

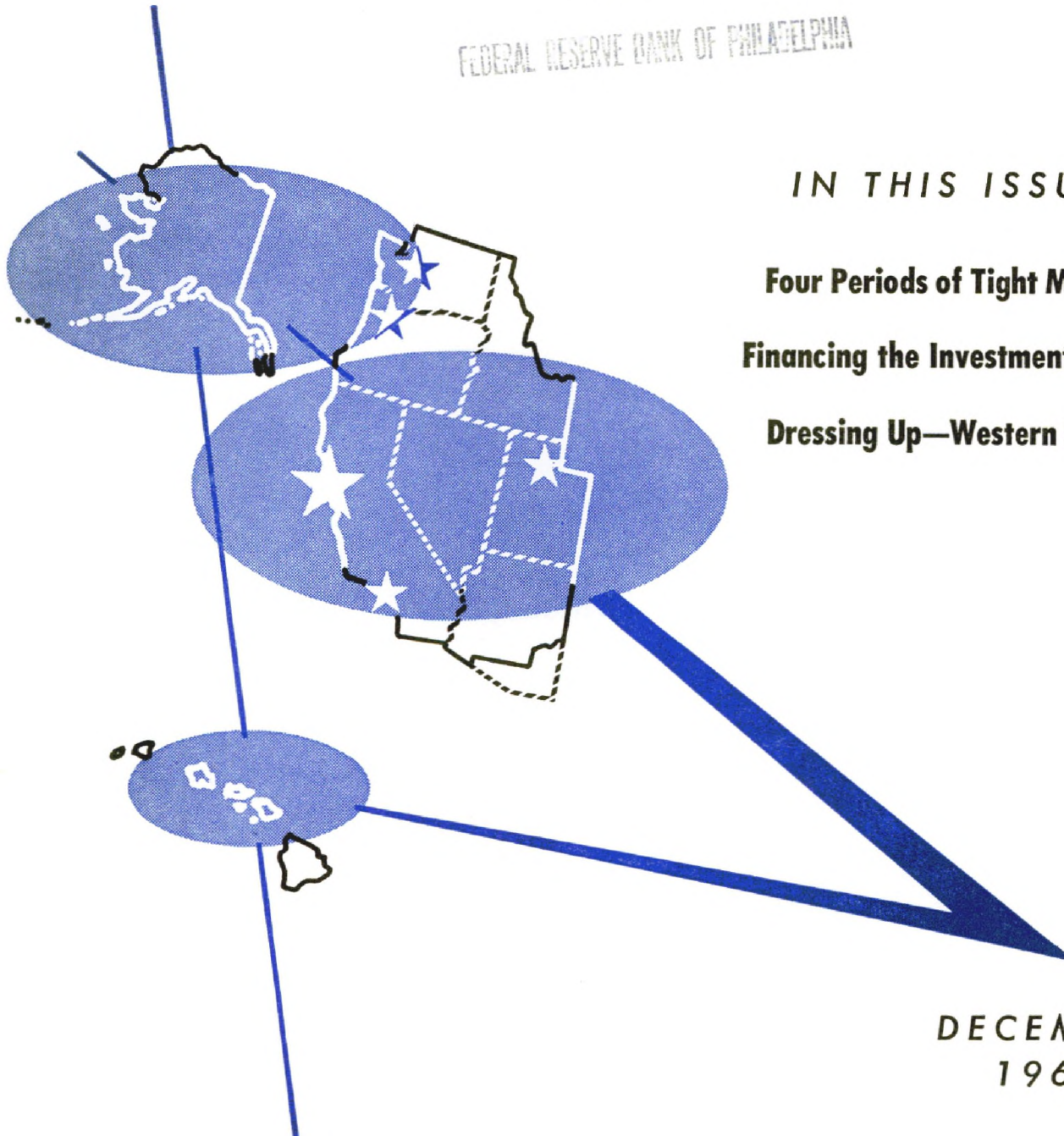
FEDERAL RESERVE BANK OF SAN FRANCISCO

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Editor: William Burke

Four Periods of Tight Money

Money never changes; only the pockets it's in. —Gertrude Stein

THE current period of monetary restraint is the fourth such period since 1952. Despite the uniqueness of each tight-money episode, they have possessed a number of common characteristics—for example, a rising structure of interest rates, with new post-war peaks being reached in every case. Of course, the structure of interest rates is only one among many measures of the restrictiveness of monetary policy, but it does reflect the adjustments which the nation's financial system makes to an over-exuberant economy.

The initial point of impact of a restrictive credit policy is the commercial banking system. In response to pressure upon their reserve positions, the banks adjust the composition of their assets and their liabilities. Typically, banks have sold off securities from their investment portfolios to meet at least part of the demand for loans, putting upward pressure on the yields for the types of securities sold. Typically also, rising interest rates have affected the structure of their liabilities and the yields which they must offer to obtain funds.

In analyzing the four tight-money periods, there must be some agreement as to what constitutes monetary restraint and what determines the period of its duration. Money can be defined as “tight” when demands for credit have grown so much more rapidly than the supply of money-to-lend that the financial system encounters difficulty in providing the desired funds. From the standpoint of commercial banks, money is “tight” when their reserves are threatened with depletion. From the standpoint of monetary policy, money is being “tightened” when the Federal Reserve is not supplying reserves to the banking system at a rate commensurate with the rate of growth in demands for bank credit, although this tightening usually appears some time be-

fore money can be considered “tight” in the sense defined above.

One measure of tight money that has some usefulness is the “net borrowed reserve” position of the member banks of the Federal Reserve System. When their total borrowings are greater than their total excess reserves, they are said to have “net borrowed reserves.” Thus, one definition of a tight-money period is the succession of months in which net borrowed reserves are reported. By this measure, the four periods can be dated July 1952-June 1953, August 1955-December 1957, December 1958-May 1960, and March 1965 to date.

However, this is a qualitative rather than a quantitative definition of tight money, and as such has certain limitations. The degree of monetary restraint may vary considerably over the time when free reserves first become negative and until they become positive again. Further, a given level of net borrowed reserves, say \$300 million, is not necessarily identifiable at all times with a consistent degree of restraint. Net free or net borrowed reserves are a residual item, and the reserve base of the member-banking system—that is, total reserves—could be expanding, unchanged, or contracting at different points in time with the identical net borrowed-reserves figure. Nevertheless, the Federal Reserve System utilizes differing levels of net borrowed reserves as one of a number of short-term policy guides in pursuing a policy of monetary restraint, and the financial community generally interprets a deeper level of net borrowed reserves as a move in the direction of tighter money.

Tightness: money supply

Most financial observers during a tight-money period carefully watch the amount of monetary expansion, as measured either by the extension of bank credit or by the increase

in the money supply. The standard textbook description draws a direct casual relation from an increase in bank loans to an increase in the money supply through an expansion of demand deposits, the major part of the money supply. Generally speaking, any increase in bank assets should be reflected in an increase in the money supply. However, a change in the structure of bank deposit liabilities may have different effects upon the money supply as well as upon money "tightness."

