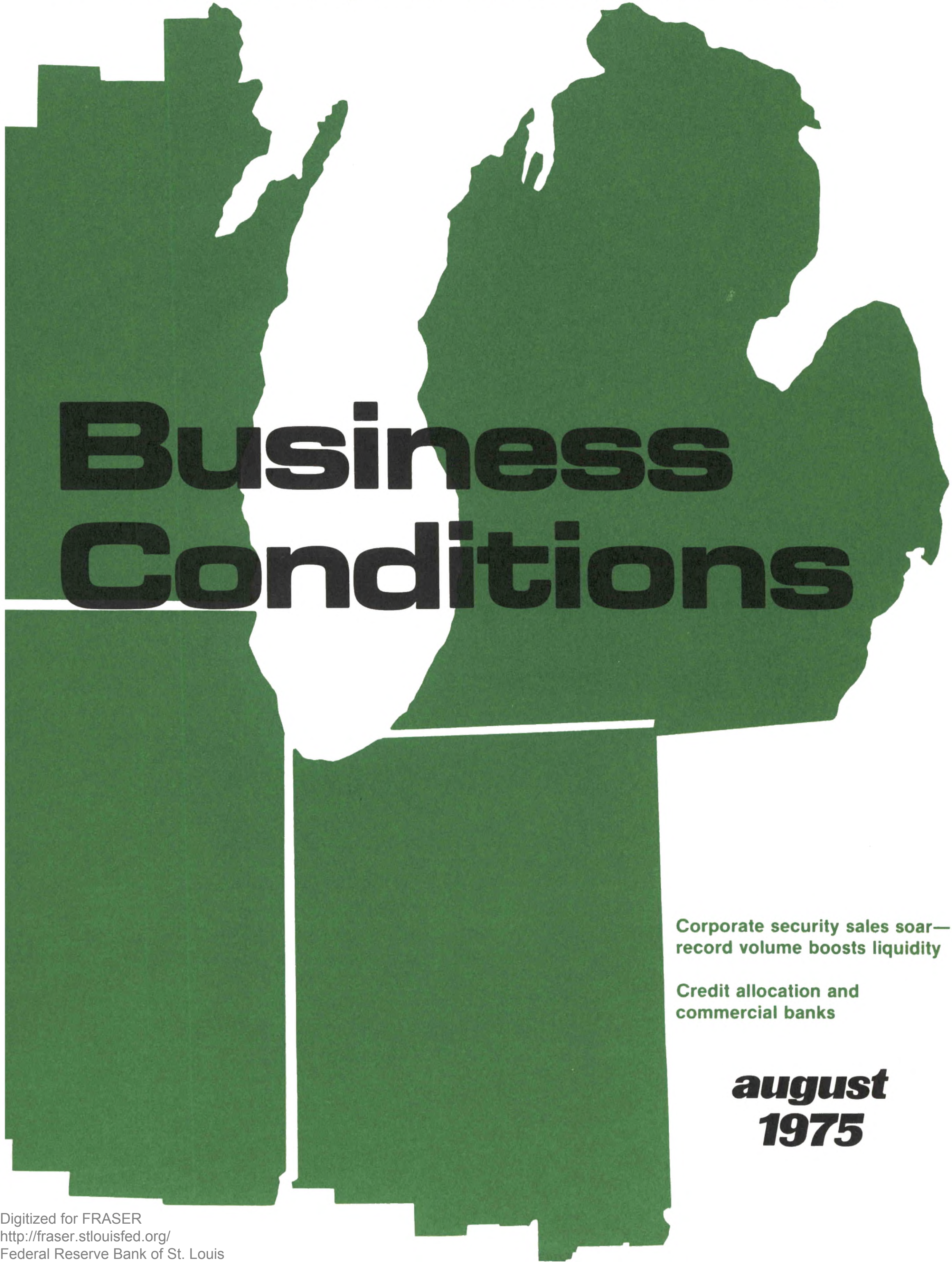
an economic review by the Federal Reserve Bank of Chicago



Business Conditions

Corporate security sales soar—record volume boosts liquidity

Credit allocation and commercial banks

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Corporate security sales soar—record volume boosts liquidity

Corporate financial managers have been hard pressed in recent years to provide the funds needed to support the current operations and expansion programs of their firms. During the boom years prior to the 1974 recession, they relied heavily on bank loans and other short-term financing, but security issues also were at a very high level. Debt burdens have grown, not only because of the rise in outstanding bonds and notes, but also because of record high interest rates.

Nonfinancial corporations reported sharply rising profits in the years prior to 1975, but a large share of these gains have represented inventory profits rather than cash available for dividends or other purposes. Capital consumption allowances have continued to increase, but total internally generated funds have supplied a much smaller proportion of corporate needs than earlier in the postwar period; hence, the increased reliance on outside financing.

This year corporate bank loans are being paid down, while the capital markets have been called upon to purchase an extremely large volume of stocks and bonds. Corporations are getting their financial houses in order in 1975 to prepare for renewed expansion. They are competing with other sectors, including government. Many analysts doubt that sufficient funds will be available in the years ahead to satisfy all demands, public and private, suggesting a need to reexamine national goals and priorities.

The upsurge in new issues

Despite depressed business conditions in 1975, new issues of corporate stocks and bonds have been far outpacing all previous periods. Gross proceeds from new security sales were about $30 billion in the first half, almost two-thirds more than in the first half of 1974, and more than in any full year prior to 1970. For all of 1975 it appears certain that new corporate securities will exceed the 1971 record of $45 billion by a wide margin.

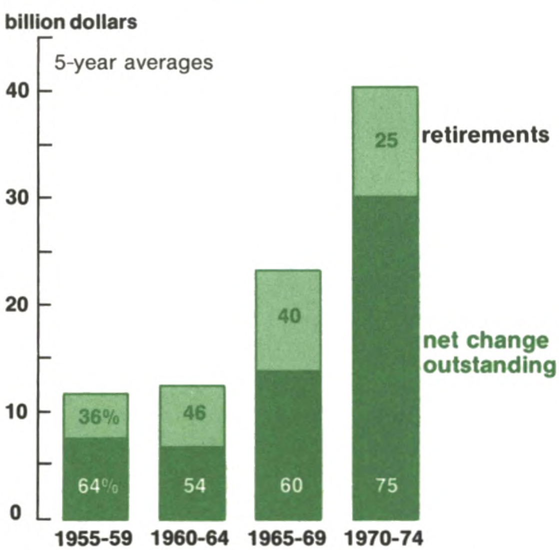
The huge volume of corporate underwritings may seem paradoxical this year in view of sharply reduced total needs for funds. Inventories and receivables declined substantially in the first half after big increases over a three-year period, and the extended uptrend in plant and equipment spending was reversed. Profits have plummeted this year, while dividend payouts were about maintained, thereby reducing internally generated funds. But the main reason for the heavy resort to the securities markets has been the desire of executives to rebuild liquidity positions and to strengthen capital structures that were weakened during the boom. Corporations have increased their demands on the capital markets in various past recession periods, having relied heavily on short-term financing during the preceding business expansions. The strategy is especially marked this year, however.

