CREDIT DEMAND LUSTY IN 1957

THE money and capital markets have remained relatively tight so far this year even though the rate of growth in over-all business activity has slowed down. This situation appears to present something of a paradox, since it might seem reasonable to conclude that a slowing down in the rate of growth of business activity would probably be accompanied by some easing in credit conditions as well. Some light on this seeming paradox is cast by the more detailed examination which this article undertakes.

The relatively small amount of borrowing in total consumer and mortgage credit categories and in other types of bank loans has been rather widely discussed and publicized. Perhaps not quite so generally realized is the fact that the demand for funds by the United States Treasury and the raising of new capital by corporations and state and local governments have been of unusually large size, particularly in the first quarter. Owing entirely to the demand in these latter two categories, the total amount of loans in the first quarter in all five of the categories named was approximately $1.7 billion larger this year than last.

Although the total demand seemed to moderate in the second quarter as a whole, both the money and capital markets remained under pressure and interest rates in both markets rose rather sharply in the second half of May and early June. The rise in short-term rates reflected in part the effect of the Treasury's having to raise $1.5 billion in new cash late in May. Market reports indicated that long-term rates on both Federal and other types of securities rose primarily from pressure originating in the corporate and municipal securities market. Although the volume of new issues sold in April and May was below the level of the first quarter, the prospects of continued large demand in the capital market have contributed to the recent increases in rates.

A brief review of each of the principal types of demand for funds will provide a better understanding of the particular factors that have been responsible for the large over-all demand that has existed this year.

Treasury and Capital Market Borrowings Up

Treasury's first-quarter requirements unusually large

Because of the concentration of tax receipts in the first quarter of the calendar year, the Treasury typically is able to reduce its outstanding debt considerably from the peak that develops toward the end of the fourth quarter each year. Largely as a consequence of a rather rapid rise in defense expenditures in the early months of this year, the Treasury was able to reduce its gross debt outstanding by only $1.6 billion during the first quarter, in contrast with a decrease of $4.5 billion in the corresponding period of 1956. In other words, this year holders of Government securities received $2.9 billion less in cash from redemptions, thereby limiting the funds which they had available from this source for new investment. In addition, there were changes in the composition of debt ownership, resulting from the cashing in of Savings Bonds, the demands for dollar exchange of the International Monetary Fund, and the demand for cash by holders of maturing securities which forced the Treasury to raise additional funds in the short-term money market. In both relative and absolute terms this was a large change from last year.

Funds raised in capital market set first-quarter record

The $5.2 billion of new capital raised through the sale of securities of corporations and of state and local governments during the first three months of this year was the largest quarterly volume on record and $1.5 billion larger than a year ago. Corporate securities accounted for $3.5 billion of the total, which was an all-time quarterly high and two-thirds more than in the corresponding period of 1956. This record volume no doubt reflects the higher level of expenditures this year upon plant and equipment,

which typically require considerable financing through the capital market. Such expenditures were estimated to be at a record high of nearly $37 billion (seasonally adjusted annual rate) in the first quarter of this year, which is $4 billion larger than in the corresponding period a year ago.

Manufacturing companies accounted for over one-third of all corporate offerings in the first quarter, and their volume of $1.3 billion was twice that of a year ago. Nearly all groups of manufacturing industries shared in this marked increase in security sales, with the primary metals and the petroleum and petroleum refining groups having the largest percentage increases. The textile industry was the only group in the manufacturing sector that had a significant decline in security sales from a year ago.

Electric, gas, and water utilities accounted for nearly another third of the corporate security sales in the first quarter, with a total volume of $1 billion. Communication companies were third in importance with net proceeds amounting to $432 million.

The financial and real estate category was the only major industrial group which had a decline in security sales from the first quarter of a year ago, with most of the decrease reflecting smaller offerings by sales and consumer finance companies. Their smaller need for funds this year stems from the first-quarter decline of $45 million in their outstanding instalment credit compared with an increase of $166 million last year. A lower level of residential construction this year has no doubt contributed to the smaller demand for capital funds by real estate firms.

The $1.7 billion of municipal securities sold in the first quarter of this year was $260 million more than a year ago and the largest amount since the fourth quarter of 1955. These sales reflect the continuing growth in state and local spending as the public need for community facilities of all types expands. The need for schools, highways, sanitary facilities, and many other types of public construction is so pressing that there is little opposition to proceeding with such programs. This is affirmed by the voter approval of $2.6 billion in municipal issues throughout the nation last November, the largest amount on record for a general election. These facts indicate that municipal securities are likely to be offered in substantial volume for many months to come.