A shift from demand to time deposits decreases the money supply (narrowly defined) but it nonetheless increases the banking system's ability to expand bank credit because of the difference in reserve requirements for the two types of deposits. Member-bank time-deposit reserve requirements are now 4 percent for all savings deposits and for time deposits up to \$5 million, and 6 percent for time deposits in excess of \$5 million; demand-deposit requirements are 16½ percent for city banks and 12 percent for country banks. Every dollar held on deposit with the Federal Reserve Bank will support at least 2½ times as many time deposits as demand deposits.

The ability of commercial banks as a whole to expand their loans during a period of tight money depends importantly upon their success in increasing their time deposits, which increase total bank resources, in contrast to banks' sales of securities. Especially has this been true during the most recent period. To the extent that commercial banks are able to attract and hold time deposits, they may be able to offset some of the pressure exerted on their reserve positions by the Federal Reserve.

Tightness: bank lending

The money supply increased in each of the tight-money periods except 1958-60, but bank credit generally increased at a much faster pace, as did total spending. The faster pace of total spending is traceable, at least in part, to the rise in the rate of turnover of money, while the faster pace of bank credit

expansion is traceable, at least in part, to the concurrent leak of funds from the money supply into bank time deposits.

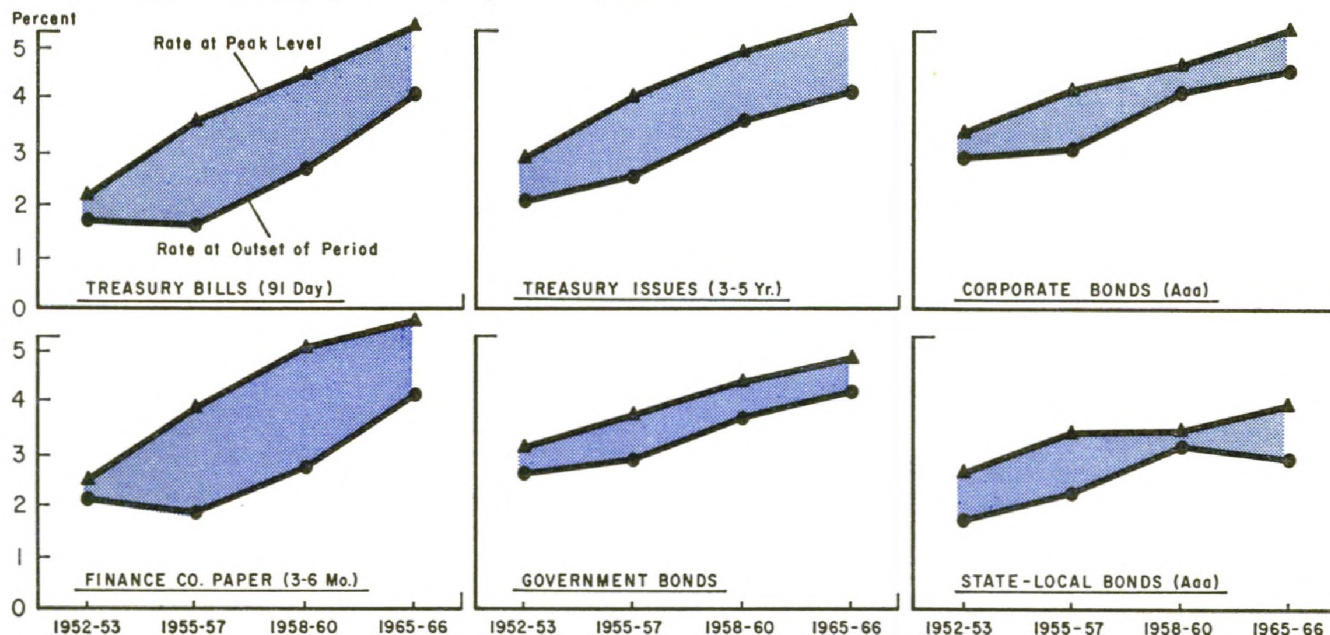
In each tight-money period, while total bank credit was increasing rapidly, the commercial banks shifted the composition of their assets to meet the even greater demand for loans, specifically by selling off U. S. Government securities. However, the commercial banks added to their holdings of other securities (chiefly municipals) in each period except 1958-60. Indeed, in the current period of tight money—except for the last several months—banks acquired more than enough tax-exempt issues to offset their sales of Governments. In 1958-60, the commercial banks made substantial inroads upon their holdings of both Governments and tax-exempt securities to meet loan demands, which increased slightly faster than in 1955-57.

Tightness: interest rates

Interest rates, being quite responsive to changes in money-market pressures of supply and demand, have shown fairly substantial increases in all maturity ranges during these tight-money periods. The rise in rates has not been uniform, however, and short-term and intermediate rates have generally risen much more than long-term rates. Moreover, the highest levels of rates have generally occurred two to six months before the end of each tight-money period. The shift from deep levels of net borrowed reserves to net free reserves may be gradual, as it was in 1960 when net borrowed reserves moved from \$375 million in January to a plus figure in June. In such a situation, less pressure develops on bank reserves and the money markets, and interest rates recede from their peaks, even before the tight-money period comes to an end in terms of zero-level net borrowed reserves.

Long-term rates came under considerable pressure in the 1955-57 period, as average yields on outstanding corporate and municipal issues rose by more than a full percentage

Interest rates reach progressively higher levels in each tight-money period of postwar era



point at their peaks. In the 1958-60 period the pressure was felt most heavily in the short- and intermediate-maturity ranges; market yields on Treasury bonds rose above the 4¼-percent statutory limit on new issues of long-term Governments, and the Treasury thus was forced to conduct its refinancing operations in shorter-term maturities.

In the current period, interest rates in all ranges of the maturity spectrum have exceeded the highs reached in previous postwar periods of monetary restraint. In the third quarter of 1966, new issues in the corporate market were priced to yield well above 5½ percent. The Treasury-bill rate broke through the 5-percent level, and a note and certificate offered in the August-November Treasury refunding carried coupons of 5¼ percent. The offering yield on one Federal Agency issue was 6.25 percent, and others were priced at a 6.20-percent yield. In September and October, on the other hand, interest rates fell back somewhat from the highs reached in August.

The present vigorous and extended boom in business spending for plant and equipment has resulted in a high volume of business bor-

rowing from banks and record flotations of corporate issues in the capital market. In the first half of 1966, these factors helped keep the Treasury-bill rate well below other money-market rates—largely because of the existence of a strong demand for temporary investment of the receipts of corporate and municipal capital-market flotations. The Federal Reserve System was also a large net buyer, purchasing nearly \$900 million of Government securities in the course of its open-market operations during this period.

Tightness: depositary-type savings

Flows of depositary-type savings—including savings and time deposits held at commercial banks, mutual savings banks, and savings-and-loan associations—have played an increasingly important role in tight-money periods. In 1958-60 the increase in total savings-type deposits was rather small in comparison with the gains in the 1955-57 and 1965-66 periods. Moreover, the relative positions of the commercial banks and the S&L's in the savings competition were almost reversed in the two most recent periods. To date in this period, commercial banks have garnered

roughly two-thirds of the total increase in savings-type deposits at all types of savings institutions, and the S&L share has correspondingly declined.

