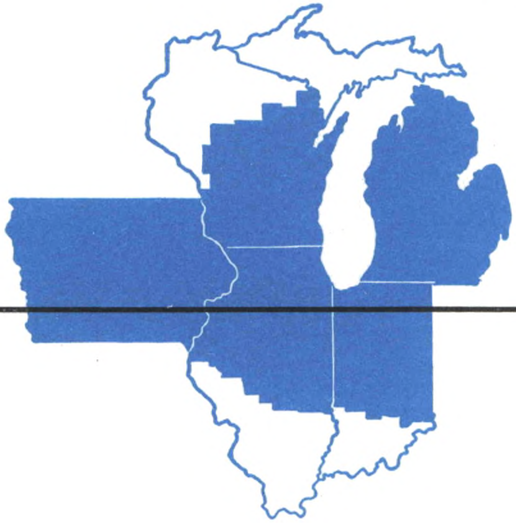
A *review by the* **Federal Reserve Bank of Chicago**

Business Conditions



1955 August

Contents

THE Trend OF BUSINESS

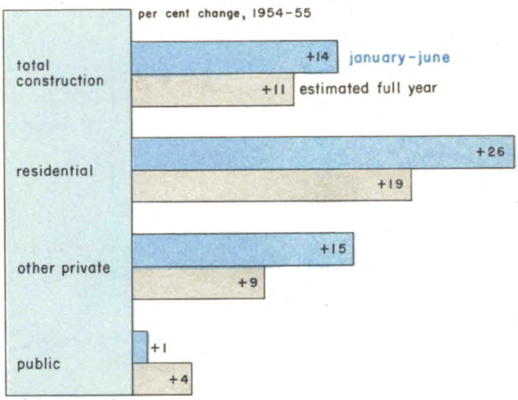
Moving into the second half of 1955, the American economy presents a picture of virtually full employment of men and resources. In June, 64 million individuals were reported at work in civilian jobs—more than ever before. Current estimates place the gross national product at a record annual rate of about 383 billion dollars during the second quarter, up 28 billion dollars from a year before, for one of the sharpest gains in the postwar period. In May, personal income crossed the 300 billion mark for the first time in history.

Even the most optimistic forecasts, however, do not suggest that recent rates of increase can be continued. Upward pressure from two of the most potent factors in the general rise, motor vehicles and construction, has already eased. Business spending on equipment and inventories, however, doubtless will continue to rise. Personal income levels indicate that total consumer buying of goods and services will continue to show excellent year-to-year gains in the months immediately ahead. Nondurable lines are likely to benefit as hard goods buying slows.

Over-all demand has been so strong that renewed concern has been noted over the stability of the purchasing power of the dollar. General price indexes continue quite stable, but price increases for individual commodities and services are showing up more frequently. Steel firms, operating near capacity and enjoying a vigorous market, responded to the recent wage settlement by raising prices of finished steel products about $7.50 per ton or 6 per cent on the average, one of the largest increases on record. Building materials, including ready-mixed concrete, siding and various fixtures, have all been increased substantially since last year. Certain automobile and appliance manufacturers have announced that prices may be increased later in the year. Surveys of business executives' opinions indicate that they expect widespread if moderate price rises. Meanwhile, farm prices, declines in which had tended to offset higher industrial prices since 1951, seem to have been quite stable in recent months.

Business inventories had been moving up gradually until May when an estimated 600 million dollar rise occurred. However, on June 1 total business inventories remained slightly below the figure of a year earlier. Automobile dealers' stocks were about 400 million dollars higher than last year so holdings of other types of businesses still lagged noticeably. Total business sales meanwhile continued to rise on a seasonally adjusted basis and in May topped 1954 by over 12 per cent. Deliveries in many lines have been slow with 90-day waits for goods common. Thus, incentives for inventory build-ups exist, and it is possible that net ac-

Housing leads construction rise



cumulation of stocks at a high rate may continue for some time.