Billions of dollars of short-term corporate debts, especially bank loans, have been repaid since year-end, and many businesses have increased their holdings of liquid assets. Reduced short-term debt and larger pools of cash and marketable securities, together with larger open credit lines, will help business firms withstand further shocks and also increase their ability to expand operations when the expected business recovery is under way.

In March and April a widespread view held that various corporate issues were being rushed to market to corral available funds before being "crowded out" by the Treasury's financing of the $60 to $70 billion federal deficit projected for fiscal 1976. Flotations continued at a very high level past midyear, however, and the calendar of upcoming issues remains heavy.

The avalanche of long-term corporate financing probably will subside somewhat as the second half proceeds, but the volume of funds raised, no doubt, will continue to be substantial through the remainder of 1975 and in 1976 as well. This article provides a perspective on the manner in which corporations have used the capital markets in recent years, the types of securities sold, the relative importance of various classes of investors, and the relation of security sales to the overall corporate financial picture.

New corporate security issues surged in the 1970s



SOURCE: Securities and Exchange Commission.

Trends in security sales

Corporate security sales have moved generally upward since World War II. Offerings, as tabulated by the Securities and Exchange Commission (SEC), averaged about $9 billion annually in the early 1950s and $13 billion in the early 1960s. The long business expansion of the 1960s, accompanied by accelerating inflation, strained corporate resources. One result was heavier use of long-term financing through sales of stocks and bonds. In the five years 1970-74 offerings averaged about $40 billion annually.

From the early 1960s to the early 1970s gross proceeds from sales of new securities increased about one and one-half times as fast as the total dollar volume of activity measured by the gross national product in current dollars. The net change in outstanding securities, new issues less retirements, increased even faster than gross proceeds. A large volume of outstanding bonds and notes mature each year or are purchased for sinking funds. Existing issues also may be retired (refunded) with cash from new issues. In addition, firms with surplus cash may buy their own bonds or stocks on the market for a variety of reasons. Changes in outstandings measure the net volume of funds raised by the corporate sector through security sales.

In the past five years the net change in outstanding corporate securities has averaged 75 percent of gross proceeds, compared to about 50 percent in the previous ten years. Aside from the very large needs for funds in the 1970-74 period, the rise in this proportion reflects the virtual disappearance of refunding issues both because of high interest rates and because bonds issued in the past several years usually have been made "noncallable" for five years or more to attract long-term investors.

In 1974, 83 percent of all corporate security issues were bonds or notes, 11 percent were common stock, and 6 percent were preferred stock. In each of the two previous years these ratios were 65, 25, and 10 percent. Sales of common stock dropped to $4 billion in 1974, compared to the record high of almost $11 billion in 1972. Sales of common stock are stimulated when market prices are rising strongly and discouraged when prices are low or declining.

While sales of stock were down last year, bond sales at $31.6 billion exceeded the previous record of 1971. About 80 percent of all bond sales in 1974 were public offerings, as opposed to "private placements" negotiated with large institutional investors that accounted for about half of all bond issues in 1965 and 1966. Reflecting the depressed market for common stocks, only $500 million of the bonds sold last year—less than 2 percent—were convertible issues. In the three years 1967-69, when stock prices were relatively strong, 20 percent of all bonds sold were convertibles.

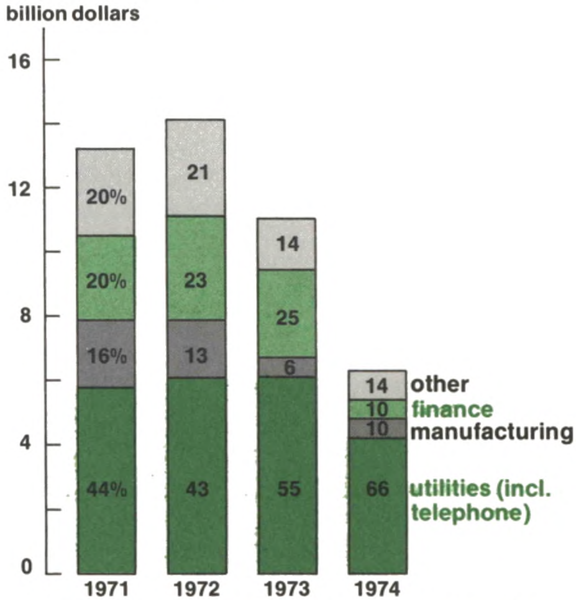
Electric and gas utilities accounted for one-third of all securities sold both last year and in 1973. Ten years ago utilities accounted for only 20 percent of all security issues. About half of all common stock sales last year were by utilities, which are under strong pressure from regulatory authorities to maintain or bolster the equity portions of their capital structures. Utilities accounted for virtually all of the $2 billion of preferred stock sold last year. Funds required for expansion by electric utilities have exceeded internally generated funds by an unusually large margin in recent years.

The proportion of security sales by manufacturing concerns has fluctuated widely over the years. (Manufacturers' security sales are usually greatest in periods following rapid expansions when financial positions are consolidated as is occurring this year.) This ratio rose from 15 percent in 1973 to 28 percent in 1974, and apparently will be even larger this year. In 1967 manufacturers accounted for 45 percent of all security sales, but the average has been below 30 percent since 1965.

Financial enterprises, including commercial banks, constitute the third major sector selling corporate securities. Their share of total issues dropped from over 22 percent in 1972 and 1973 to 14 percent in 1974. The financial category has been even weaker this year. Many bank holding companies would like to sell capital issues in the second half if market conditions are favorable.

Security sales by communications firms (almost entirely telephone companies) accounted for 10 percent of gross proceeds in 1974, somewhat below the

New stock issues declined sharply last year. . .



SOURCE: Securities and Exchange Commission.

average for earlier years. Bond issues by telephone companies, which appear throughout the year, typically are very large, have long maturities (usually 40 years), and are rated triple-A. As a result, the offering yields on new telephone bond issues and the market reception accorded them are watched closely as "bellwethers."