Other Demands for Funds Less This Year

All the other major categories of demand for funds as indicated by the volume of loans showed reductions in the first quarter from a year ago, but the declines only partly offset the $4.4 billion increase arising from the Treasury's needs and the sales of corporate and municipal securities.

Slower growth in mortgage loans

Total real estate mortgages outstanding increased $2.6 billion during the first quarter, which was substantially less than the growth in the same quarter in 1955 or 1956 and $750 million below the increase during the fourth quarter of last year. The trend in housing starts on a seasonally adjusted basis has been generally downward since the spring of 1955, although there has been some increase since March 1957. Because of the important role played by FHA and VA loans with their fixed contractual interest rates, the mortgage market has been somewhat more adversely affected by the change in credit conditions than have those security and loan markets in which interest rates may respond more readily to changing demand and supply conditions.

Greater decline in consumer credit outstanding

Total consumer credit outstanding typically declines in the early part of the year as charge accounts are reduced from their Christmas season peak, and some reduction in that portion of consumer credit used to finance instalment purchases often occurs as well. Total consumer credit outstanding dropped $1.4 billion in the first quarter of this year compared with $900 million a year ago. Contributing to the drop this year was a decline of $300 million in instalment credit in contrast to an increase of $100 million last year. Part of this latter difference was attributable to a somewhat smaller proportion of credit sales to total sales of automobiles this year. While total extensions of consumer instalment credit were high in the first quarter of this year, repayments were also high as a consequence of

the large increases in consumer credit during the last two or more years.

Bank loans decline during first quarter

Bank loans, excluding real estate and consumer loans which were included in those broad categories already discussed, declined $600 million in the first quarter of this year compared with an increase of $700 million a year ago. Most of the difference between the two periods was accounted for by commercial and industrial loans. Their increase of $1.3 billion in the first quarter of last year was exceptionally large and exceeded the growth in the corresponding period of this year by $900 million. Commercial and industrial loans frequently decline in the first quarter of the year, and consequently the $400 million increase during that period this year reflected a substantial demand for business loans even though it was much smaller than the unusually large increase of last year. The first-quarter increase in business loans was more than offset, however, by declines of $700 million in bank loans for purchasing or carrying securities and $400 million in miscellaneous loans.

One of the important uses of bank loans to business is to finance inventories. Businessmen increased their investment in inventories (after adjustment of book values to reflect changes in physical inventories) by $4 billion in the first quarter of 1956, and a significant proportion of the large increase in bank business loans during that period was probably used to finance those larger inventories. In the first quarter of this year, by contrast, investment in inventories declined by $1.2 billion, which was no doubt partly responsible for the much smaller expansion in business loans.

Owing to seasonal factors affecting their operations, food processors, commodity dealers, and wholesale and retail firms typically reduce their outstanding loans at banks in the first quarter of the year. The drop of $679 million in their loans this year at a sample of banks which regularly report larger loans by industry was more than three times as large as a year ago, but roughly only 20 percent larger than in the same period of the three years preceding 1956. Sales finance companies increased their borrowing from banks during the first quarter of this year compared with a decrease a year ago. However, they raised considerably less new capital through security sales this year than in 1956. But the combined total of their new funds raised through security sales and bank loans was larger this year than last, even though their holdings of instalment loans declined slightly in the first quarter of this year compared with a small increase a year ago. All other groups of classified borrowers, except the construction industry, increased their bank borrowing during the first quarter of this year, but by smaller amounts than in 1956.

Second-Quarter Credit Demands Smaller Than in 1956

Although the total demand for funds continued to be large in April and May, it diminished somewhat and reflected, in part at least, the leveling off in business activity that has occurred. Nevertheless, the volume of demand for long-term funds in the first five months of this year, relative to the supply, was so large that it tended to build up a cumulative pressure in the capital market. In particular, the Treasury's need to raise cash by the sale of a new issue in late May created pressure in the money market. Consequently, both short- and long-term rates rose rather sharply in the last half of May and the early part of June.

The Treasury's financial needs

In contrast with the experience in the first quarter, the Treasury's demand for funds in April and May was smaller than it had been a year ago. During those two months the total gross debt of the Treasury increased $400 million in 1956 and $200 million this year. If special issues held by Government investment accounts are excluded, then the demand was $300 million less this year, which means that the demand on the money market was smaller by that amount this year.