This commercial-bank success has been due mainly to the shift in the interest-rate advantage away from savings-and-loan associations. The gross differential between yields on S&L savings accounts and yields on bank time-and-savings accounts has narrowed considerably over the postwar period, declining from about 1.6 percent to less than 0.5 percent between 1952 and 1965. The one exception to this trend was the 1958-60 period, when the yield differential and the trend of deposit flows worked to the advantage of the S&L's.

In the 1958-60 period, the total reserves of the banking system declined very sharply and the money supply (seasonally adjusted) actually decreased. In that period, moreover, the commercial banks lost out rather badly in the competition for savings. This may well have made the central-bank pressure upon reserves even tighter; to the extent that the commercial banks did not maintain their relative share of the savings flow, they had to make greater inroads upon their security holdings in order to obtain loanable funds.

By contrast, in 1965-66 the commercial banks enjoyed such a large share of the increase in savings that they were able to make substantial net additions to their holdings of tax-exempt securities — substantial enough to more than offset their sales of Governments — even while meeting an exceptionally strong demand for loans. However, the current tight-money period is not yet over, and later developments may be somewhat different.

In the competition for savings, of course, there are other outlets for the short-term investment of funds besides the three major types of savings institutions. If money-market rates rise above the rates offered by the savings institutions, funds may flow away from, or out of, the savings institutions.

This phenomenon occurred, to some extent, in the 1958-60 period, when the market yield on Treasury bills rose to a high of 4.66 percent and finance-company paper earned the investor over 5 percent. Yields on intermediate Treasury issues also rose well above the average interest return on savings-type deposits. (A five-year Treasury note issued in August 1959 with a 5-percent coupon came to be known in the market as the "magic five," for the response that it evoked among individual investors.) This situation was repeated in the third quarter of 1966; in that period, yields on finance-company paper climbed above the 5½-percent ceiling on interest payable on commercial-bank time deposits, and selected U. S. Treasury bonds and Federal Agency issues in the intermediate-maturity range yielded about 6-percent on an investment basis.

The implications for commercial banks and other savings institutions are quite clear. Although commercial banks have been highly successful in the intramural competition for funds among savings institutions in the present tight-money period, this advantage is of

FACTORS AFFECTING THE MONEY SUPPLY

(billions of dollars)

	1952-53	1955-57	1958-60	1965-66
Change in bank credit	+ 3.5	+ 9.7	+ 5.2	+ 35.7
Loans	+ 5.6	+ 16.0	+ 16.7	+ 32.8
U.S. Governments	- 2.3	- 7.4	- 10.8	- 5.0
Other securities	+ 0.2	+ 1.1	- 0.7	+ 7.9
Plus: Change in time deposits	- 3.1	- 8.1	- 2.2	- 26.8
Plus: Change in other net factors	+ 3.0	- 0.5	- 3.6	- 0.4
Equals: Change in money supply	+ 3.6	+ 1.1	- 0.6	+ 8.5

Note: For time-deposit change, minus sign indicates increase. Four periods are dated July 1952 - June 1953, August 1955-December 1957, December 1958-May 1960, and March 1965-September 1966. Source: Board of Governors of the Federal Reserve System.

rather limited value when the yields on money- and capital-market instruments rise above the highest rate that the savings institutions can pay. A slackening in the net inflow of time-and-savings deposits to commercial banks would require that the banks make stronger efforts to sell off securities in order to accommodate the demand for loans. To the extent that the banks must place a greater reliance upon this source of loanable funds, the net expansion of bank credit will be smaller and the money supply will increase at a slower rate.

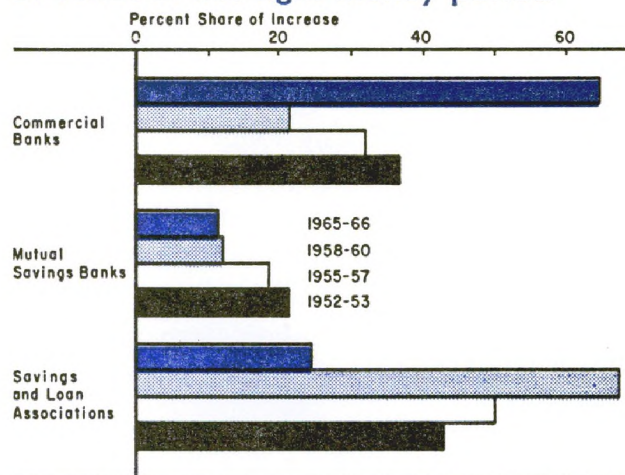
Current period: policy

The present tight-money period may, for the sake of convenience, be divided into three parts. These are most readily defined in terms of policy actions taken by the Federal Reserve System. First, and most significant perhaps, was the change in monetary policy from ease to what might be described as mild restraint. This took place in March 1965, when the member-banking system first began to register net borrowed reserves on a continuing basis. The change was accomplished entirely through the use of open-market operations, as the Federal Reserve supplied reserves to the banking system in lesser amounts than needed to meet the demand for bank credit.

The second phase began in early December 1965, when the discount rate was raised from 4 percent to 4½ percent. Over the next six months monetary policy became progressively more restrictive. During this time, moreover, the commercial banks raised their prime rate three times—from 4½ percent to 5 percent, thence to 5½ percent, and thence to 5¾ percent. (This August, it went to 6 percent.)

The third and latest phase of the current tight-money period covers July through September 1966. In this interval the Federal Reserve took a variety of actions designed to implement and reinforce its policy of monetary

Commercial banks gain lion's share of funds in this tight-money period



restraint. To discourage the dependence of the banking system upon large-denomination negotiable time certificates of deposit, the reserve requirement against time-and-savings deposits of over \$5 million was raised twice, first from 4 percent to 5 percent and then to a maximum of 6 percent in August.

Regulation D was amended to define short-term promissory notes of banks and similar instruments as deposits, thereby requiring a reserve against such instruments, and Regulation Q was amended, first to reduce the maximum interest payable on multiple-maturity time deposits, and then to set a 5-percent ceiling on interest payable on both certificates of deposit and other time deposits of less than \$100,000 issued or received after September 26. At the same time, the Federal Home Loan Bank Board prescribed maximum dividend rates for savings-and-loan associations on passbook accounts and certificate or "bonus" accounts. These actions were taken with a view to ending the competition for funds among savings institutions.

On September 1, the Federal Reserve System circulated a letter to member banks suggesting that a further expansion of loans—and of business loans in particular—at recent rates of increase was likely to lead to an inflationary rate of total spending. It also suggested that

banks should refrain where feasible from liquidating municipal securities and similar types of assets to meet the surging demand for business loans, since this could put upward pressure on interest rates in other credit markets. While offering longer accommodation at the discount window for banks requiring the additional time to make their adjustments through business-loan curtailment, the System reiterated its traditional policy of accommodating seasonal, short-term, and emergency borrowing in the traditional manner.

