966 continued well into 1969. Indeed, starts of multi-family dwellings in the first nine months were 16 percent greater than in the corresponding months of 1968. Construction of single-family dwellings, on the other hand, was down 7 percent.

Credit market conditions undoubtedly were primarily responsible for the divergence in performance by these two sectors of private homebuilding. For one thing, multiple dwellings typically are financed by developers not subject to interest-rate ceilings imposed by usury laws or other regulations, while single-family homes usually are financed by mortgage credit extended within such limitations. Consequently, when market interest rates are high and rising, mortgage credit tends to flow more freely to apartments and other commercial properties than to the market for single-family homes.

Another factor is that single-family homes are financed in large part by savings and loan associations and mutual savings banks, and these financial intermediaries are quite vulnerable to the impact of tight credit upon their inflows of funds. During much of 1969, as in 1966 and late in 1967, the inflow of savings at thrift institutions declined as funds were redirected to higher yielding securities available from other sources.

Apartments, on the other hand, are financed principally by life insurance companies, pension funds, and other large institutional investors in a position to make the large loans often required for such structures. These lenders have been relatively less affected by competition from market interest rates than have the savings intermediaries and, therefore, have been able to sustain apartment lending at a comparatively high level. Adding to the inclination of the life insurance companies and other major institutional investors to continue supporting apartment construction (and nonresidential construction as well) has been the emergence of the equity kicker, an arrangement whereby the interest yield on a mortgage loan is supplemented by a share of project earnings. The equity kicker may be compared to a variable-rate mortgage, to the extent that it has the ability to keep the yield fairly well in line with market conditions during a period of rising prices and interest rates.

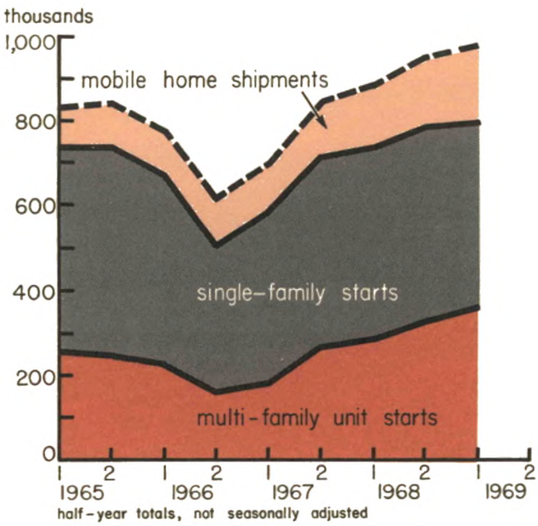
Mobile homes' growing share

Even though on-site construction of single-family homes has declined substantially during 1969, the total production of single-family homes has held up, when mobile homes are taken into account.

Factory shipments of movable prefabricated units designed for more or less permanent sites, as differentiated from travel trailers, have grown substantially. From 318,000 in 1968, shipments are projected at near 400,000 for 1969.

Though many of these units become summer homes, temporary dwellings for seasonal workers and the like, an appreciable share of the yearly output provides essentially permanent single-family housing. Indeed, mobile units today are supplying about four-fifths of all new low cost ($15,000 and less) single-family homes. Undoubtedly, the pronounced growth reflects primarily the sharp climb in conventional on-site construction costs.

Uptrend in mobile units sustains single-family share in total housing production



Cushioning from two sources

The impact on housing of credit market tightness in 1969 might have been considerably greater except for two factors not present earlier. One of these has been the active role of the reconstituted Federal National Mortgage Association (FNMA). The FNMA each week auctions commitments to accept future delivery of Federal Housing Administration and Veterans Administration mortgages originated by lending institutions. Mortgage companies are the major participants in these auctions. Since the inauguration of the present procedure in 1968, the FNMA has considerably enlarged its operations, giving lenders assurance of an ultimate market for a growing share of the loans advanced to real estate developers. While the FNMA has been obliged to step up its own borrowings in order to finance its purchases of mortgages, the existence of this expanded backstop for the market probably has enhanced the ability and willingness of lending institutions to commit funds to builders.

In addition, there has been the relatively aggressive posture of the Federal Home Loan Bank System (FHLB). Twice in the past year, the FHLB has reduced liquidity requirements applicable to member savings and loan associations while encouraging the associations to utilize Bank advances to support expansion of their mortgage loan portfolios. Home Loan Bank advances to member associations reached the unprecedented level of $8 billion in early October. These advances—a partial substitute in the short run for savings inflow to the associations—oblige the Home Loan Banks themselves to raise funds in the capital market. This additional source of funds probably has supported mortgage lending by the savings and loan associations during a time of uncertainty over their prospective inflows of savings.

Is whiplash inevitable?