The big borrowers

A striking aspect of the corporate securities picture in 1975 has been the large number of huge long-term debt issues floated by leading companies with excellent credit ratings. With the biggest and strongest borrowers seeking such a large volume of funds, some companies wishing to sell long-term debt, especially smaller firms and those whose bonds are rated below the top three grades, have been forced to bide their time.

Part of the impact of heavy sales of high-grade bonds on lower rated issues is reflected in yield data. Moody's index of yields of seasoned corporate bonds rated Aaa was at 8.8 percent at midyear. Yields on Baa corporates, the fourth grade, averaged 10.4 percent at midyear. The spread between the Aaa and the Baa indexes—160 basis points at midyear—was up from 90 basis points one year earlier and 75 basis points in mid-1973.

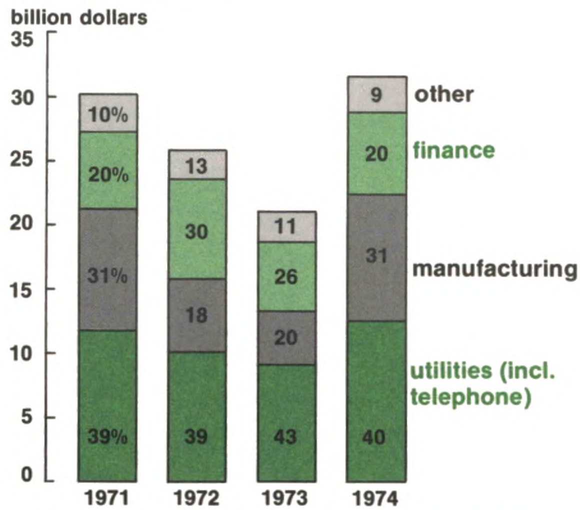
Bond issues of an even $100 million are a popular size with large borrowers. In the first half of this year 91 corporate bond issues amounted to $100 million or more, compared with 53 in the year-earlier period and 47 in the record-breaking first half of 1971. Seventeen issues in the first half amounted to $200 million or more. Mostly triple-A rated, the issues ranged up to $600 million for AT&T in January and a similar amount for General Motors in March. The GM issue was the largest ever by an industrial firm, exceeding the previous record of $500 million set by du Pont in November 1974. GM had not sold bonds in years, while du Pont had no outstanding long-term debt prior to the November sale.

Some highly rated firms have sold notes of seven to ten years maturity recently, rather than the 25-year maturity usually favored by industrial companies and 30 or more years preferred by utilities in order to reduce interest costs. (Some investors have insisted on shorter maturities.) Some of the largest issues—including those of AT&T, GM, and du Pont—have been divided into two parts, short-term notes and long-term bonds sold concurrently.

The congestion in the capital markets last spring has probably never been equaled in the past, except during financial panics. Several issues were withdrawn in March and April because of unfavorable receptions with the marketing process well under way—a highly unusual step.

Despite pressures on the bond market in the first half of 1975, long-term yields never approached the record levels of the fall of 1974. Yields on new triple-A utility bonds averaged over 9.6 in April and May,

. . . but corporate debt issues hit a new peak



SOURCE: Securities and Exchange Commission.

compared to a peak of 10.4 last September. Recent bond rates, although not at record levels, were very high historically. Yields on new utility issues averaged well under 8 percent in 1973 and about 4.5 percent ten years ago.

The fact that many companies postponed security issues in the first half, together with evidence that various smaller firms did not even attempt to obtain the long-term funds they desired, suggests that suppressed demand for such capital funds remains large.

The rise in the stock market, up about 50 percent at midyear from last December's low, has encouraged sales of new stock issues, especially by utilities. In the first half, sales of common and preferred stock totaled about $5 billion, double the volume in the first half of 1974. There were 21 issues of common stock of $50 million or more, compared to five such issues in the first half last year.

Business firms are hesitant to sell common stock when market prices are low (far below book value in many cases late last year) to avoid diluting the value of holdings of existing stockholders. A continuing factor tending to deter stock issues is the fact that dividends paid are not tax deductible as interest payments are. Nevertheless, the financial soundness of a firm and its ability to incur debt are related to the size of its equity "cushion." Continued strength in the stock market, therefore, can be expected to bring forth a further heavy volume of new issues.

Who buys stocks?

Flow of Funds accounts prepared by the staff of the Federal Reserve Board include estimates of net acquisitions of stocks and bonds by various investor groups. These data are used in the following analysis.

Holdings of corporate common and preferred stock (equities) are largely in the hands of "households" (a category that includes personal trusts and nonprofit institutions as well as individuals), insurance companies, pension funds, and foreign investors. The proportion of total net new issues acquired by each of these groups has varied substantially from year to year and over time. Net acquisitions by the various investor groups in the aggregate, of course, determine the ability of corporations to sell new issues.

The household sector now holds about 75 percent of all outstanding corporate equities. (This proportion has dropped fairly steadily from over 90 percent in the years immediately following World War II.) Private pension funds now hold about 10 percent of outstanding equities. Life insurance companies, state and local government retirement funds, open-end investment companies, non-life insurance companies, and foreigners each account for 3 percent or less.

Sales of corporate equities by the household sector—including shares of open-end investment companies—have exceeded purchases each year since 1961. Although hundreds of thousands of individuals have acquired stocks during this period, their purchases have been more than offset by sales of other individuals, trusts, and foundations. Some huge blocks of stock have been sold (frequently through underwriters) by individuals, by their estates, or by the trust funds and nonprofit institutions they have endowed. Substantial portions of these offerings have gone into the portfolios of institutions. Purchases of investment company shares, mostly by people of moderate wealth, had been a supportive factor in the stock market for most of the postwar period, but even these investments have been liquidated on balance in the past three years.

Private pension funds have been by far the largest net purchasers of equities since World War II. Acquisitions reached a peak of $8.9 billion in 1971, almost two-thirds of the new supply that year. Private pension fund net purchases of equities have declined each year since 1971 and were only $2.3 billion in 1974.

Life insurance companies were not important purchasers of equities until the 1960s, after state laws and regulations restricting such investments were relaxed to some degree. Net purchases of equities by life insurance companies totaled about $3.5 billion in each of the three years 1971-73, before dropping to $2.2 billion in 1974.