The Federal Reserve has now used all of its instruments of general monetary control in the present tight-money period. Reserve requirements have been used as a restrictive measure for the first time since 1951. Admittedly, this weapon has been applied only to time deposits—but this is understandable, in view of the large increases in time-and-savings deposits at the commercial banks, where they have become the major source of loanable funds.

The discount rate has been raised only once in this tight-money period, compared with seven increases in the 1955-57 and five increases in the 1958-60 periods. This does not mean that the discount mechanism has played a secondary role in current monetary policy, but rather that less reliance on the level of the discount rate itself has been required.

Open-market operations have continued to represent the major avenue for implementing policy on a day-to-day basis to allow for growth and to cushion the heavier impact of other policy tools. And the control of commercial-bank time-deposit rates through Regulation Q has played an important role.

Current period: tightness

The policy of monetary restraint obviously contributed to the tightness that was evident in the money and capital markets in the third quarter of 1966. However, it would be giving monetary policy too much credit to say that

it bore the sole responsibility for this tightness. The sharp rise in interest rates that took place during that period owed a great deal to various market factors.

On the savings side, commercial-bank time deposits increased at only a 10-percent annual rate in January-September 1966—as against 16 percent in the comparable 1965 period—although the banks continued to gain the largest part of inflows to savings institutions. This slowdown in deposit inflow is attributable in part to a lower rate of saving out of disposable income and in part to the competition from short-term investments; the latter now offer a higher yield than bank time deposits, which are restrained by Regulation Q ceilings.

In spite of a slackening in the growth of bank reserves—down from a 4.7-percent annual growth rate in the first three quarters of 1965 to a 2.6-percent rate in the same period of 1966—business borrowings from commercial banks increased at an annual rate of over 18 percent during this 1966 period and thereby put considerable pressure on the commercial-banking system. The business-loan expansion recently decelerated, especially in September, when the annual growth rate dropped to 4.6 percent.

However, the demands for credit have not been confined to the banks. Corporate offerings in the capital market were more than one-fourth larger in the first nine months of 1966 than in January-September 1965. The capital market flotations of state and local governments rose by nearly 9 percent in the same period.

Thus, a combination of factors—a strong demand for funds pushing against a supply of savings that was not growing apace, along with a monetary policy designed to limit the increase in bank reserves—was responsible for pushing interest rates to such record levels during this most recent tight-money episode.

—Herbert Runyon

Financing the Investment Boom

INVESTMENT by nonfinancial corporations has reached record levels in this sixth straight year of economic expansion. The rising demand for goods and services has stimulated private business to enlarge productive capacity, and this in turn has increased total demand even more. Gross domestic investment in physical assets, at \$118 billion (annual rate) in mid-1966, was up 65 percent since 1961, compared to a 41-percent gain for GNP.

Part of this gain undoubtedly reflected a recovery from the below-normal rate of investment in the pre-1961 period, but most has been due to the recent record performance of the American economy. Corporate financing, moreover, has been even more dynamic. Nonfinancial corporations have almost doubled their capital spending on physical assets—machinery, structure, and inventories—from \$35 billion in 1961 to a \$70-billion rate in the second quarter of 1966. In the last two years especially, corporate investment expenditures have been a major source of new demand for goods and services.

To finance this capital investment program, corporations have had access to a steadily growing flow of funds from retained earnings and capital-consumption allowances (mainly depreciation). In addition, corporations have turned increasingly to external sources in the banking and financial system. These external sources have remained quantitatively less important than the internal flows, but the proportion of external funds to total funds raised has risen from about 20 percent in 1961 to over 30 percent in 1966. And, within the financial markets, this shift in financing has been a major source of new credit demands since the end of 1964.

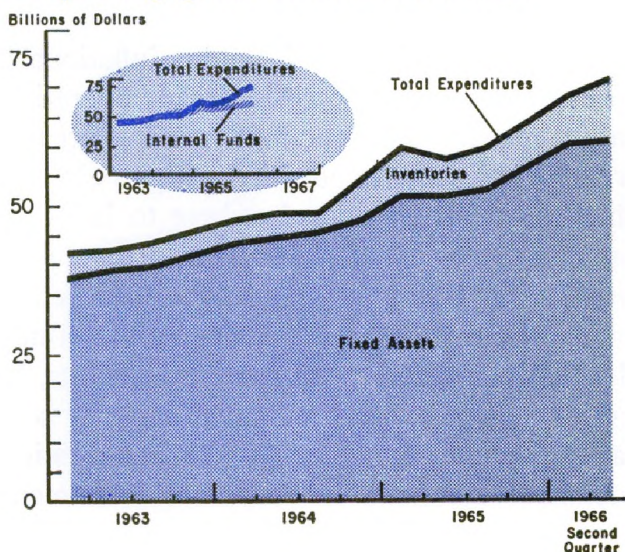
Gain in capital spending

Corporate investment expenditures have in-

creased every year since 1961, and the spending pace has accelerated since the last quarter of 1964. In 1965, corporate investment jumped by \$9.6 billion—roughly two-thirds as much as the entire 1961-64 increase—and it has continued at a similar fast pace this year. The upsurge has been dramatic in both inventory spending and plant-equipment spending.

Inventory accumulation has often been a destabilizing cyclical element, first by stimulating increased orders as inventories are rapidly built up during cyclical expansions and then by forcing reductions in demand as orders are cut to permit liquidation of stocks. In the current expansion, inventory spending has risen to new highs in 1965 and 1966, yet overstocking has not been discernible until quite recently. The several peaks in spending, as in fourth-quarter 1965 and second-quarter 1966, were mainly due to such temporary factors as an over-rapid build-up of retailers' auto inventories. And, reassuringly, inventory-sales ratios have been falling almost continuously throughout this entire expansion as a

Business investment accelerates, outpacing gains in internal funds



reflection of improved inventory-control techniques. Thus, for all manufacturing firms, the inventory-sales ratio dropped from 1.74 in 1961 to 1.61 in 1965—and it remained near that level in mid-1966 despite a record dollar value of inventory accumulation.

The greatest spending increase has been for fixed plant and equipment. A gradual rise in such expenditures occurred until the last quarter of 1964, but spending then accelerated in response to business tax incentives and, particularly, to pressures on demand. Total demand as measured by GNP increased by 7 percent in 1964, and manufacturing capacity utilization reached 89 percent in the first quarter of 1965. Businesses consequently began to accelerate their investment spending in order to expand their productive capacity sufficiently to deal with the increased demand. Corporate plant-equipment expenditures thus increased from \$44 billion in 1964 to \$51 billion in 1965, and increased further to a \$58-billion rate in the first half of 1966. In percentage terms, this amounts to annual increases of 16 percent in 1965 and 12 percent in first-half 1966, as compared with GNP increases of less than 8 percent in both periods.