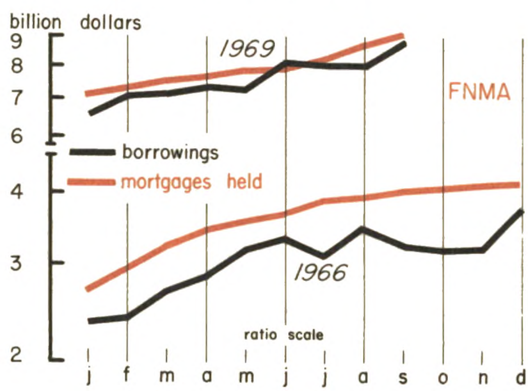
During any time of tightness in credit markets some prospective borrowers are bound to be disappointed. Some are unwilling or unable to pay higher interest rates. They apparently consider the cost to be excessive in relation to the urgency of their needs. Some others, however, are excluded by the practice of nonprice rationing that supplements the role of interest rates in credit markets. These would-be borrowers may be confronted by increased equity requirements, shortened loan maturities, or stiffer collateral and credit standards that make them ineligible for the full amount of credit they seek—even though they are willing to pay the going rate.

Still other factors are at work in times of tight credit. These include such institutional constraints as interest rate ceilings, established by usury laws and administrative regulations, which interfere with market processes and alter the pattern of credit allocation.

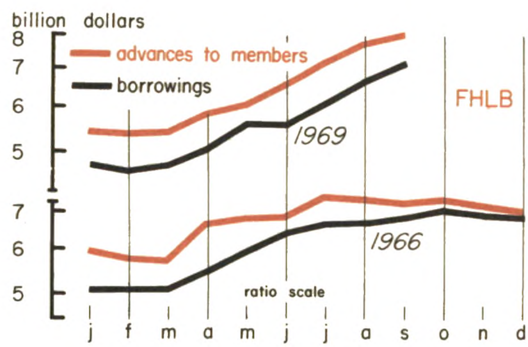
The effects of tight credit probably are seen more clearly in housing than any other one sector of the economy. Interest costs loom relatively large to many homeowners

Federal agency support for housing on a larger scale in 1969 than in 1966

FNMA mortgage holdings, and its own market borrowings, more than double



Seasonal rise in FHLB advances to savings and loans extends through third quarter to new high



and a rise in interest rates often discourages their use of mortgage credit. Moreover, for many purchasers of homes, the amount of credit required is large relative to household income and assets, so that any tightening of credit standards, such as the maximum debt-equity ratio or income-to-debt relationship—or rise in house prices—excludes a substantial proportion of prospective borrowers from the market. Such effects are illustrative of the way the credit market functions, serving to channel the available short supply to those having the most urgent needs or the least sensitivity to the rising cost and who are best able to satisfy lenders of their capacity to meet repayment schedules.

The impact of tight credit on housing finance is accentuated by certain characteristics of the principal suppliers of mortgage credit. The savings and loan associations and mutual savings banks are alike in that they hold largely long-term assets (predominantly mortgage loans) that are supported by short-term liabilities (that is, deposits or share accounts that, in practice, are paid on demand). A strong rise in yields on alternative short-term assets such as Treasury bills tends to draw away funds that normally would flow to the savings and loan associations and mutual savings banks.

Notwithstanding that in times of tight credit new mortgage loans made by the thrift institutions will bear rates reflecting prevailing conditions in the mortgage market—the great bulk of the mortgage loans on the books of these institutions were made earlier at the lower interest rates prevailing under easier credit conditions. As a result, average earnings on mortgage holdings tend to lag the market in a time of rising interest rates, and it becomes increasingly difficult to pay the rates that must be offered if savings funds are to be attracted.

In the present circumstances, there probably is little that can be done to correct this situation. But a shift to mortgage instruments providing for interim rate adjustments, both upward and downward depending upon the course of mortgage market conditions, appears to have promise as a longer term solution. During the immediate future, prospects for the savings institutions will likely depend upon the emergence of easier credit market conditions and lower market interest rates—something that hinges on the curbing of inflationary pressures.

Changing styles in business finance

A Rip Van Winkle skilled in the methods and techniques of business finance—20, 10, or even 5 years ago—would find his knowledge seriously outdated were he to return to the scene today. Changes in practices have been increasingly rapid in recent years. Prospective vigorous competition for funds by governments, consumers, and businesses in the 1970s suggests that experiments and change in financial management will continue.

In the late 1940s, many business corporations held large amounts of cash and low-yield government securities. Debts were low relative to assets and earnings. Corporate executives commonly boasted that their firms were debt free, with neither outstanding bank loans nor bonds.