State and local government retirement funds began to purchase equities in appreciable volume in the mid-1960s. Their purchases rose steadily to a peak of $3.9 billion in 1973. A decline to $3.5 billion occurred last year, but this was the largest amount absorbed by any single category in 1974 and equaled 70 percent of net new issues.

Non-life insurance companies, mainly fire and casualty companies, have always invested a significant portion of their reserves in equities. Their purchases peaked at $3 billion in 1972 but dropped in 1973. Last year sales exceeded purchases.

Purchases of equities of U.S. corporations by foreign investors have become a significant factor in the past seven or eight years. Such purchases have varied widely, dropping from $2.8 billion in 1973 to less than $0.5 billion last year.

Who buys bonds?

At the end of 1974 U.S. investors held almost $290 billion in corporate and foreign bonds and notes, according to the Flow of Funds data. Of these, 80 percent were obligations of nonfinancial corporations, 14 percent were obligations of financial institutions (mainly finance companies), and the remainder were foreign bonds.

Life insurance companies hold almost $100 billion, or 34 percent, of outstanding corporate bonds. Although life insurance companies have increased their bond portfolios each year, their proportion of the total has slipped steadily from over 60 percent in the early 1950s. State and local government retirement funds have increased their holdings of corporate bonds regularly and now have 20 percent of the total. Households hold 19 percent, private pension plans 12 percent, and the remainder is divided among mutual savings banks, commercial banks, non-life insurance companies, and other investors, including foreigners.

The mainstays of the corporate bond markets in recent

Net purchasers of corporate securities

	1971	1972	1973	1974
	(billion dollars)			
Stocks				
Households, personal trusts, and nonprofit organizations	-6.4	-4.7	-6.6	-2.0
Life insurance companies	3.6	3.5	3.6	2.2
Private pension funds	8.9	7.1	5.3	2.3
State and local government pension funds	3.2	3.5	3.9	3.5
Other	4.3	4.2	3.4	-1.1
Total	13.6	13.6	9.6	4.9
Bonds				
Households, personal trusts, and nonprofit organizations	9.3	5.2	1.1	-2.3
Life insurance companies	5.5	7.0	5.9	5.4
Private pension funds	-.7	-.8	1.6	4.7
State and local government pension funds	4.2	5.3	5.9	8.4
Other	6.5	3.5	-2.0	7.1
Total	24.8	20.2	12.5	23.3

SOURCE: Flow of Funds, Federal Reserve Board.

years have been the life insurance companies and the state and local government retirement funds. In 1974 the latter were the largest purchasers of bonds with net acquisitions of $8.4 billion, 36 percent of the increase in total outstandings. Life insurance companies acquired at least $5 billion of corporate bonds in each of the past four years. Private pension funds—which had reduced holdings of corporate bonds slightly in 1971 and 1972, when their stock purchases were especially large—became net buyers of bonds again in 1973, and they acquired $5 billion worth in 1974. The household sector had been the largest purchasers of bonds in 1970 and 1971, but these investors were lesser factors in the two following years, and they reduced their holdings by over $2 billion last year.

The record of the past several years shows marked shifts in purchases of corporate bonds among the major sectors of investors. Nevertheless, the bond market is, and doubtless will continue to be, an institutional market. Attempts to sell private bonds to individuals in relatively small amounts have not proved to be very successful. Individuals who wish to buy fixed income obligations usually favor the safety and liquidity of Treasury securities and insured deposits in banks or thrift institutions or the tax exemption of municipals. Life insurance companies can be expected to continue their traditional role as steady purchasers of corporate bonds. High quality, long-term, debt instruments yielding about 9 percent annually would appear to be attractive investments for any financial institution that must pay contractual obligations stated in dollars.

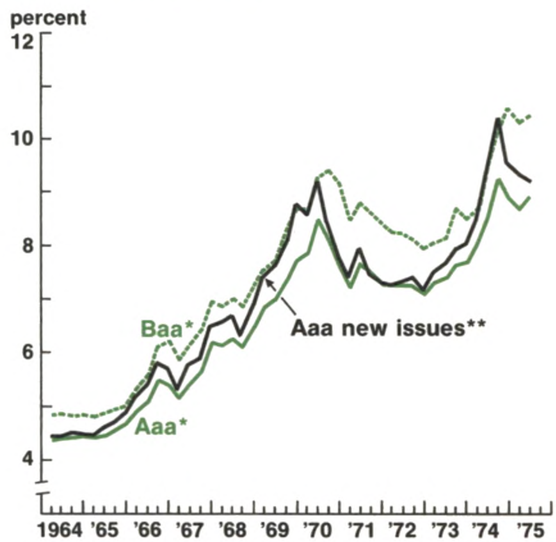
Debt burden grows

Most analyses of corporate financial developments focus on nonfinancial corporations (called corporations from here on) because these firms account for about 80 percent of all nonfarm business activity and almost all manufacturing. Moreover, a large share of the funds raised by financial institutions are re-lent to corporations or to their distributors and customers.

At the end of 1974 corporations owed $585 billion in credit market instruments—$231 billion in bonds, $131 billion in mortgages, and $223 billion in loans—primarily bank loans. Corporate credit market debt equaled 28 percent of the debt of all nonfinancial sectors, including the federal government. This proportion has risen fairly steadily from 15 percent in the late 1940s. Last year corporations accounted for 43 percent of funds raised by all nonfinancial sectors.

Corporate debt also has increased relative to the volume of their business in the past 20 years. The ratio of total liabilities (including payables and other debts) of corporations to corporate gross product rose from 80 percent in 1954 to 91 percent in 1964 and to 115 percent last

Bond yields remain high although below 1974 peaks



*Seasoned issues composite index, Moody's Investors Service.
**Federal Reserve Board, starting with December 1971 utilities only.

year. Moreover, the burden of debt has become much heavier than these ratios imply because of the sharp rise in interest rates over this period.

Corporate debts were borne easily for a decade or more after World War II. In the 1960s and 1970s corporate debt became increasingly burdensome and a limiting factor in expansion plans. Meanwhile, interest costs have risen substantially, both because of larger debts and because of higher interest rates. In the past five years both short- and long-term interest rates have been at or near record levels. Net interest paid by corporations rose from less than $2 billion in 1954 to $5 billion in 1964 to $23 billion last year.

While corporate debts have increased relative to activity, their holdings of liquid assets have declined, relatively, from the very strong situation 20 or more years ago. Corporations had $113 billion in cash and money market instruments at the end of 1974, more than double the amount of 20 years earlier. However, the ratio of liquid assets to total liabilities declined from 32 percent in 1954 to 21 percent in 1964 and to 13 percent last year.