Automobile production dropped back 10 per cent in June, mainly because of scattered walkouts arising from dissatisfaction with newly negotiated labor agreements. As a result, a continued high level of sales brought the first reduction in new car stocks since last October. With less than a month's supply on hand at mid-year, passenger car inventories were lower relative to sales than a year ago. Prospects for an orderly cleanup of 1955 models, therefore, appear to be improved.

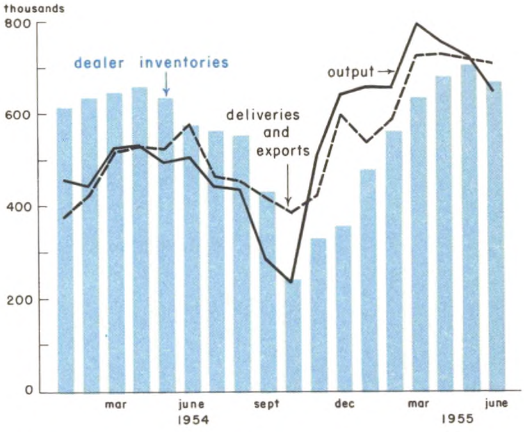
Employment trends furnished the best evidence that the current prosperity has a broad base. In July, expanding job opportunities had reduced the number of persons receiving unemployment compensation below 1.2 million for the first time since the end of 1953. Only 3.1 per cent of covered workers were receiving benefits compared with 5.6 per cent a year before. In the District states the reduction in insured unemployment from last year was striking, particularly in Michigan and Indiana:

	July 1954	July 1955
Michigan	5.0%	1.9%
Illinois	6.5	3.5
Indiana	5.0	1.8
Wisconsin	3.7	1.6
Iowa	2.3	1.2

Construction work put in place in the first half topped 1954 by 14 per cent, and new contract awards reported by F. W. Dodge continued to be especially strong. Awards were up 29 per cent for the first six months, and the June gain was only slightly below this level. There is little question that some construction work is being delayed by shortages of men and materials, particularly cement. In addition, tighter money is dampening effective demand for some new work. This fact has been noted especially in housing, but dealer inventories of municipal issues are high and some flotations have been postponed because markets have been unreceptive.

New Government estimates indicate that construction for the year 1955 will total 41.7 billion dollars, 11 per cent above 1954. Although these projections suggest that construction activity will offer less upward push to general activity in the second half, no significant dip from recent seasonally adjusted levels is implied.

Car inventories moderate at midyear



SOURCE: *Ward's Automotive Reports*

The Midwest is participating fully in the construction and capital spending boom. For example, Dodge awards in this area showed a 41 per cent rise in the first half, well above the national average. Each of the "big three" car manufacturers has recently announced new expansion plans, including important projects to be located in this area. General Motors alone plans a new 500 million dollar program to be completed by the end of 1956. The bulk of the money will go for new equipment, but over 6 million square feet of floor space will also be added. In Detroit, a large convention hall and an important new shopping center have been launched. In the Chicago area, all of the major steel producers have announced sizeable new additions to existing facilities. Commercial building plans continue to be heavily dominated by shopping center projects. New developments of this sort, ranging in size from 2 to 25 million dollars, are under way in Detroit, Indianapolis, Grand Rapids and Milwaukee.

Funds for the retired and the jobless

The development of industry and government programs to provide Americans with steady incomes when retired or unemployed is one of the most remarkable changes in the economic environment in this generation. A variety of programs have taken root and blossomed, expanding both in the numbers of people they will benefit eventually and the kind and amounts of benefits they will pay.

To back these programs up, private and public trust funds are growing rapidly—perhaps more rapidly than any other type of financial accumulation. In some of their economic overtones, the trust funds resemble the rapid growth of other financial institutions, but certain economic problems are unique to the pension field. Policies appropriate to these problems so that neither will the economy's growth be hindered nor its vulnerability to the business cycle increased are of vital importance.

Twenty-five years ago, pensions were a small affair indeed. Fewer than 2.5 million persons were covered by private pension plans, and about half of the 3 million government employees shared in the various civil service retirement funds. Pension trust funds probably did not total 1 billion dollars. Today, there are few people working who are not currently accruing pension benefits under one or more plans. Private plans cover close to 12 million people. Social Security covers nearly all of these and over 50 million others, and other public plans (mainly for government employees) cover about 7.5 million persons.