Almost every year since World War II, aggregate corporate holdings of liquid assets have declined relative to liabilities. Close control of cash positions of U. S. business firms increasingly has become a job for specialists. Along with the decline in liquidity more and more corporation executives have set aside their anti-debt scruples. In recent years, an increasing number of these executives have begun to point with pride to high indebtedness that leverages upward the earnings per dollar of equity—assuming, of course, there are earnings.

Financial managements in recent years have made extensive use of commercial paper, leasing agreements, convertible debt and preferred stock, subordinated debentures, mortgages or other loans with equity kickers (participations in earnings), term loans, revolving credits, Eurodollars, and Eurobonds. The pace of change has accelerated under conditions of monetary restraint and the business boom. The explanation is found in the long-continued high level prosperity and the strengthening of inflation. These have reduced the apparent risks and increased the rewards—current and prospective—of innovation in financial techniques. Significant also has been the slow but steady succession of financial executives in both industrial firms and financial institutions. Those schooled in the adversity of the Great Depression are being replaced by younger men who have known only economic growth and upward pressures on both prices and wages.

Needed—$50 billion

Business corporations (other than banks, finance companies, savings and loan associations, insurance companies, and the like) raised $113 billion in 1968 to finance capital expenditures, working capital, and for other purposes. This was a record amount—up 19 percent from 1967 and double the average annual requirements of the early 1960s. In 1969, an even larger amount, perhaps $120 billion, will be raised.

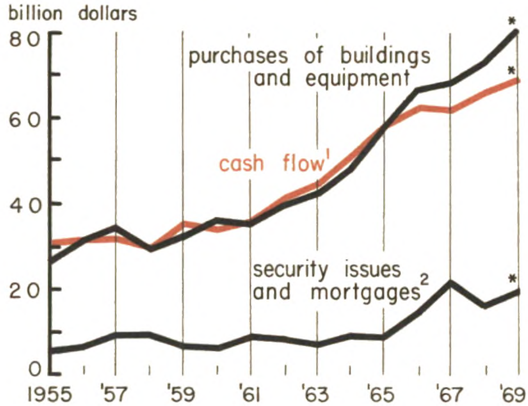
About three-fifths of the funds used by these nonfinancial corporations in recent years have been from internal sources, mainly undistributed profits and depreciation. In 1969, about $50 billion will have to be obtained externally: from security issues, loans, trade debt, and increases in other liabilities. In seeking outside funds corporations, of course, compete in the credit markets with the Federal government, state and local governments, consumers, unincorporated businesses, farmers, and foreign borrowers.

When profits are favorable and opportunities for expansion appear attractive, corporations are vigorous competitors for funds. Interest is typically a relatively small item in their total costs, and, like other expenses, is tax deductible. They pay the going rates, knowing that competitors must do the same. Furthermore, corporations are exempt from usury laws and similar regulations that restrict many individuals and governments in their access to funds. They can obtain funds from a variety of sources utilizing equity financing as well as short- and long-term borrowings from various lenders.

The largest share of corporate funds has always been the cash provided from current operations—taking the form of retained earnings, depreciation, and increases in reserves, including reserves for profits tax liability. On average, in the postwar period about two-thirds of corporation funds have been obtained from internal sources. This proportion has tended to rise in years of business recession or slow growth, and to decline in years of vigorous expansion when funds from internal sources were supplemented more heavily with funds from external sources. As recently as 1965, 66 percent of corporate funds were from internal sources. This proportion has dropped each year since then, probably falling below 60 percent in 1969.

In the early postwar years, retained profits were larger than depreciation. But depreciation has grown steadily with rising investment in new plant and equipment and with changes in Treasury regulations permitting faster write-offs. Retained earnings have fluctuated with changes in profits. Since 1967, depreciation has been more than double retained earnings. In 1969, depreciation may exceed $47 billion and may provide corporations with almost 40 percent of their total new capital funds needs.

Corporate capital outlays have outrun cash flow since 1965



*Estimated.
[1]Undistributed profits plus depreciation.
[2]Net increase
SOURCE: Flow of Funds, Federal Reserve Board.

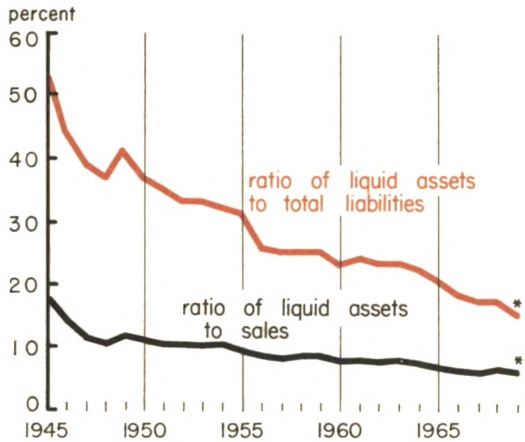
Total after-tax profits of nonfinancial corporations probably will reach a new high in 1969, exceeding last year's $40 billion total. But with dividends continuing to rise, undistributed corporate profits probably will only about match last year's $20 billion total, which was below the record set in 1966. Most corporate managements attempt to maintain or expand dividends, but some have announced reductions or omissions in recent months in order to conserve funds for other uses.