Financial ratings of the securities of many business firms, especially utilities, have been lowered in the recent period. Many firms have been unable to borrow on terms consistent with viability, and financial distress of some businesses frequently has hampered the borrowing ability of healthy companies in similar industries. Meanwhile, the route to equity financing has been constricted because of the depressed stock prices, and funds generated from depreciation and retained earnings, although nominally large, appear inadequate after adjustment for the inroads of inflation.

Inventories and profits

After-tax profits of nonfinancial corporations increased for the fourth straight year in 1974, rising 18 percent to a record $65 billion. Although dividends increased sharply to $31 billion last year, retained earnings rose further to $34 billion. Depreciation allowances continued the uptrend of recent years reaching $73 billion. Net cash flow (depreciation plus retained earnings) amounted to $107 billion, up 7 percent from 1973. Unfortunately, all of these figures are greatly inflated by inventory profits because supplies purchased at lower price levels were costed against current selling prices.

The Department of Commerce calculates an inventory valuation adjustment (IVA) to remove the profit or loss that results when the book cost of goods removed from inventories differs from current replacement cost. The IVA (sometimes equated with "inventory profits") has been negative almost every year since World War II because of the general uptrend in prices. From 1947 through 1971 the IVA had never exceeded a negative $6 billion. In 1972 it rose to $7 billion, in 1973 to $17.6 billion, and in 1974 to $35.1 billion!

If all firms used last-in-first-out accounting (LIFO), the IVA, theoretically, would be small or nonexistent. However, until last summer it was estimated that

Profit rate, less inventory gain, at postwar low in 1974

about 80 percent of all business inventories were accounted for on the first-in-first-out (FIFO) basis. A switch from FIFO to LIFO, or vice versa, must be approved by the Internal Revenue Service (IRS). Since mid-1974, a large number of proposals to convert to LIFO accounting have been submitted to the IRS by firms (some very large) who wish to reduce taxes paid on what they term "phantom" inventory profits. Extremely rapid inflation has overcome various drawbacks that had previously deterred switches to LIFO. No solid estimates are yet available as to the extent of the switch to LIFO, but it has been sufficiently widespread to substantially reduce total reported profits in periods of inflation and to raise net cash flow by reducing taxes.

With inventory profits reflected in the IVA subtracted, after-tax profits of corporations were only $29 billion in 1974, down from $37 billion in 1973, and well below the total for each of the five years 1964-68—in retrospect a high watermark for profits. As a proportion of gross corporate product, after-tax profits plus IVA dropped to 4 percent last year (compared to an average of about 9 percent in the 1964-68 period) and was much lower than in any postwar year.

Undistributed profits after subtraction of the IVA were a negative $1 billion in 1974, rather than a positive $34 billion. This figure had never been negative before in the postwar period. Net cash flow plus the IVA dropped from $82 billion to $72 billion. Increased profits from foreign branches more than offset this decline for the entire corporate sector.

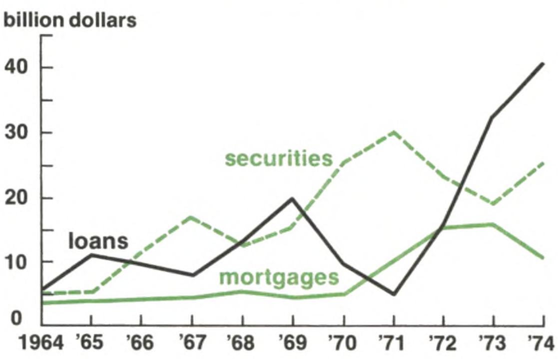
With inflation at a substantially reduced rate this year, inventory profits will be much lower, regardless of changes in accounting methods. Financial strains on corporations will be mitigated to this extent. If inflation accelerates again, however, funds raised to finance inventories, once more, will be a greater factor influencing total requirements. LIFO accounting helps only by eliminating taxes on inventory profits.

Sources and uses

From World War II through 1967 internally generated funds—capital consumption allowances plus retained earnings adjusted for inventory profits—supplied about two-thirds of all funds required by corporations. Since 1967 this proportion has declined substantially. It dropped to 48 percent in 1973 and to less than 45 percent in 1974, as corporations relied much more heavily on outside financing.

Total funds raised externally by corporations rose from $52 billion in 1971 to $102 billion in 1974. There was a sharp increase in reliance on loans, mainly short term, from $5 billion in 1971 to $41 billion in 1974. Commercial banks alone supplied $30 billion in both 1973 and 1974, far more than ever before. Net sales of securities supplied $18 billion in 1973 and $25 billion last year. Commercial paper supplied $4 billion last year and loans from finance companies added another $5 billion. The net increase in corporate mortgages declined from a record $16 billion in 1973 to $11 billion last year, mainly reflecting the

Nonfinancial corporations used loans heavily in 1973 and 1974



Note: Net change in outstandings.
SOURCE: Flow of Funds, Federal Reserve Board.

drop in commercial building. About $18 billion was supplied by trade debt and about $7 billion by miscellaneous liabilities, including the profits tax accrual.

Turning to uses of funds, fixed investments in buildings and equipment, as usual, absorbed the lion's share of corporate funds in 1974. Fixed investments required $115 billion, extending a rise dating to the early 1960s. Spending on fixed investments is expected to rise little, if at all this year, and real outlays may be down 10 percent after adjustment for inflation.

Receivables absorbed about $22 billion of corporate funds last year, and inventories took $11 billion (rise in the book value less the IVA). Liquid assets rose by $13 billion, and about $7 billion went into foreign investments.

Corporations probably will reduce both inventories and receivables in 1975, so these assets will supply funds rather than use them. Substantial additions probably will be made again to liquid assets because liquidity ratios remain uncomfortably low. Foreign investment is expected to rise somewhat.

On balance, it appears that total outside funds required by corporations will decline appreciably in 1975. Internally generated funds, after dividends and adjustment for inventory profits, probably will rise significantly, despite a substantial decline in reported profits. Cash flows also will be aided by the increase in the investment tax credit to 10 percent, which may add $3 billion, and by shifts to LIFO accounting.

While funds raised by corporations on the credit markets will be less in total this year, the drop will be reflected entirely in reduced demands for loans and mortgages. The very heavy rate of sales of securities by corporations in the first half can be expected to slow down as 1975 proceeds. A growing list of large manufacturers have indicated that they have completed their plans for sales of securities this year.