In addition to retirement plans and funds, we now have a large-scale government system for providing benefits to the unemployed, which covers almost 40 million employees, and the recent pacts in the automobile industry suggest that private systems will be significant supplements to these payments.

Balances in the various trust funds total over 65 billion dollars—nearly a third in private pension funds, about a fifth in public employee retirement funds and about half in the funds which relate to government programs providing retirement and unemployment benefits to employees of private and public nonfederal establishments. Moreover, they are growing rapidly—by more than 5 billion dollars a year—and, if anything, may grow more rapidly in the next few years as more private programs spread through industry.

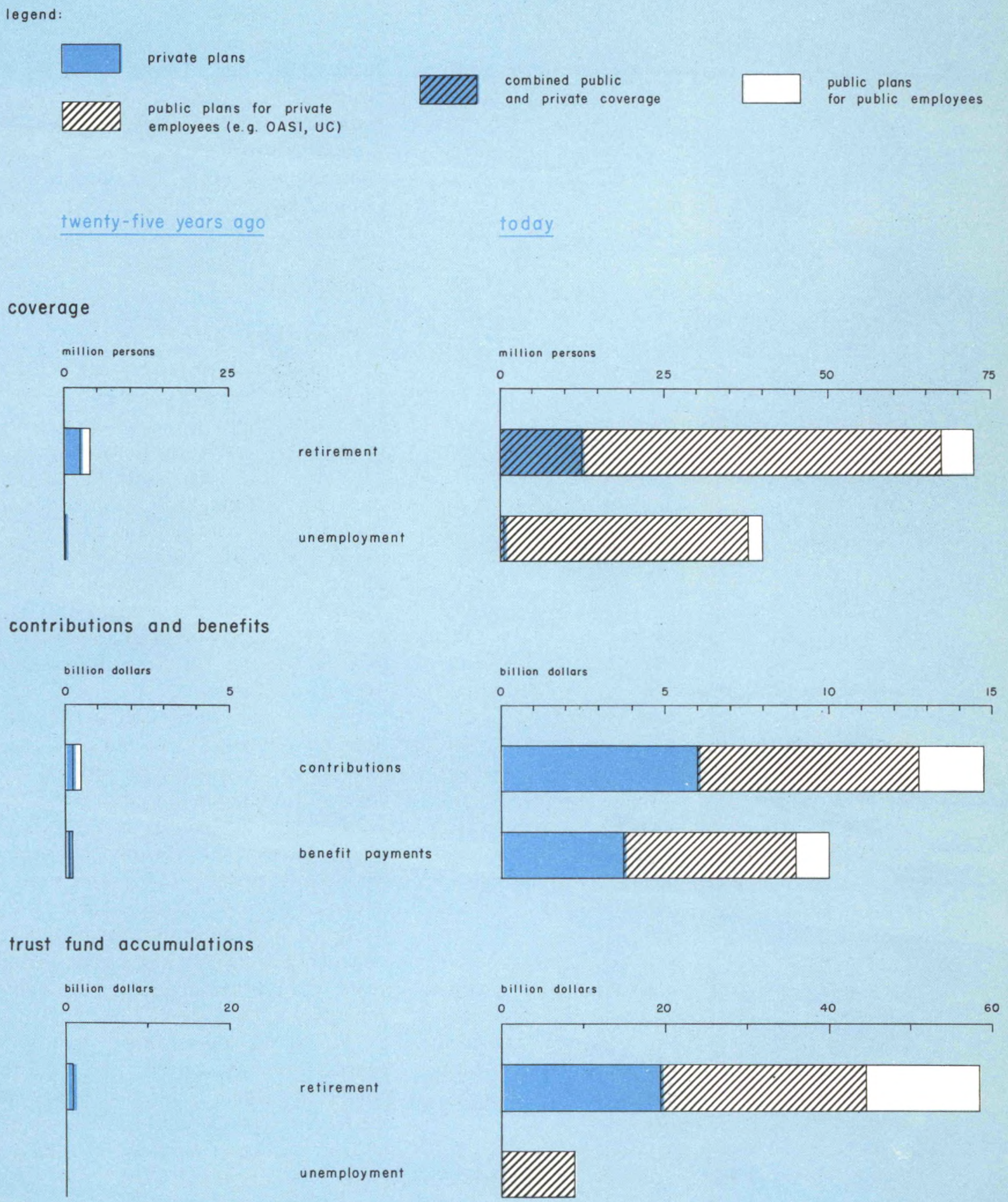
Why they grow

Pension funds inevitably accumulate rapidly in the first years after they are established. Benefit payments are small at the outset, because the largest obligations are to employees who will retire well in the future. Ordinarily the number of employees eligible for full benefits retiring in each of the first few years of the plan is small. On the other hand, contributions to the pension fund are apt to be substantial from the beginning. This is because an effort is usually made to accumulate reserves to cover benefits based on the years in which no plan was in effect.

For a number of reasons, it is usually found desirable to provide for funding, the term used to describe the practice of building reserves to cover liabilities carried over from the past, over a 20 or 30 year period. In addition to covering past-service liabilities for present employees who have been working for some time, funding, in contrast to a pay-as-you-go plan, fully covers the liability for current-service credits. Funding thus involves heavy contributions in the early years of the program, but it has important advantages.

The pay-as-you-go alternative in private pension plan financing is risky from the viewpoint of the potential beneficiaries, because even the largest and strongest firms cannot be sure of their ability to continue pension payments for generations ahead. Then, too, earnings on

A generation of pensions



trust fund investments will reduce the total contributions needed to assure a given level of future benefits.