Investment cuts two ways

Investment, it should be remembered, cuts two ways: ultimately it builds greater capacity, thereby reducing inflationary pressures, but currently it increases demands upon existing capacity, thereby reinforcing inflationary pressures if the economy is already operating at fullspeed. During the past year this greater rate of investment coincided with an already high level of demand elsewhere to bring to an end a five-year-long period of price stability. Of course, price movements are determined by the total level of demand, and not by that of one sector alone. Nevertheless, in an economy whose productive capacity was already under some strain to meet existing demand, the jump in corporate investment was a crucial element in pushing total de-

mand to levels inconsistent with continued price stability.

Not surprisingly, then, when the Federal Government moved in September to restrain the boom, corporate investment was chosen to bear the major burden, through the suspension of investment-tax incentives and accelerated-depreciation procedures. In principle, greater reductions in Government spending or increased taxes on consumers would have been alternatives. But the greater cyclical variability of investment makes it a prime subject for short-run stabilization policy, even though a time lag occurs between the initial impact of tax changes on new orders and the eventual impact on expenditures. In any event, Congress exercised control over the investment sector on this occasion by varying the flow of funds available to corporations. This technique is a common feature of European stabilization programs, and it may become a more familiar feature on the American scene as well.

Squeeze on internal funds

The pressure of investment expenditures has been reflected in the decreased ability of corporations to finance their spending out of internal funds. Whenever these internal funds (retained earnings plus capital-consumption allowances) are insufficient, corporations must turn to external sources and thereby add to the competition for funds in the banking and financial system—precisely as they did from late 1964 on. This situation did not arise because of any levelling-off in internal funds, for these showed a substantial increase; the cause rather was the jump in investment expenditures.

Over the course of this business expansion, internal sources of finance have grown at an average annual rate of 10 percent, from \$35.6 billion in 1961 to \$55.3 billion in 1965—and then to a \$57.8 billion rate in second-quarter 1966. Capital consumption (depreciation) allowances have increased by over \$10 billion

in this period, in part because of liberalizing tax regulations for depreciation. But capital consumption allowances have fallen from 71½ percent of total internal funds in 1961 to 63½ percent in 1965, as a consequence of the sharp upsurge in retained earnings. Nonfinancial corporations' retained earnings doubled between 1961 and 1965, from \$10.1 to \$20.2 billion, and then rose further to a \$20.5 billion rate by mid-1966.

This favorable trend has been due to the continued prosperity of the economy, which has boosted total sales and, just as important, sales margins. For manufacturing corporations, profits before taxes have risen from below 11 percent of sales in 1961 to nearly 13 percent in 1965. Moreover, net profits have gone up even faster, because corporate taxes were reduced and depreciation allowances liberalized during this period as part of an expansionary fiscal policy; taxes thus dropped from 49 to 44 percent of gross profits in the 1961-65 period. Then again, corporate dividend policies have further increased the flow of internal funds, since corporations reduced the payout to their shareholders from 51 percent of net earnings in 1961 to below 43 percent in 1965.

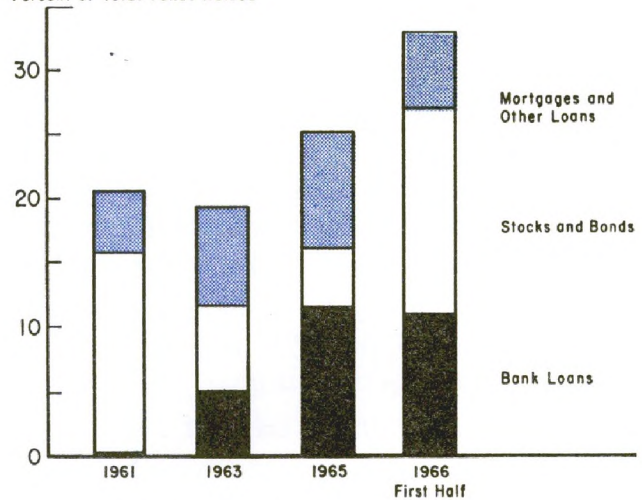
The tax changes during this period included an investment tax credit on new plant and equipment and accelerated depreciation allowances, both introduced in 1962, and a corporate-income tax reduction in 1964. The 1962 incentives were recently suspended until January 1968, but while they were in effect they added an estimated \$7 billion to corporate funds.

Shift to external sources

With their internal resources lagging increasingly behind their investment programs, nonfinancial corporations have had to rely more and more upon external sources of funds. Corporations, of course, have continuously turned to external financing for various

Corporations get more financing from banks and credit markets

Percent of Total Funds Raised



business needs, with the credit markets normally supplying about one-fifth of total funds, but since late 1964 their demands have sharply increased.

The fourth quarter of 1964 marks a turning-point, as corporations increased their bank borrowing in that quarter by \$3 billion (annual rate). In 1965, external financing from all sources increased by almost \$7 billion, and almost the entire amount was obtained through increased bank borrowing, so that banks provided 11.8 percent of all funds raised by nonfinancial corporations in that year. (Previously, the largest bank share of corporate financing was 5.6 percent.) Moreover, heavy reliance on banks has continued in 1966.

When this corporate borrowing is added to that of the other sectors of the economy, it is not surprising that the banking system was under such great pressure in the last two years. For all commercial banks, total loans and investments expanded by \$28.6 billion in 1965, as compared with \$23.2 billion in 1964. The largest increase occurred in commercial and industrial loans, the category where corporate borrowing is most important. Business loans *altogether* rose by \$11.2 billion in 1965, after rising by \$7.3 billion in the preceding year.

But *corporate* borrowing, after increasing hardly at all in 1964, went up by \$6.5 billion in 1965—which suggests that corporations garnered the lion's share of the business-loan increase and thereby tended to squeeze other borrowers out of the market for bank loans.

To supplement bank loans, nonfinancial corporations have increased their direct financing in the capital markets. Net proceeds of security (mostly bond) issues rose only slightly in 1965, to \$5.4 billion. Proceeds then jumped to an \$11.9-billion rate in the first quarter of 1966, on the basis of a strong upsurge in bond financing, and were \$15.2 billion in the second quarter as stock issues reached a new peak. However, these net figures for *nonfinancial* corporations measure only imperfectly the total demands upon the financial system, since business borrowing through bank loans or mortgages may be indirectly financed by new security flotations of *financial* corporations. Consequently, total corporate financing has to be examined.