Future financial needs

In retrospect, 1975 doubtless will be viewed as a year of difficult adjustment in corporate finance following a phenomenal boom. The contraction in activity has followed patterns set earlier in the postwar period, although in a magnified fashion. In the summer of 1975 it appeared that the storm had been weathered and that a new expansion had begun. It also appeared that the fundamental strength of the nation's businesses and financial institutions, once again, had been demonstrated.

Most observers do not expect total activity to return to prerecession levels until late 1976. A continued lower rate of inflation also will tend to reduce needs for funds in the next year. Meanwhile, corporate profits are expected to recover very rapidly from the recent low level as output moves toward optimum rates.

Looking ahead to the remainder of the decade, it is clear that corporations will require vast sums to provide the facilities to produce the goods and services demanded by a growing and maturing population. These amounts will be inflated by outlays to promote health and safety and to preserve or improve the environment. Financial pressures will be intensified by new requirements for the funding of pension plans. Uncertainties will be all the greater because of energy shortages and possible liabilities resulting from litigation of various kinds that has assumed a much larger role than in the past. Corporations will be competing actively with other sectors, including the federal and state and local governments, whose needs will be very large. All these factors suggest that the skills and ingenuity of corporate financial managers will continue to be tested as they attempt to provide funds in adequate volume for the tasks ahead.

George W. Cloos

Credit allocation and commercial banks

Recent Congressional proposals for implementing credit allocation—a set of quantitative credit restrictions—have been of special interest to commercial banks and bank regulators in the United States. These proposals would create a credit allocation system that would be administered by the Board of Governors of the Federal Reserve System and would rely principally, or even solely, on controlling credit flows through banks.

Although the latest Congressional debate over credit allocation has ended, good reason exists for believing that the issue will reappear. Credit allocation tends to be a cyclical issue, arising when credit becomes relatively expensive and hard to find. Periods of restrictive monetary policy and rising interest rates underscore the imperfections in the financial network of the United States that lead to sectoral dislocations in the flows of financial and real resources—especially into housing, small business, agriculture, and state and local governments. For advocates of controls it is a short step from these problems to plans for implementing credit allocation.[1]

Credit allocation defined

In its broadest usage "credit allocation" describes a formal system, or any techniques, whereby some governmental authority—the President, Congress, or a designated agent such as the Federal Reserve Board—intervenes in credit markets to exert direct or indirect influence on the quantities of credit transacted therein. More specifically, credit allocation includes control over the composition of earning assets held by lenders, particularly financial institutions, or over nonprice lending terms offered borrowers on certain types of debt obligations. Thus, credit allocation can be aimed at changing either the demand or supply of separate types of credit.

Credit allocation deals with a limited subset of activities within the category of "selective credit controls." For example, Federal Reserve regulation of maximum interest rates payable on commercial bank deposits (Regulation Q) is classified as a "selective credit control," but not as "credit allocation," because this regulation operates on the price rather than on the volume of debt claims. Interest rate regulations, of course, do influence the dollar volumes of deposits through demand/supply forces, but these quantitative effects are too indirect to qualify as credit allocation.[2]

The major historical precedents for credit allocation in the United States have been restrictions on the nonprice lending terms of debt instruments. During both World War II and the Korean War, these controls included maximum maturities and minimum downpayments on consumer loans (Regulation W). During the Korean War the same types of controls

[1]Credit allocation powers already exist in the Credit Control Act of 1969 which grants the President standby authority to institute a far-reaching system of credit controls to be implemented by the Federal Reserve System.

[2]Selective credit controls, while encompassing credit allocation techniques, are usually defined to include state usury laws, federal deposit insurance, taxes or subsidies on some forms of debt, and myriad other legal and regulatory arrangements.

were extended to residential mortgages and other real estate credit (Regulation X). A voluntary credit restraint program applying to banks and other financial institutions also was implemented. Federal Reserve Regulations G, T, and U currently govern margin requirements (downpayments) on credit extended by banks and other lenders for purchases of corporate stock.

Most recent proposals for credit allocation have focused on controlling the supply side of credit markets, particularly various types of credit provided by commercial banks. Controls have been proposed that would place outright quotas on dollar volumes of certain earning assets held by banks—maxima for some categories of credit and minima for others. These plans have also included incentive and penalty provisions designed to influence lenders' holdings of particular categories of assets.

An important example of incentive-type credit allocation is the recently publicized plan calling for asset reserve requirements and reserve credits for banks belonging to the Federal Reserve System. Under this plan reserve requirements would be assessed against some categories of assets so that banks would find it more profitable to hold other assets enjoying high social priorities. In addition, reserve credits would be allowed on priority categories of assets, thereby allowing banks to reduce their holdings of cash-type reserves and providing banks with an additional incentive to hold these assets.

The issues

Numerous issues are central to the debate over credit allocation in the United States.

- Have the Federal Reserve System's general monetary policy tools proved inadequate to the task of stabilizing the economy?
- Has the nation's credit market system failed to channel credit to various sectors of the economy in a manner deemed acceptable to some broad conception of the public interest?
- Are "high priority" uses of credit identifiable? Do they warrant additional interference with the market mechanism and, possibly, with the structure of the U.S. financial industry?
- Will credit allocation actually work? Is it feasible administratively? Will it satisfy its intended objectives?

Advocates of credit allocation have argued that monetary policy is both too effective and too ineffective during inflationary periods accompanied by tight money and rising interest rates. Monetary policy may be 'too' effective in that, through increases in interest rates and decreases in the availability of credit, it discriminates against some sectors (e.g., housing and state and local governments) and provides them with less credit than is deemed socially acceptable in terms of "national priorities."

A restrictive monetary policy may be ineffective in that, by discriminating *in favor* of some sectors (e.g., large corporations), it fails to deal with the inflationary pressures arising from the excessive demands of these sectors on existing real resources. A related contention is that monetary policy, because of its uneven sectoral influences, has a sluggish impact on cyclical fluctuations and that its effects could be accelerated by a credit allocation program.

Opponents of credit allocation argue that the harsh impact of tight monetary conditions on some sectors of the economy reflects the efficacy, rather than the weakness, of general monetary measures. Monetary policy would be less effective if it did not have differential sectoral impacts and would involve even longer lags in its counter-cyclical effects. Moreover, the sectoral incidence of monetary policy tends to be symmetrical in the sense that excessive restriction in some periods is offset by compensatory overstimulation in others. There is no evidence that "priority" industries are systematically "starved" for credit over the entire business cycle.