Money owed on Federal income taxes (and to other creditors) helps to finance business firms until payments are made. Starting in 1967, large corporations have been required to pay income taxes in quarterly instalments in the year profits are made. Underpayments of as much as 20 percent are not penalized, however, and the penalty for larger underpayments is 6 percent per annum. With market interest rates at 8 percent or more, deferment of tax payments can be a relatively cheap source of funds.

Deferred payment of trade accounts is another method of easing the burden on financial resources, especially when cash discounts are insufficient to encourage prompt settlement of invoices. Since most corporations have trade receivables as well as trade payables, the inclination to defer payments works both ways. On balance, attempts to slow payments of trade debts probably increase the financial burden on corporations, especially large manufacturers, because they commonly finance customers' inventories in this way.

All told, in 1969 internal sources of funds for nonfinancial corporations—depreciation, undistributed profits, and the rise in the tax liability—will probably exceed last year's total of almost $70 billion. But, because uses of funds are larger in 1969, the need for funds from outside sources has risen.

Corporate liquid assets have declined relative to liabilities and sales



*Estimated.

SOURCE: Securities and Exchange Commission and Flow of Funds, Federal Reserve Board.

Uses of funds

Purchases of new buildings and equipment will utilize about two-thirds of the funds obtained by nonfinancial corporations this year. This ratio is near the average for the postwar period, but is above the 60 percent average for the early 1960s before capital spending accelerated. In 1969, corporate spending for buildings and equipment may reach $80 billion, up about 10 percent from 1968.

Most industries have slightly scaled down capital spending plans since the first quarter of 1969. Lower than expected sales, concern over general economic prospects, delays in the completion of construction projects, and slow deliveries of equipment apparently are the major causes. In some instances, spending plans were curtailed because of inability to obtain financing on acceptable terms. Some corporations, however, have raised their spending plans. Important among these are most utilities—water, gas, electric, and communications—that are finding their facilities increasingly inadequate in the face of sharply rising demand. Some manufacturing companies, in efforts to cut costs and improve the quality of products, have also added to backlogs of projects, even though there are margins of unused capacity.

A number of private surveys taken in the early fall of 1969 indicate that capital expenditures would rise next year—perhaps by 5 or 10 percent. Since prices for capital equipment are expected to rise by about 5 percent, relatively little increase is indicated for physical volume. Experience with these surveys suggests that capital spending plans can be adjusted either up or down, depending on future developments.

Next to plant and equipment, the most important use of corporate funds has been credit extended to customers—consumers, businesses, and government. In 1968, receivables rose by almost $17 billion—a record amount. The rise will be even larger in 1969.

Inventories rank after receivables among the uses of funds for working capital. Corporate inventories rose about $10 billion in 1968—more than in 1967, but less than in 1966 when they rose very rapidly after sales slowed late in the year. Like receivables, inventories appear to be rising more in 1969 than in 1968. Any slowdown in sales is likely to bring a temporary bulge in inventories before adjustments in orders and production can be made.

Even if the rise in the dollar volume of business activity were to moderate further in 1970, inventories probably would continue to rise, although perhaps at a slower pace. For competitive reasons inventories must be adequate to accommodate customers who have alternate sources of supply. Corporate inventories have not declined in any calendar year since 1958. Even the recession year of 1960 saw a $3-billion increase. As in the case of receivables, suppliers' investments in inventories, especially finished goods, lessen the financial requirements of business customers who would otherwise have to carry larger inventories.

Liquidity squeeze

Composite balance sheets can give only partial and tentative indications of changes in corporate liquidity. In essence, liquidity is a state of mind, a matter of judgment, and is related to current and prospective cash flows, commitments to spend or lend, and to credit availability. Nevertheless, changes in liquid assets, especially in relation to current liabilities, provide a clue to the pressures upon corporate financial resources.

At the end of World War II, liquid asset holdings of corporations, consisting then mainly of demand deposits and short-term government securities, exceeded 90 percent of current liabilities. Since then this ratio has increased appreciably only in 1949. By the mid-1950s, the liquidity ratio had dropped below 50 percent. The ratio reached a low of 27 percent in 1967 before increasing slightly in 1968. Similar trends are noted when liquid assets are compared to total liabilities or to sales. This year, the liquidity ratio appears to have declined further as many corporate treasurers have reduced liquid assets in the face of high borrowing costs and heavy needs for outside funds.