Relatively trendless in the 1961-1964 pe-

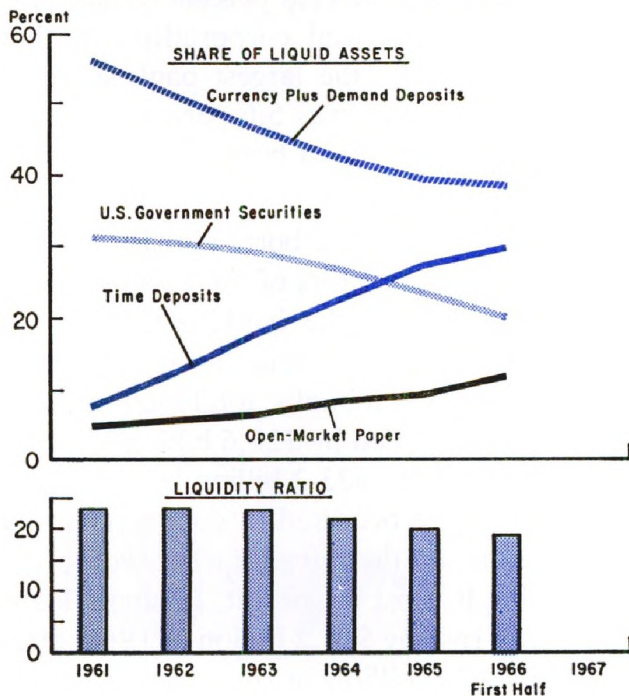
riod, total security financing by all corporations jumped about 15 percent in 1965, to \$15.8 billion. And the demand for funds has continued to grow in 1966, with \$10.0 billion of new issues being sold in the first half of the year alone. Furthermore, these funds were directed mainly into the capital-goods boom; \$6.1 billion of the \$10.0 billion raised in first-half 1966 was intended for purchases of plant and equipment. The biggest increases occurred in the manufacturing sector and the financial and real estate sector, and much of the increase in the latter category represented indirect financing for manufacturing corporations.

Squeeze on liquidity

Corporations meanwhile have turned to an alternative source for financing their increased investment in physical assets, by conserving their holdings of financial assets. Nonfinancial corporations have experienced a steady decline in their liquidity ratio—liquid financial assets over current liabilities—from 23.4 percent in 1961 to 20.0 percent in 1965, and thence to 19.0 percent in the first-half 1966. Part of this decline is no doubt attributable to improved administrative techniques which have allowed the economizing of cash, but the increased scarcity and cost of funds, by limiting the availability of external funds, have recently necessitated further attention to the management of financial assets. In 1965, for example, corporations faced an expanded need for funds in the face of an already low liquidity ratio; despite a \$32.7-billion rise in liabilities, liquid assets rose by only \$0.6 billion in that year.

Even more pronounced shifts occurred among the various classes of assets as corporations re-arranged their asset portfolios to meet changing credit conditions. Most noticeable was a reduction in the absolute as well as relative holdings of U. S. Government securities, from 31 percent of corporate liquid

Business suffers decline in liquidity as cash and Governments run off



assets in 1961 to 20 percent in 1966. Similarly, corporate holdings of currency and demand deposits declined from 56 percent to 38 percent of the total. This year, U. S. Governments have totalled about \$15 billion, and currency and demand deposits, \$28 billion.

Time deposits, on the other hand, have grown in favor even as pressures to economize on financial assets have intensified. Time deposits totalled in 1961 only \$4.6 billion, 8 percent of total liquid assets, but by mid-1966 they had risen to \$22.1 billion, or 30 percent of the total. This change was due to the appearance of negotiable time certificates of deposit (CD's)—which were almost as liquid as cash, which could be obtained in maturities suited to each individual corporation's needs, and which bore relatively higher yields than alternative types of assets. These features encouraged many corporations to replace U. S. Government securities with CD's, and at the same time permitted them to economize on cash and demand deposits. Meanwhile, open-market paper also showed an increase in popularity during this period, as a consequence of market developments which increased their yield. Thus, open-market paper increased from 5 to 12 percent of total liquid assets between 1961 and 1965.

Shift in corporate patterns

In sum, the rapid expansion of investment expenditures by nonfinancial corporations has strongly affected their pattern of finance. One obvious feature is their greater reliance upon external funds, especially bank funds, with all the consequent pressures on the financial system that that shift has entailed. Another feature is the reduction in corporate liquidity to release assets for other uses, which involve long-term as well as cyclical shifts in financial practices. Internal funds, meanwhile, despite their insufficiency for the greatly

enlarged investment plans of 1965 and 1966, have continued to grow rapidly and to provide the bulk of corporate funds. In particular, retained earnings have shown substantial growth, due both to the nation's overall prosperity and to certain changes in corporate taxes and corporate dividend policies.

Finally, Federal fiscal policy has had a greater effect on corporate finance. Its main object continues to be the control of total demand for goods and services in the economy. As before, changes brought about in total demand through fiscal policy indirectly influence corporate investment expenditures. Nonetheless, since 1962, there has been greater reliance upon fiscal actions which directly affect the flow and mix of corporate funds in order to achieve desired movements in total demand. The tax changes of 1962 with respect to depreciation allowances and investment credits represent an attempt to stimulate the general economy via the corporate sector, a sector which had recorded below-normal levels of expenditures in the recent past. The present suspension of these incentives is almost the exact opposite of the steps taken in 1962, with the object now being to restrain overall demand via a sector which had exhibited above-average levels of expenditures in the recent past.

This, then, is the pattern: what is stimulated in order to *increase* total demand is cut in order to *decrease* total demand. Consequently, corporate finance in the future may be one of the regular channels through which fiscal policy operates. Should greater stabilization of the economy be achieved, then the cost of greater year-by-year variability in the flow of funds will be offset by the gain of a continuously higher level of demand and, in turn, a higher long-term level of investment. How successful this stabilization policy will be, remains to be seen. —Robert Johnston

Dressing Up—Western Style

JUDGING from regional sales of yardage goods, Western households get a great deal of use out of their home sewing machines. But statistics may be somewhat misleading in this case—homespun and calico no longer set the style in the region's apparel markets. Rather, with a ready-to-wear market of some \$5 billion in annual sales, the average Western family spends more for off-the-rack clothing than its counterpart elsewhere; only the industrial Northeast boasts a higher average level of spending.

The West, of course, has a reputation for casual and sporty dress, perhaps as a result of California's outsized proportion of photogenic surfers. Westerners, like everyone else, have benefited from higher family incomes and expanded leisure time to increase their purchases of sport coats, slacks, blouses, and other casual wear. But they buy heavily in almost every other segment of the clothing market too.

Consumers nationwide now spend about \$40 billion annually for apparel and upkeep, with women's and children's wear accounting for about two-thirds of the market and men's and boys' wear making up the rest. Although the market has doubled over the postwar period, apparel spending accounts for a smaller share of the consumer budget than at the start of that period. In the first postwar decade, apparel spending dropped from 12 to 8 percent of total consumer spending,