This view of the matter does not, however, highlight the truly significant difference in the Treasury's position this year and last during the period from late March through May. The much higher rate of redemption of Savings Bonds this year compared with last, coupled with a rather

rapid rise in defense expenditures so far this year, has required the Treasury to resort more often to the sale of public marketable issues to maintain its cash balance. During March, April, and May last year the Treasury did not have to sell marketable issues to raise new cash. This year the situation has been quite different. Late in March $3.4 billion of new issues were sold for cash, and $1.5 billion more were sold in late May.[1] Moreover, on the refunding of more than $4 billion of issues in the early part of May, the holders of more than a fourth of the total demanded cash, which was an extremely high attrition rate. These factors forced the Treasury to make sales of marketable securities to raise new cash and placed much more pressure on the money market than occurred a year ago, even though the over-all debt position of the Treasury resulted in a somewhat curtailed need for funds compared with April and May of last year.

Smaller increase in consumer instalment credit and bank loans

The $259 million increase in consumer instalment credit during April (latest data available) was less than that in the same month of 1955 and 1956. It was, however, $219 million larger than the increase in March of this year. The growth from March to April was concentrated in automobile paper and personal loans. Total consumer credit increased $512 million during April, which was the first monthly gain this year and was $51 million larger than the growth in April last year. However, the greater growth this year was concentrated in charge accounts and no doubt reflects the fact that Easter came on April 1 last year and April 21 this year.

Bank loans and sales of corporate and municipal securities in April and May behaved in a manner similar to that in the first quarter, that is, the growth in bank loans was less and the sale of securities was greater than in the corresponding period of 1956. The $300 million expansion in total loans of commercial banks during April was only half as large as the increase a year ago. In the four weeks ending May 29, total loans of weekly reporting member banks dropped $698 million compared with a decline of $53 million in the corresponding period of 1956. Business loans accounted for roughly half the decline in May of this year and loans on securities contributed most of the remainder. The $369 million decline in business loans was about $100 million larger than a year ago, and loans on securities increased last year. During April and May the growth in bank loans to wholesale and retail concerns, construction firms, metal and metal products producers, public utility and transportation firms, and sales finance companies was considerably less than a year ago, while petroleum, coal, and chemical producers borrowed substantially more.

Second-quarter security sales estimated to be below first-quarter volume

The volume of corporate securities sold in April and May to raise new capital was considerably below the $3.5 billion first-quarter level, which is the largest quarter on record. However, it is estimated that sales in June will rise substantially to $1.4 billion and produce a quarterly total of $3.1 billion, which exceeds the sales in any quarter of 1955 and 1956. Municipal security sales reached their peak so far this year in April when $750 million were sold. Although estimated sales of $425 million in June will be the lowest monthly volume in the first half of the year, if realized they will bring a quarterly total nearly as large as the $1,750 million sold in the first quarter of this year, which was the largest volume since the last quarter of 1955.

If the estimates for corporate and municipal security sales in June are realized, then the demand for funds from the capital market in the second quarter will total $4.8 billion, which is $400 million less than in the first quarter but $400 million more than in the second quarter of 1956.

Data for total real estate mortgages outstanding are available only quarterly, but it is a certainty that the growth in the second quarter of this year will be less than a year ago and may be less than the $2.6 billion increase in the first quarter of this year. Changes in the volume of mortgages outstanding tend to lag behind changes in housing starts. Housing starts in the first four months of this year were significantly

[1] Furthermore, as this article goes to press, the Treasury has just announced a new issue of $3 billion of Tax Anticipation Bills to be sold at the end of June.

below the level of the closing months of 1956. Therefore, it is likely that the volume of mortgages outstanding will grow more slowly in the second than in the first quarter of this year.

This brief review indicates that the over-all demand for funds, although larger in the first quarter of this year than in the same period last year, was probably somewhat smaller in the second quarter of 1957 than in the second quarter of 1956.

Yields on short- and long-term securities have risen sharply

Market reports indicate that the pressure of corporate and municipal security offerings upon the supply of funds became particularly noticeable beginning with the second half of May. Consequently, yields rose rather sharply during that period. These developments also spread to the market for long-term Government securities. In addition, the Treasury's need for funds late in May contributed significantly to pressures in the short-term money market. The market yield on 90-day Treasury bills rose above 3.25 percent in late May and early June, whereas it had been below 3 percent in the first half of May. The new issue of Treasury bills dated June 6 carried a rate of 3.374 percent, the highest since the banking holiday period of 1933. The rate on the succeeding issue dropped to 3.256 percent, then jumped to 3.404 percent the following week. The yield on Government securities in the 3-5 year bracket was about 3.64 percent in early June compared with about 3.5 percent in the first half of May.