Available empirical evidence indicates that some sectors (e.g., state and local governments) may not suffer as seriously from tight money as had once been supposed. Other sectors often considered immune to tight credit conditions (e.g., consumer durable goods) may actually be more sensitive to increases in interest rates than was supposed earlier.[3]

Fungibility of credit and diversion of demand

Probably the most important area of disagreement between proponents and opponents is the issue of whether or not credit allocation would actually work in the United States. Credit is "fungible" in the sense that funds borrowed for one purpose may be used for another. As a result, a policing mechanism to insure that a borrower's actual intentions match his stated reasons for seeking credit is difficult, if not impossible, to devise. This problem is exacerbated by the large proportion of corporate investment financed by internal funds—i.e., funds generated through operations of the firm rather than through debt sources.

For example, suppose a corporation contemplates two investment projects requiring identical dollar outlays: Project A financed with internal funds and Project B financed with a bank loan. Now suppose Project A qualifies as a "priority use" in terms of a credit allocation plan and Project B is considered an "inflationary use" for which bank loans are unavailable. The corporation could switch its plans, financing Project A through its bank and Project B with its own funds, thereby nullifying the intended goals of the credit allocation scheme.

[3]See Thomas Mayer, "Financial Guidelines and Credit Controls." *Journal of Money, Credit and Banking*, IV (May 1972), 360-74.

Another problem is that credit allocation techniques that operate through the *supply* of bank credit do not correspondingly affect the *demand* for credit. Borrowers wishing to finance "inflationary uses" disfavored under a credit allocation plan may have sufficient size, information, and market power to divert their credit demands to nonbank credit markets—either to financial institutions not controlled under the plan or directly to money and capital markets.

It is conceivable that bank borrowers who qualify for priority-use status could receive even less credit as a result of credit allocation. As nonfavored borrowers are diverted from banks to the open market, the pressures of increasing credit demand and rising interest rates could lessen the availability of bank funds for priority users to the extent that banks find it more difficult to bid for funds in the marketplace. In addition, the ability of large firms to divert their demand to nonbank markets raises a serious issue of equity because smaller firms would not have equal access to nonbank credit sources.

Both the fungibility and diversion-of-demand arguments suggest the need either for controls on all financial institutions and money and capital instruments or for application of credit allocation directly to borrowers instead of lenders. Each of these alternatives would involve severe administrative difficulties.

Banking risks and profits

Credit allocation could lead to serious problems for the stability of commercial banking. Mandating particular dollar amounts or percentages of a bank's total assets to specific types of loans or investments would change two crucial banking factors—risks and profits. In the absence of such constraints commercial banks undoubtedly would not choose the combinations of risks and profit targets implied by allocation.[4]

[4]This result would follow both for allocative quotas applied to loan categories and for supplementary asset reserve requirements and reserve credits. Asset reserve requirements would lower marginal returns on some categories of loans, while reserves credits would raise marginal returns on other types of loans. These changes in effective loan proceeds would alter a bank's risk-profits choices.

Credit allocation would be expected to reduce the profitability of banking and have deleterious effects on the competitive position of banks vis-a-vis other institutions. Furthermore, riskiness of banking institutions would increase to the extent that categories of credit favored by allocation carried higher default risks than disfavored categories. Banking risks would be increased even more by alloca-

Precedents and proposals

• ***February 1965***—The Voluntary Foreign Credit Restraint Program, administered by the Federal Reserve, placed ceilings on the amounts of overseas credit flows from U.S. banks and other financial institutions. The program was in effect until January 31, 1974.

• ***September 1966***—As a short-lived attempt to influence the allocation of domestic bank credit, the Federal Reserve System sent a letter to member banks cautioning them against the creation of adverse credit market conditions through liquidation of municipal securities and informing them that discount rate administration would be informally linked to borrowing banks' attempts to restrain the growth of business loans.

• ***December 1969***—Congress passed the Credit Control Act of 1969 giving the President broad powers to authorize the Federal Reserve to "regulate and control any and all extensions of credit." This authority, aimed at "preventing and controlling inflation generated by the extension of credit in excess volume," has not been used.

• ***April 1973***—The Committee on Interest and Dividends—part of the wage-price control program—published guidelines calling for a "dual" prime rate system, consisting of a "large-borrower" and a "small-borrower" rate. These guidelines requested that banks hold down the "small-borrower" prime and mortgage and consumer loan rates and, at the same time, that banks "meet legitimate credit needs of home buyers, consumers, small businesses and farmers." This clause, coupled with a provision to monitor bank lending through periodic reports, was a prime example of "voluntary" credit allocation.

• ***September 1974***—A set of lending guidelines drafted by the Federal Advisory Council (a Federal Reserve committee composed of one leading banker from each of the 12 Federal Reserve districts) was sent to all member banks. These guidelines were designed to promote some types of bank lending (e.g., mortgage loans) and to discourage others (e.g., loans for speculative purposes).

• ***October 1974***—The Joint Economic Committee of Congress surveyed 300 large banks to check their compliance with the Federal Advisory Council guidelines. The majority of banks did not respond fully due to data retrieval problems.

• ***January 1975***—The Federal Reserve mailed its own "Survey of Bank Responses to Federal Advisory Council Statement on Lending Policies" to 125 large commercial banks. Basically, the results of this survey showed compliance with the Council guidelines (see *Federal Reserve Bulletin*, March 1975).

• ***January 1975***—Representative Henry Reuss of Wisconsin—since elected chairman of the House Committee on Banking, Currention if it led bank managements to attempt to recoup reduced profits by "reaching for yield"—making loans with higher profit margins but also higher default risks. One outcome of these higher risks could be an increase in the number of bank failures.

If credit allocation were applied only to those banks belonging to the Federal Reserve System, the rate of egress of banks from membership would accelerate. A significant number of state-chartered banks have left the membership rolls of the Federal Reserve System in recent years and few newly chartered banks have chosen to join. Effects of credit allocation on member banks' profits and risks would provide new incentives for nonmember status, which in turn could erode the Federal Reserve System's ability to control the money supply.

cy and Housing—introduced a bank credit allocation proposal to establish five "national priority uses of credit." These categories, closely following the Federal Advisory guidelines, were: "(1) essential and productive capital investment, (2) normal operations of established business customers to overcome lack of adequate working capital, (3) low- and middle-income housing, (4) small business and agriculture, and (5) state and local government." The bill also called for channeling bank credit away from "inflationary uses," including: "(1) purely financial activities, (2) loans for speculative purposes, and (3) loans to foreigners or for foreign activities which divert funds from United States customers." The proposal gave the Federal Reserve Board authority to impose supplementary asset reserve requirements and reserve credits on various categories of member bank credit and to administer the allocation scheme using the services of other federal and state agencies.