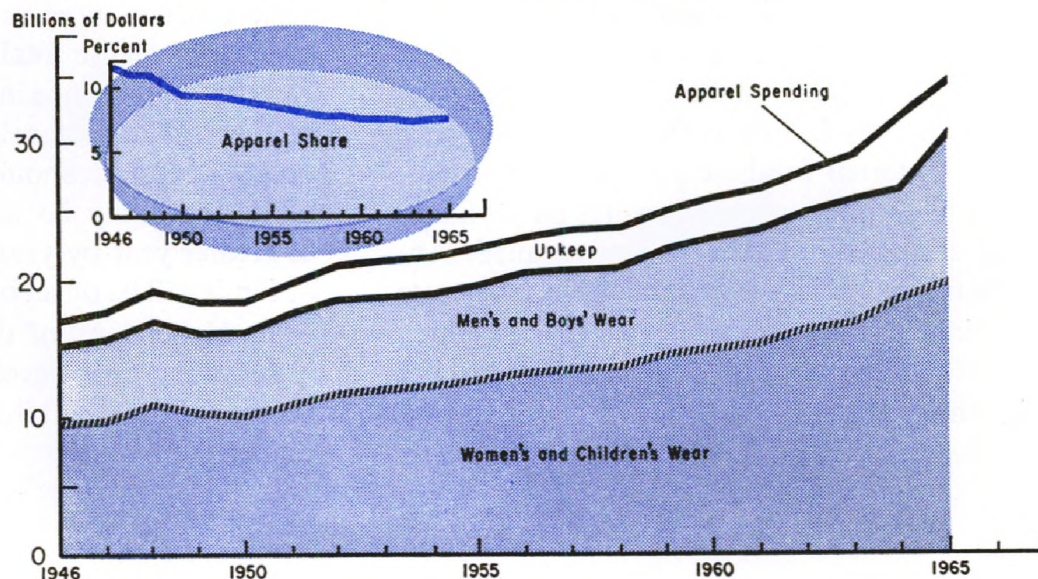
but it has since maintained its 8-percent share. This year, in fact, the proportion will be higher because of a sharp upturn in activity in the nation's dress salons and bargain basements.

The West has participated fully in this recent upsurge in apparel sales. Retail apparel stores in District states, for example, have recorded an 8½-percent average annual growth rate in the 1962-66 period, as against a 5-percent annual gain elsewhere. Regional sales lagged somewhat last year, with only a 2-percent gain, but sales to date in 1966 have increased by a whopping 18 percent—half again as great as the sharp gain recorded elsewhere. And comparable gains have been rung up by department stores, whose clothing departments account for about two-fifths of total department-store sales.

Max incomes and miniskirts

The 1966 upsurge undoubtedly reflects maximum incomes—and miniskirts as well. What with the surging popularity of the "mod look", Carnaby Street, London, is now exerting a stronger influence on styles than either

Sales upsurge in dress salons and men's stores helps stabilize apparel share of consumer budget



Seventh Avenue, New York or Ninth Street in Los Angeles. And besides offering a host of new style changes this year, the industry is also offering the prosaic but welcome "permanent press", a process which involves baking creases into fabrics. Not all the wrinkles have been ironed out of this new process, but the nation's launderers are properly grateful for the innovation, even if its clothes-pressers are not.

The strong Western market has been supported over the years by greater-than-national gains in income and in population. District states account for about one-seventh of total U. S. population but for about one-sixth of the nation's income. More than that, population growth is most concentrated in the most clothes-conscious group, the 15-24 year-olds. During the present decade, this mod-loving generation is growing by more than half in the West, as opposed to a one-third increase elsewhere.

To keep their cash registers ringing, apparel stores thus may be forced to heed the demands of the West's youthful and casual population. According to historical data, retailers sell lots of sweaters and blue denims in this market, but they can quickly go broke if they concentrate on hats. And furriers might just as well stay on the East Coast; the average Western woman spends (or has spent on her) only one-fifth as much as the Eastern purchaser of fur coats and stoles. At the same time, the Westerner spends half again as much on jewelry and watches as his (her) counterpart elsewhere. The glamor girl of the West may be casual, but she glitters—and ticks, too.

In the West as elsewhere, apparel prices have risen more rapidly than other non-food commodities, but more slowly than food and service items. Despite recent increases, apparel prices nationwide are now about 9½ percent above the 1957-59 average, as opposed to a 14-percent rise in the overall consumer price index. The index for California



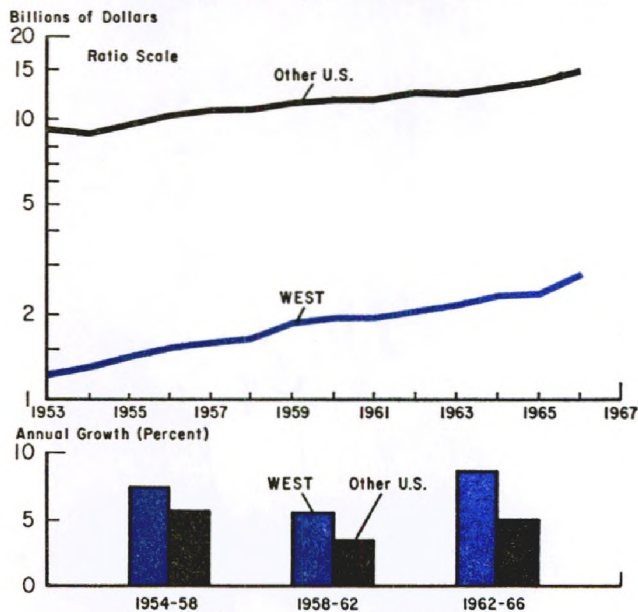
shows a 10½-percent gain for apparel and a 15-percent increase for all consumer items. Los Angeles apparel prices actually have lagged behind the national increase, but San Francisco prices have recorded a somewhat sharper rise.

Cutting the cloth

The \$40-billion apparel market is served mostly by factories and lofts in the Northeast states, but California accounts for about 5 percent of industry employment. (Hawaii and the Pacific Northwest states also have a foothold in the industry.) Some 51,000 workers are employed by firms in the Los Angeles-Long Beach area, and about 16,000 are employed by San Francisco Bay Area firms. The average weekly wage in the regional industry last year was \$72.50—about 10 percent above the national average.

In the allied activity, textiles, California accounts for only about 1 percent of the national industry, which is centered in the Mid-Atlantic region. Significantly, however, Los Angeles this summer opened its first knitting mill to supply piece goods to the regional apparel

Apparel stores post sharp gains this year, especially in Western market



industry. Until now, practically all California-grown cotton has been exported to other states and countries for manufacture into yarn or fabrics.

Los Angeles, of course, means sportswear. That casual metropolis produces about 20 percent of the nation's bathing suits and a good share of its supply of men's and women's sweaters. Hawaii, in addition, is now nurturing an apparel industry, in an attempt to exploit the unique aspects of style and design indigenous to the islands.

Nationwide, the apparel industry utilizes about two-fifths of total U. S. fiber production. Cotton is still the dominant material, but man-made fibers are making increasing inroads into the market. The non-cellulosic fibers (nylon, polyester, acrylic, and the like) have become increasingly competitive with wool and cotton over the past decade. Cotton fibers still account for 73 percent of men's clothing materials—down slightly over the past decade—but cotton's share of the women's clothing market has dropped from 55 to 45 percent over that period.

The apparel industry has been slower than

other industries to adopt technological advances, but with the increasing growth of large firms in the industry, more attention is now being given to automatic machinery, cost accounting, and inventory control. Admittedly, there is a Las Vegas atmosphere about the industry; hot items can make a fortune overnight, and the death rate for losers is high. But although style-setting garners the headlines, most apparel manufacturers—being small and undercapitalized—are content to take the safer route of following the trend.