The decline in liquid assets in the postwar period has been a relative decline in most years. This year, for the first time since 1960, there may be a decline in the dollar total of liquid assets.

Despite increased needs for funds for all major purposes and higher borrowing costs than in earlier years, corporations were able to increase their liquidity slightly in 1968 on a relative basis and by $9 billion, or 12 percent, in dollar totals. The buildup in liquidities last year is one reason why corporations could increase their investments in capital goods and working capital.

Changes in the mix of corporate liquid assets provide insight into the changing financial patterns of the postwar period. Demand deposits and currency were more than half of corporate liquid assets until 1963. At the end of 1968, this proportion had declined to 35 percent, and is probably even lower at the present time. Corporate holdings of demand deposits and currency (currency is relatively unimportant) reached a high of $33 billion in 1958. Ten years later the amount was $28 billion, even though the volume of payments has increased greatly.

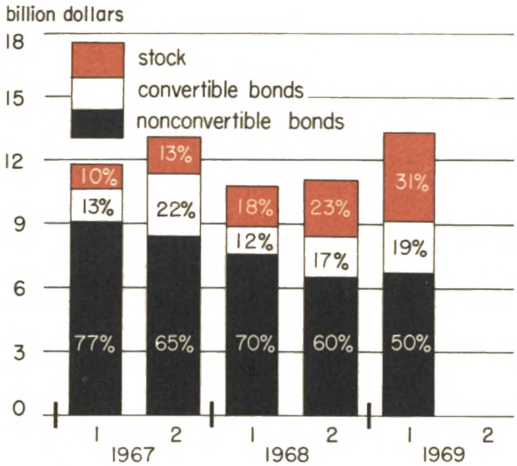
The obvious reason for holding demand deposits is to make payments. However, substantial, although unknown, amounts of corporate demand deposits are either compensating balances under loan agreements or balances held to reimburse banks for other services. The tendency has been to reduce demand deposits under conditions of high interest rates and tight credit.

Although demand deposits of corporations have declined in most recent years, their holdings of time deposits have increased. Rates paid by banks on time deposits increased sharply in the 1960s as banks began to tap this source of funds. In addition, holding time deposits in commercial banks tends to solidify lender-borrower relationships, especially in times when banks are unable to compete actively for funds because of rate ceilings on such deposits. Corporate holdings of bank time deposits exceeded $25 billion at the end of 1968, up from less than $2 billion in 1959. Holdings have declined sharply in 1969, partly because banks were not permitted to pay competitive rates, and partly because corporations needed funds for other purposes.

Federal government securities continued through the first half of the 1960s as the dominant short-term investment of corporations but have declined sharply in recent years. Holdings reached a high of $25 billion in 1959. By the end of 1968, this amount had declined to $14 billion, mainly because of the attraction of higher yielding time deposits, commercial paper, and other short-term investment opportunities.

Commercial paper (short-term unsecured notes of business corporations and financial institutions) has become a major outlet for surplus corporate funds in recent years. At the end of 1968, corporate holdings of commercial paper were about equal to their holdings of government securities. About two-thirds of the commercial paper outstanding was held by corporations.

Equity-type securities account for growing share of new issues*



*Gross proceeds.
SOURCE: Securities and Exchange Commission.

Security issues rise

Corporations sold a record total of $20 billion of securities in the first nine months of 1969, 25 percent more than in the same period of 1968, and more than in any entire calendar year prior to 1967. Moreover, many issues apparently have been postponed, awaiting a more receptive market. (These data include issues of financial corporations as well as domestic issues and foreign issues of nonfinancial corporations.)

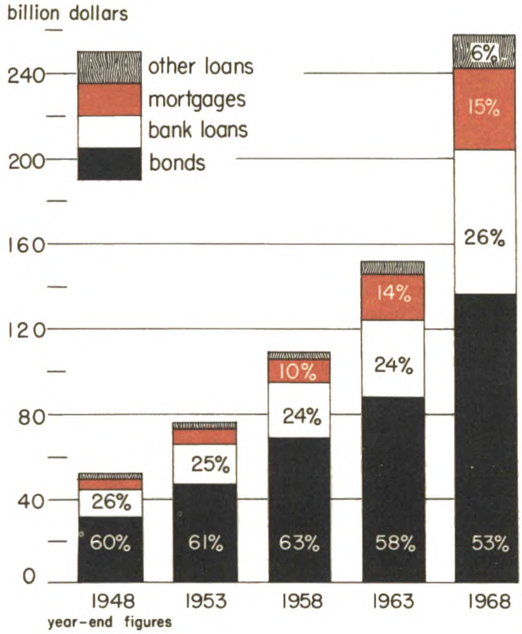
Refundings of outstanding bonds have been rare in recent years because of prevailing high interest rates. Thus, virtually all of the gross proceeds of these issues have been for new capital. The net increase in securities outstanding is always substantially less than gross proceeds of new issues. Bonds are paid off at maturity or are purchased for sinking funds, some stock is repurchased by issuing companies, some businesses are liquidated, and some securities are retired with the proceeds of bank loans or other funds, especially in conglomerate mergers or other financial reorganizations. Also, the debt-equity mix is influenced by conversions of one type of security into another, as when convertible debentures are exchanged for shares of a corporation's stock.

