

Research Department  
Federal Reserve  
Bank of  
San Francisco

H.R.

April 19, 1974

## In Two-digit Territory

The current turmoil in financial markets suggests that an era of two-digit inflation is bringing an era of two-digit interest rates in its wake. During the incipient downturn of late 1973 and early 1974, short-term rates fell at least 1½ percentage points below last summer's highs, and long-term rates fell ½ percentage point or more below their earlier peaks. But during the recent turnaround, short-term rates have made up most of their earlier declines—the prime business-loan rate in some cases has exceeded its earlier 10-percent peak—while most long-term rates have risen to new record levels.

These developments, temporary as they may be, have caught many market participants flatfooted, and have led to serious problems for bond dealers who found themselves overloaded with inventories of suddenly cheapened securities. In the area of short-term business financing, this situation has forced a reassessment of the generally accepted view that the prime rate would continue downward to the neighborhood of 8 percent by midyear.

Part of the explanation for the sudden shift can be found in the growing belief that the nation will soon snap out of its first-quarter slump but not out of its inflation fever. (Preliminary first-quarter estimates indicate that real GNP declined at a 5-percent annual rate and that the general price level rose at a 10-percent rate during that period.) Part

of the explanation can be found also in the market's reaction to the maintenance of a firm anti-inflation policy stance, inferred from Chairman Arthur Burns' recent statement that the Federal Reserve is "determined to follow a course of monetary policy that will permit only moderate growth of money and credit." But much of the shift can be attributed simply to the soaring costs of doing business in an inflation-wracked atmosphere. A look at the bank-lending scene will indicate the magnitude of the problem.

### Record of 1973-74

Corporations this year have substantially increased their long-term financing, but even more significantly, they have matched the unbelievably high early-1973 level of short-term financing at the banks and in the commercial-paper market. Still, the parallel with early 1973 is not exact; the structure of short-term credit flows has differed between the two periods, largely because of the absence of the constraint on the prime rate formerly exercised by the Committee on Interest and Dividends. Early last year, with the prime rate held back from advancing in tandem with the commercial-paper rate, business borrowers turned increasingly to bank lines as a cheaper source of credit, and the outstanding volume of more costly commercial paper declined sharply.

Pressures on the banks continued in 1973 until the CID developed its

# Research Department Federal Reserve Bank of San Francisco

Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, nor of the Board of Governors of the Federal Reserve System.

two-tier system, permitting rates on large business loans to move in line with market rates. But as long as such pressures continued, banks were forced to bid for needed loan funds at high marginal rates, especially in the market for large-denomination CD's.

In late 1973 and early 1974, practically all of the increase in short-term financing was in the paper market, as the paper rate fell more precipitously than the bank prime rate. The gain was concentrated in dealer-placed paper, such as that issued by commercial and industrial firms; the directly-placed paper issued by large finance companies lagged because of the weakness in the auto and other consumer markets financed by such paper.

In March, however, bank business loans rose even more steeply than in the preceding March, while some commercial paper ran off, because of the resumption of the early-1973 pattern of fast-rising market rates and a lagging prime. Reflecting this March upsurge, business loans rose at a 23-percent annual rate (seasonally adjusted) for the January-March quarter—over four times the preceding quarter's increase. (Once again, heavy credit demand forced banks to bid aggressively for CD money, so that rates on these deposit instruments jumped about 2 percentage points above their February lows.) The situation was saved for the banks only by a definite slowdown in real-estate and

consumer borrowing, because of the slowdown in the housing and auto industries.

### **Parallel with 1973**

One common thread runs through the pattern of early 1973 and early 1974. Then as now, the rate upsurge was triggered primarily by the growing realization in the market that inflation pressures were even stronger than anticipated. And then as now, aggregate demand was stronger than expected, and many observers concluded that the monetary authorities would soon restrain the fast-growing money supply. Some of these factors are again at work, especially in view of increased price pressures and the likelihood that these pressures will continue as the price-control mechanism is dismantled.

In addition, with market rates again soaring, thrift institutions are worried about a resumed outflow of savings funds, which could knock the expected housing recovery in the head. The danger of another bout of disintermediation can be seen in the recent upsurge in individual purchases of Treasury bills, since this market is a frequent refuge for funds withdrawn from thrift institutions.

In the last several months, the volume of noncompetitive awards—the amount of bills awarded at the average price for accepted competitive bids—exceeded 1973 levels and approached the peak levels of early 1970, even though

investors must now put up a \$10,000 minimum instead of a \$1,000 minimum as before. This phenomenon is likely to continue as long as the three-month Treasury-bill rate remains in the neighborhood of 8 to 8½ percent—far in excess of the 6½ percent offered by the thrifts on one-year savings certificates.

#### **Soaring inventory costs**

Despite a still-sluggish economy, inventory levels continue to rise as businessmen react to materials shortages and rapidly rising costs. Thus, business-loan demand has soared, reflecting business borrowing to finance speculative holdings of inventories as a hedge against inflationary price increases. (For some firms, however, the speedy turnover of inventories has eased their liquidity position and reduced the need for substantial inventory financing.) Also, corporate longer-term borrowing—including bank term loans—has risen to record levels as a means of financing a plant-equipment spending boom. In addition, the expected continuation of strong price pressures has led many borrowers to ignore current high levels of interest rates in their financing plans.

Some easing of borrowing pressures could occur if the recent break in commodity prices continues, relieving the pressure on business to carry ever more costly inventories. Although wholesale prices rose at a 25-percent annual rate during the first quarter, the bubble seemed about to burst in at least several

major categories. In early April, commodities such as wheat, cotton, hogs and steers were anywhere between 15 and 35 percent below their early-1974 peaks. On the other hand, copper-scrap prices were up 50 percent since the outset of the year, while steel scrap was 80 percent higher in price.

However, the banks' task can be complicated by the recent turmoil in the bond market. That market has been suffering not only from a surfeit of new corporate issues, but also to some extent from the banks' action in lending funds to business borrowers rather than investing them in Treasury and agency securities. Sharp rate increases and investor apathy have made it impossible for underwriters to sell new corporate issues without sharp price cuts, thus pushing up the yields required to move future offerings.

Some borrowers have reacted by postponing planned security offerings. If this situation continues, corporations may be unable to pay down short-term bank debt from the proceeds of new bond issues, and instead, may seek further bank loans as a substitute for the funds that otherwise would have been raised by bond financing. Also, any delay in obtaining funds from the capital market would leave corporations short of funds to invest in CD's, just at a time when banks are likely to be turning to the CD market for funds to meet increased bank-loan demand.

**William Burke**