Capital investment, quite obviously, is low in the industry—lower than any of the 21 other major industrial categories. Capital investment amounts to only \$5,000 per employee in apparel manufacturing, as compared with an all-industry average of \$16,000 and a dazzling \$92,000 per employee in petroleum refining. Some firms are now attempting to expand, largely through the merger-and-acquisition route, but the largest apparel firm today still accounts for less than 1 percent of total industry sales.

The apparel industry, however, is benefiting from the rapid technological progress of its ally, the textile industry. In particular, continuous-flow factories are eliminating many manual steps in the process of converting fibers to knit and woven goods. The textile industry has upped its capital spending by 30 percent in each of the last two years, to \$1.3 billion in 1966, in order to take advantage of the favorable situation created by import quotas on foreign products, "one-price" cotton, and investment-tax incentives.

Finding the money

The financing of the apparel industry is generally done through "factoring," a system uniquely suitable for an industry made up of a large number of small firms. Under this system, a manufacturing firm which holds small-lot orders from a number of retailers will turn those orders over to a factoring firm, and the latter will then check the retailers' credit

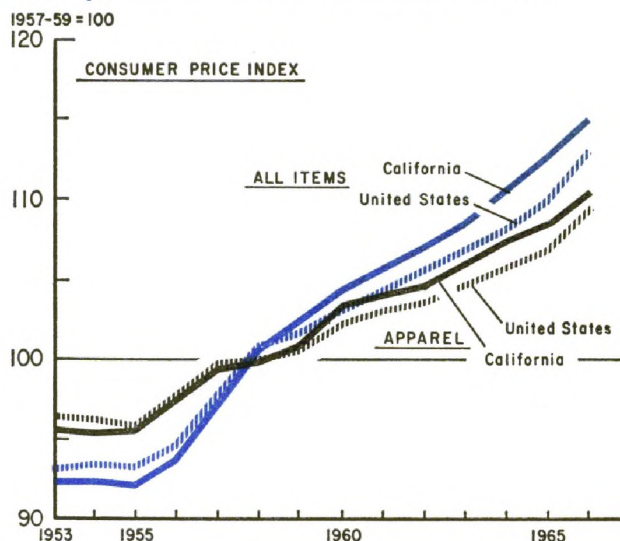
standing and guarantee payment of the manufacturer's invoices within 30 days or less.

Under the factoring system, the manufacturer is relieved of the cost of maintaining his own credit and collection departments, but for this service he must frequently pay interest rates twice as high as those available to prime bank borrowers. However, the system undoubtedly provides a real service to the industry; in fact, about 80 percent of the factoring business is associated with the financing of the clothing industry. Factoring activity in the Los Angeles area alone runs to about \$500 million annually.

The apparel industry this year has been beset with supply problems, especially those connected with the outfitting of an expanded military establishment. When the industry failed to come up with adequate bids for a rapid upsurge of defense orders, the Defense Personnel Support Center issued a number of "direct" mandatory orders (455 orders in the first half of 1966 alone) compelling manufacturers to give priority to Pentagon demands. The supply pinch is indicated by the fact that output increased only 3 percent in the first half of the year, despite the heavy influx of military orders and the very strong civilian market. But the pinch may be eased as the military buildup eases; defense orders during fiscal 1967 are expected to be 30 percent below the fiscal-1966 level.

The industry, meanwhile, must cope with another type of problem—not just the growing demand from military purchasing agents, but also the growing competition from foreign producers. Domestic production of apparel has increased about 50 percent since 1960, but imports have increased more than four-fold in the same period. In particular, since becoming a net importer of cotton products in 1960, the U. S. has become increasingly aware of an upsurge in import sales. It called an international conference in 1961 to achieve an orderly flow of goods in the world cotton

Apparel prices rise, but more slowly than prices of other consumer items



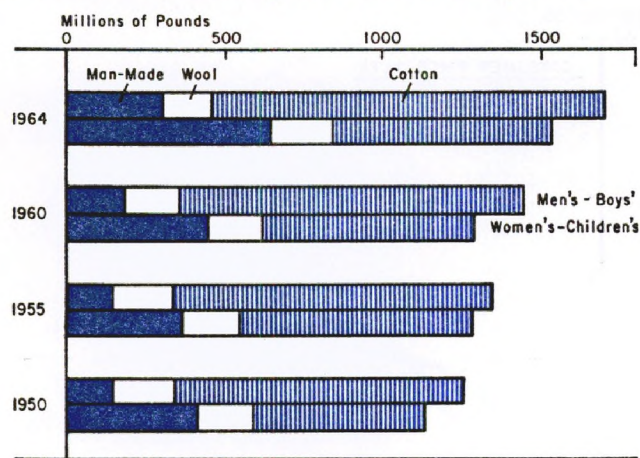
trade, and the agreement which was subsequently adopted will be up for renewal in October 1967.

Ceilings on imports

World trade in cotton apparel and textile products—those with over 50 percent cotton-fiber content—is now regulated under a Long-term Cotton Textile Agreement (LTA). This agreement is designed to provide the maximum growth of the exporting nations' sales consistent with the minimum disruption of the importing nations' markets. The U. S. is now operating under the provisions of the LTA as well as bilateral arrangements with 19 separate nations. These agreements provide import ceilings for 80 percent of cotton-product imports, the ceilings being raised automatically by 5 percent each year.

Since the import ceilings are generally related to the level of the previous year's imports, they benefit the large established importers while hampering the newcomers in this market. The principal beneficiaries tend to be Japan and Hong Kong, which have accounted for about 70 percent of the nation's cotton-product imports since 1960. Some importers, moreover, are able to escape the LTA

Man-made fibers increase share of market, mostly at cotton's expense



ceilings completely by shipping in cotton-synthetic materials which contain less than the 50-percent cotton content that would bring them under the terms of the agreement.

Domestic apparel and textile producers are experiencing strong import competition from other quarters as well. The handful of domestic wool producers, fighting against an influx of worsted materials amounting to half of total domestic production, are attempting to limit this enormous expansion of worsted imports; otherwise, they may be tempted to build their own plants abroad. Producers of man-made fibers are also seeking protection from imports, since they foresee some problems of overcapacity developing in the near future.

Clothing imports last year increased by about 20 percent, to \$543 million, while ex-

ports held almost steady at \$143 million. To date this year, imports have increased about 10 percent more, while exports have actually declined. During this import upsurge, articles made from man-made fibers have scored the largest gains.

Observing these figures, domestic apparel and textile manufacturers admit to some concern over the "disruption of domestic markets" mentioned in the import agreements. But they realize that the competition from imports will not disappear, especially since developing countries traditionally tend to promote the products of the easy-to-establish apparel and textile industries when they make their debut on the world stage. At the same time, these domestic producers should be able to maintain their competitive position in the U. S. market, given due attention to quality control and price stability, because of the textile industry's sharp increases in capital investment and the apparel industry's increasing modernization.

In any case, the apparel industry has come a long way since Brooks Bros. first opened its doors to provide New England sailors with ready-to-wear for their limited shore leave. (Today, even Paris sells off the rack—"prêt à porter.") Clothes rank high in projecting the individual image, so the industry deserves credit for serving myriads of people in this image-conscious society.

—Joan Walsh

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