Reserve position of banks tighter in second quarter

Owing to the effect of seasonal factors, the reserve position of banks was easier in the first than in the second quarter of this year. The return flow of currency after the holiday season typically adds to bank reserves in the early part of each year. Required reserves also generally decline as deposits drop off following the year-end peak. The Federal Reserve System usually attempts to offset a considerable part of the effect of these seasonal factors through sale of securities in the open market so that the reserve position of banks will not be unduly easy in that one portion of the year. The offsetting effects this year, particularly in January, were less than a year ago, largely because the return flow of currency and the decline in deposits was greater than had been anticipated. Member banks had free reserves in January, that is, their excess reserves were larger than their borrowings from Federal Reserve Banks. In February, the reserve position shifted to one of net borrowed reserves, which means that member bank borrowing exceeded excess reserves, thereby restoring the type of reserve situation that had prevailed since August 1955. Net borrowed reserves increased further in March.

The various pressures in the money and capital markets kept the reserve position of member banks fairly tight during April, May, and early June. During this period member bank borrowing from Federal Reserve Banks exceeded the excess reserves of member banks by amounts ranging from a high of about $700 million on a weekly average basis to a low of about $300 million, with the average for the entire period lying a little below the $500 million level. The Federal Reserve System confined its open market operations during this period to relatively small amounts, sometimes adding to reserves and sometimes diminishing them in an effort to stabilize bank reserves without otherwise influencing money markets.

In summary, the magnitude of the demand for funds so far this year seems to provide more convincing evidence of the continued strength of inflationary pressures than do various other indicators of over-all economic activity, such as trends in employment and industrial production. Moreover, the diminished demand for bank loans, real estate mortgages, and consumer credit may have tended to divert attention from the increased needs of the Treasury and the larger sales of corporate and municipal securities. Although the total demand for funds was somewhat smaller in April and May than it had been during the first quarter, there was increased pressure upon the available supply in late May

and early June and interest rates rose sharply as a consequence. The greater evidence of inflationary pressures in the financial markets than in the markets for goods and services suggests that somewhat closer attention than usual to the diverse trends in the financial markets may be rewarding at present in short-range forecasting for the economy.

Commercial Bank Financing of Intermediate-term Farm Investments

ARE intermediate-term loans important to the bankers and the farmers of the Twelfth District? They are, if number of loans is any criterion. Although they are small in average amount, there were over 111,000 of these loans outstanding at Twelfth District banks in mid-1956, and the outstanding balances totalled $213 million.

For the purposes of this article, intermediate-term farm credit may be defined on the basis of the major purpose for which the loan was made. The words "intermediate-term farm credit" suggest a period of time or a maturity period, and we might also define the term as including all farm credit with a maturity period in excess of one year, except credit to purchase farm real estate. Practically all of the farm credit extended by commercial banks in the intermediate maturity zone (approximately one to five years maturity) is included, however, in loans made for the following purposes: the purchase of machinery, consumer durables, and livestock (other than feeder livestock), and the improvement of land and buildings. These are the purposes, therefore, used as the criteria for classifying intermediate-term farm credit in this article.

The common denominator of such loans is that the items purchased have a useful life of several years. Indeed, one of the problems associated with the financing of intermediate-term investments is that of permitting the borrower a repayment period that is related to the useful life of the investment. Loans made for the purchase of machinery or consumer durables are undoubtedly familiar ideas to the readers of this article, and because the useful life of these items extends over a period of several years, they fall within the intermediate-term time period. Loans to finance the purchase of livestock such as milch cows, pigs, sheep, chickens, and all animals or insects which the farmer may need money to purchase to grow for a profit, with the single exception of "feeder" livestock, are also classified as intermediate term, because their useful life also extends over a period of several years.

Feeder livestock, on the other hand, are those animals bought up by certain farmers in quantity and fed grain for three to four months or longer until they are "finished," that is, grown and fattened to the point where, when slaughtered, they will make acceptable steaks and roasts for the table of the meat-eating consumer. Feeder livestock loans are not included in the intermediate-term category because of their generally short maturities.

Land can be "improved" by grading and contouring in preparation for irrigation—a process which may cost several times the price of the unimproved land. It may also need clearing of trees, rocks, or brush; sub-soiling, which sometimes involves plowing with special equipment to a depth of six feet or more; and, more rarely, reclamation from the sea or tidal flats, construction of access roads, etc. It is generally considered proper that such loans should be liquidated over a period somewhat longer than "short-term," and yet these loans are of such a nature as not to require the longer-term mortgage financing generally associated with real estate security.

Intermediate-term credit is not a new requirement of the American farmer. Operators of certain types of farms, such as dairy farms, have relied quite heavily on intermediate-term credit. The importance of this type of credit, however, has increased with changes in agricultural production techniques and the pronounced shifts in consumer preference for various agricultural products that have taken place in recent years.