Last year, when $22 billion of stocks and bonds were issued by all corporations, the net increase in outstandings was about $14 billion. In recent years, the net increase in outstandings has ranged from less than 60 percent to almost 80 percent of the gross proceeds of new issues. Net security issues of nonfinancial corporations totaled $12.1 billion in 1968, well below the $17.4 billion record set in 1967, but more than in any previous year.

Net sales of stock have played only a small role in the financing of corporations in recent years. Retirements of common stock last year actually exceeded new issues by about $1 billion, in part because of retirements resulting from merger agreements. In the five years, 1964-68, net funds raised through stock sales by nonfinancial corporations totaled a relatively modest $4 billion, while sales of bonds netted almost $48 billion.

Although the net increases in stock outstanding in the aggregate have been small in recent years, many individual firms have acquired substantial sums through sales of stock. Moreover, the amount increased sharply. Sales of common stock increased steadily from the second quarter of 1966, when sales totaled less than $200 million, to the second quarter of 1969 when sales were $2 billion. Even periods of falling stock prices did not halt the trend. Greater emphasis has been placed on the use of bonds convertible into stock, although the uptrend has not been

Outstanding debt of nonfinancial corporations



SOURCE: **Flow of Funds**, Federal Reserve Board.

as continuous as the rise for common stock.

Only half of gross sales of corporate securities, totaling $13.5 billion in the first six months of 1969, were straight (nonconvertible) bonds. In the first half of 1968, 70 percent of new security issues had been nonconvertible bonds and in earlier years the proportion was even higher.

The trend to equity, or equity-type, securities is related to the strengthening of inflation in the past several years. Many investors are convinced that the best returns on investments, current yield plus capital gains, have been from equities, and that this will continue to be true in an inflationary environment.

Average common stock prices were down more than 20 percent in late September from the peak level of November 1968. Inflation accelerated in this period, thereby casting doubt on the usefulness of stock as a hedge against inflation. Also, prices of outstanding bonds declined during this period as interest rates rose.

In the late 1940s, new high-grade corporate bond issues yielded about 2.6 percent, while stock yields commonly were 6 to 7 percent. Corporate bond yields did not move above 4 percent until the late 1950s. After continuing on a rather level plateau in the

Sources and uses of funds—nonfinancial corporations

	Average 1961-65		1966		1967		1968		1969*	
	Dollar amount	Per-cent	Dollar amount	Per-cent	Dollar amount	Per-cent	Dollar amount	Per-cent	Dollar amount	Per-cent
	(amounts in billions)									
Sources										
Total	69.5	100	101.1	100	94.8	100	112.9	100	121.0	100
Undistributed profits	15.5	22	24.8	25	21.1	22	22.0	19	22.0	18
Depreciation	30.7	44	38.2	38	41.2	44	44.3	41	47.0	39
Net security issues	5.3	8	11.4	11	17.4	19	12.1	11	15.0	12
Stocks	0.8		1.2		2.3		— 0.8			
Bonds	4.5		10.2		15.1		12.9			
Change in loans	7.4	11	12.1	12	10.7	11	14.1	12	17.0	14
Bank loans	3.7		6.9		5.2		7.2			
Mortgages	2.9		2.7		3.8		3.9			
Other loans	0.8		2.5		1.7		3.0			
Change in payables	5.7	8	7.8	8	3.1	3	9.8	8	11.0	9
Change in other liabilities	4.9	7	6.8	6	1.3	1	10.6	9	9.0	8
Uses										
Total	68.0	100	99.0	100	91.4	100	111.2	100	120.0	100
New buildings and equipment	44.5	66	66.1	67	68.3	75	72.5	65	80.0	67
Change in inventories	5.4	8	16.2	16	7.5	8	9.7	9	16.0	13
Change in receivables	10.3	15	11.9	12	9.7	11	16.6	15	19.0	16
Change in liquid assets	2.7	4	1.1	1	0.8	1	8.9	8	— 3.0	— 3
Change in other assets	5.1	7	3.7	4	5.1	5	3.5	3	8.0	7
Discrepancy:										
Sources less uses	1.5		2.1		3.4		1.7		1.0	

*Estimated.