- ***February 1975***—The Reuss bill was redrafted to separate its credit allocation proposals from provisions dealing with Federal Reserve control of the money supply. This redrawn proposal, while listing the same "priority uses of credit" as the earlier bill and allowing for supplementary asset reserve requirements and reserve credits, delegated to the President the task of enumerating "inflationary uses." The new version also permitted the President to establish a "voluntary affirmative action program" to include monthly bank reporting on credit outlays.
- ***May 1975***—Following opposition to the Reuss bill in its revised form, a new bill cited as the "Credit Uses Reporting Act of 1975" was introduced. This bill called upon the Federal Reserve System to administer a bank reporting system for eight categories of "national priority uses" of credit—the five priority areas listed in earlier Reuss bills plus three categories dealing with consumer credit, foreign transactions, and "other uses essential to the orderly functioning of markets for goods, services and financial assets." While not setting forth a mandatory program of credit allocation, the new bill called on banks to give "special attention to requests for credit of the kinds enumerated." However, the bill was subsequently rewritten so as to delete all references to voluntary credit allocation and "national priority uses," while adding a ninth credit category—"all other extensions of credit"—to the list for bank reporting.
- ***June 1975***—The Credit Uses Reporting Act failed to pass the House. Proponents tended to view the bill as simply a bank reporting procedure with no credit allocation implications. Critics contended that the proposed credit reporting would be a first step towards a system of credit allocation.

Implementation and administration

Probably the strongest case against credit allocation plans arises from the fundamental problems of implementing and administering these plans. Which financial intermediaries should be subjected to allocative controls? Fungibility of funds, divertibility of credit demand, and bank risk/profits effects indicate that credit allocation could not be limited to commercial banks and still be effective and equitable.

Which categories of loans should receive favored treatment? The fewer loan categories receiving favored status, the less administrative difficulty involved. In addition, the fewer the number of priority categories, the greater the pool of funds that could be directed to these loans from nonpriority uses. In practice, however, the number of priority uses probably would proliferate and, as a result, so would the administrative difficulties. Nonpriority uses also would need to be defined and translated into specific criteria. But no classification system could avoid all exceptions and case-by-case decisions.

What should be the specific requirements in terms of dollar volumes of credit in each favored and disfavored category for each type of financial institution? In the case of supplementary reserve requirements and reserve credits, what should be the percentage criteria? Should they be graduated by dollar volumes of lending in particular categories? Presumably, the requirements would be changed during periods of credit ease, and conceivably, the favored vs. disfavored status of some loans could be reversed over the business cycle. Quantifying allocative requirements and varying them over the cycle would involve some of the thorniest problems.

Administration would entail costly and time-consuming surveillance, including detailed reporting by lending institutions. Under a supplementary reserve requirement and reserve credit scheme, required reserve holdings against assets (to the extent that reserve credits did not provide an offset), as well as those required against deposits, would become important to the conduct of monetary policy. Data on volumes of supplementary reserves would need to be collected on a weekly and maybe even daily basis, as is presently the practice for demand deposits.

The alternatives

The many drawbacks to credit allocation are not an adequate answer to the critics who look at recurring dislocations in some sectors of the economy and say, "Something has to be done." The main question then becomes, what are the alternatives to credit allocation programs? This is a fair question, and the answer depends upon the proper role perceived for government in credit and resource markets. Alternatives include measures which apply to (1) borrowers, (2) financial institutions, and (3) debt instruments.

While most allocative proposals are aimed at influencing the allocation of real resources through credit markets, a superior alternative would be for government to take direct fiscal action, subsidizing those sectors of the economy to which real resources are to flow and taxing those sectors where reductions in resource expenditure are deemed socially desirable. The direct subsidy approach is to be preferred because of its greater efficacy and its direct bearing on specific, well-defined targets and because it makes the element of subsidy explicit in all governmental efforts to reallocate resources.

Another method is to subsidize socially desirable resource usage indirectly through existing techniques of regulation and intervention in credit markets. This alternative includes modification of existing characteristics of debt instruments and financial institutions. Many selective credit controls that do not qualify as credit allocation, but which exert some influence on financial institutions' asset and liability choices, presently exist. Among others, these include: (1) interest rate regulations and usury ceilings, (2) federal deposit insurance, (3) federal tax exemption of interest on state and local government debt, and (4) FHA and VA mortgage guarantees.

Presently, several specialized governmental and quasi-governmental agencies are vital to promoting stability and growth in housing markets—Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and others. The Federal Home Loan Bank Board in recent years has increased its role in aiding mortgage lenders through its loans to member savings and loan associations. Many agencies specialize in meeting the needs of other credit users—agriculture, small business, and others. The role of these agencies should be fostered as at least a short-run alternative to credit allocation.

Over a longer term, consideration should be given to recommendations for making financial institutions more competitively viable and more responsive to specialized sectoral needs. Revamping financial industries in the United States along these lines would call for broadening the arrays of assets and liabilities that banks and other financial institutions are permitted to hold and removing interest rate ceilings on deposits at banks and savings and loan associations. It also would suggest giving close scrutiny to innovations in debt instruments—e.g., variable-rate mortgages. Rather than being mere technological possibilities, major financial innovations in the direction of a "checkless" society are under way. Such innovations should be shaped with a view toward overcoming competitive imbalances among financial firms and cyclical problems in the distribution of credit.

Summary and conclusions

Restrictive monetary conditions and rising interest rates from time to time have led to serious debt financing problems in some sectors of the economy. These sectoral dislocations have prompted discussions of credit allocation plans which operate on the lending side of commercial banks' balance sheets. It is alleged that these plans would alleviate discriminatory sectoral effects while strengthening the overall effectiveness of restrictive monetary policy. However, upon close examination of the reasons behind credit allocation proposals, the burdens imposed on banks and other lenders under these plans and inevitable administrative difficulties become apparent.

Alternatives to credit allocation that would better achieve their intended purposes, while avoiding some of their difficulties, include both short- and long-term measures. Short-run alternatives involve reexamination of subsidies and regulations affecting credit markets and credit purchases and increased reliance on federally sponsored secondary markets for alleviating sectoral problems. Long-run measures involve reorganization of the institutional and regulatory framework of the financial services industry and experimentation with new characteristics for some debt instruments.

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