SOURCE: Adapted from **Flow of Funds**, Federal Reserve Board.

early 1960s, bond yields began to rise sharply in 1966. In September and early October 1969, new top-quality corporate bonds yielded 8 percent or more—the highest in modern times. Common stock yields in recent months averaged about 3 percent.

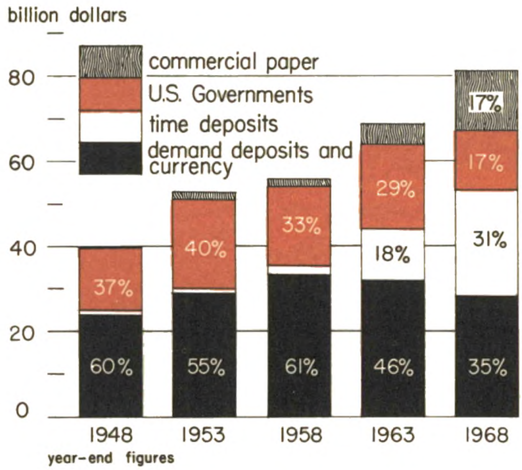
For many firms, funds obtained through sales of stock are cheaper than funds obtained through sales of bonds, even though interest on bonds is a deductible expense in computing corporate income taxes. Dividends on stock, on the other hand, are not a deductible expense. Therefore, with the tax rate on corporate profits approximately 50 percent, the net cost of capital raised through bond issues typically is about one half the market yield, when comparisons are made with the cost of capital raised through sales of stock. The rise in interest rates relative to stock yields doubtless has encouraged some corporations to raise funds by selling additional stock.

Bonds carrying conversion privileges, or accompanied by stock purchase warrants, offer lower yields than bonds without such features. These "hybrid" securities have appeal to investors who desire the safety of debt against substantial declines in price while obtaining a chance to share in the gains if shares of the issuing corporation's common stock rise appreciably in value.

Another method of sweetening bond issues is to provide that the securities will be non-callable for redemption for a period of five, ten, or more years, thus allowing holders an opportunity to benefit from capital gains if market interest rates decline. The tendency has been to strengthen non-callable features in the past two years.

In recent years, corporation bond issues have been sold in an increasingly competitive market, which is tapped also by banks and finance companies, foreign borrowers, and most important, federal government agencies.

Liquid assets of nonfinancial corporations



SOURCE: **Flow of Funds**, Federal Reserve Board.

Nonguaranteed agency issues and loan participation certificates marketed by such organizations as the Federal National Mortgage Association, the Home Loan Banks, and the Commodity Credit Corporation are not accorded the same market status as direct obligations of the Treasury. (Some financial institutions classify holdings of agency issues with corporates, rather than governments.) In 1968, agency issues outstanding rose by a record $5.7 billion, and the prospect is for an even larger rise this year. In the five years, 1964-68, when net funds obtained through bond sales by nonfinancial corporations totaled $48 billion, agency issues totaled $18 billion—far more than ever before. In the same period, net sales of bonds by banks and finance companies were $8 billion and sales of foreign issues were $4 billion.

Credit market borrowings of nonfinancial corporations outstanding at the end of 1968 totaled almost $260 billion, up 70 percent in five years. In the aggregate, these debts have increased every year since 1945.

More than half of corporate credit market debt consists of bonds. This proportion has been stable at 53 percent since 1964. In the early 1960s, more than 60 percent of corporate debt was bonds, the decline in this proportion was associated with a rise in other debts, especially mortgages.

Loans and mortgages

Bank loans, other than mortgages, account for 26 percent of total corporate debt, mortgages 15 percent, and other loans 6 percent. Loans from commercial banks have always been a major source of corporate funds, especially in the early stage of a rapid business upswing. In years such as 1947, 1956, 1959, and 1965 the proportion of bank loans to total corporate credit market borrowings has increased. In the later stages of an expansion, or in periods of reduced activity, some of these loans are either repaid or refinanced as long-term debt or equity.

Large commercial banks typically consider commercial and industrial loans their main lending activity, and their major source of earnings. They are ready to de-emphasize investments and other types of lending when business customers, especially those with established lines of credit, need funds.

Prior to the 1930s, almost all bank loans were short term (under one year), usually with maturities of only a few months. Since World War II, more and more banks have made longer maturity term loans, often three to five years in maturity, and have offered revolving credit agreements that are renewed or modified periodically.

Bank loans of nonfinancial corporations outstanding totaled $68 billion at the end of 1968, up 12 percent from a year earlier, and up almost 90 percent in five years. At times of extremely heavy demands for funds, especially in 1966 and 1969, banks have been hard pressed to satisfy all loan demands from high-grade corporate borrowers. After rising rapidly in the first half of 1969, bank loan growth slowed in the third quarter.

Pressure of bank loan demand in 1969 is indicated by the fact that the prime rate charged by large commercial banks on unsecured loans to highly rated corporations was raised three times in the first half, reaching 8.5 percent in June. For some prime rate customers, the effective rate on such loans is 10 percent or more if allowance is made for compensating balance requirements. The prime rate was 4.5 percent in the late 1950s and 2 percent in the late 1940s. Even in 1929, top-rated customers paid only 6 percent.

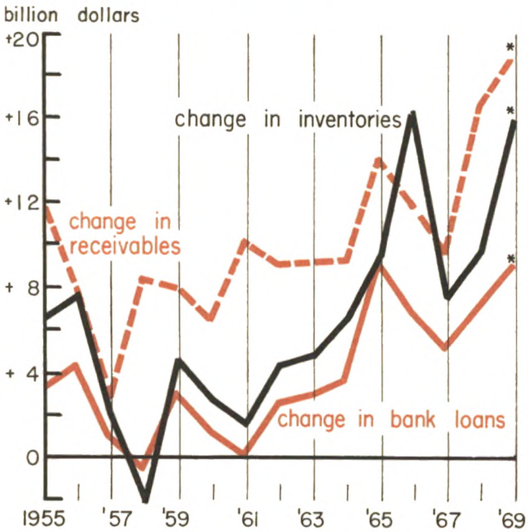
Some commercial banks have been experimenting with equity participations on business loans and mortgages. Such participations are authorized under the Comptroller of the Currency's ruling #7312 which was published in November 1966. Apparently this practice has not become widespread.

Corporate mortgages include mortgages on industrial, commercial, and residential properties. Although some of these mortgages are relatively large, most reflect financing of small- or medium-size business. Business mortgage funds have been obtained principally from life insurance companies, but banks, savings associations, pension funds, and individual investors also are important lenders in this area.

Corporate mortgages have provided a flexible source of funds for many firms with properties offering suitable collateral. These loans typically are exempt from state usury ceilings—unlike mortgage loans to individuals. In addition, terms can be arranged with variable returns to the lender. Increasingly in the past year or two, contracts have provided escalation clauses adjusting payments periodically to changes in the commercial bank prime rate or some other market interest rate. Also, equity participation features commonly have been included giving lenders stock purchase warrants, a proportion of the gross rentals, or a share of profits associated with the structure bearing the mortgage. Corporate mortgages outstanding totaled $38 billion at the end of 1968, up 15 percent from a year earlier and up 80 percent in five years.

Loans to corporations, other than mortgages and bank loans, totaled only $16 billion at the end of 1968. Part of these loans are owed to sales and commercial finance companies, an important source of funds for small- and medium-size businesses. The most dynamic factor in the rise in other loans in the past two years, however, has been commercial paper—the short-term unsecured notes of large firms with excellent credit rating that are sold to the public.

Rising working capital needs spur bank loan growth



*Estimated.

SOURCE: Flow of Funds, Federal Reserve Board.

Commercial paper of corporations placed through dealers (other than bank-related paper) exceeded $10 billion at the end of August 1969—an increase of more than 40 percent from the start of the year. This year, bank holding companies and bank affiliates have begun to market commercial paper. A large portion of these funds are re-lent to business corporations.

Another rapidly growing method of business finance is equipment leasing. Computers, motor vehicles, and virtually every other type of equipment can now be leased; and leasing is used by all types and sizes of business, including large corporations. Leases take the place of equity or debt financing, but do not appear as a liability on the balance sheet. Reliable data on the current volume of leasing is not available, but it probably amounts to several billion dollars.

Things to come

The rapid developments in corporation finance of recent years have not exhausted the possibilities for further change. Corporations will probably find ways to reduce liquid reserves still further, whenever these funds can be profitably used in operations. Channels may be developed to sell bonds and notes to individuals of relatively modest means. Equity participation features in debt issues may become even more widespread, especially if the public's fears of accelerating inflation are not overcome.

Past standards of sound finance covering debt-equity ratios, interest as a proportion of total expense, and the adequacy of liquidity reserves may be adjusted further. The imaginative innovations of corporate financial management have been matched, and often suggested or encouraged, by financial institutions. Most changes in recent years have been in the direction of greater risk exposure.

Continuance of general prosperity, therefore, is a requisite to continued success, and wider adoption, of the new methods of finance.

Most financial analysts anticipate some leveling or easing in interest rates in the months ahead, but no sharp decline. Needs for funds to finance new plant and equipment, and increases in working capital are expected to continue large. Moreover, many corporations would like to lengthen the average maturities of their debts and somewhat restore their liquidity positions.

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