Funds to provide for unemployment payments, whether public or supplementary private ones, necessarily have to be accumulated in times of good business, so that the funds are available to make heavy disbursements when unemployment is high and firms are least able to make heavy contributions.

In the absence of expanded benefits and coverage, the growth in the various trust funds will not continue indefinitely. This is because past-service liabilities of the retirement programs will eventually be fully funded or at least as fully funded as is called for in the contracts. Moreover, while the unemployment funds have no actuarially calculable liability, they sometime will reach levels deemed to provide a reasonable margin of safety. In the public systems, this has been recognized implicitly through experience rating, which has permitted a substantial scaling down of employer contribution rates following years of low unemployment and hence rapid growth in unemployment reserves. In the private systems which have been negotiated, like those in the automobile industry, a ceiling on the total accumulation is provided.

Investing the reserves

During the period before the trust funds reach the point at which disgorging is required, the problem of investing the accumulations in a manner which is safe, profitable for the trust funds and conducive to growth for the economy has to be faced. In the past, there has been some fear that the accumulation of vast pension funds, either public or private, would be a depressing influence on economic growth.

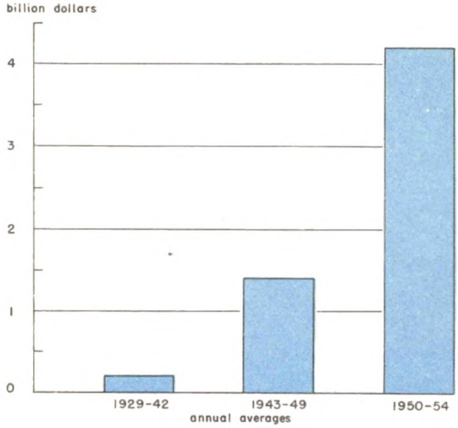
These fears were based on the fact that, if the same amounts were not deposited in the trust funds but otherwise spent, they could sustain total demand: they could be higher wage payments to employees or lower prices to customers, both of which add to consumer purchasing power, or they could be more retained earnings for business or dividends to stockholders, both of which add to the supply of funds likely to be quickly employed in adding to the nation's stock of capital assets.

Trust funds, however, do not sterilize their money. Investment managers with substantial long-term funds at their disposal, whether they manage pension trusts, life insurance company reserves, or savings and loan share capital, seek to be "fully invested," and in reasonably high-yielding assets—to the extent legally permitted. This means, first, that pension trust managers try to invest as much as prudence permits in the securities of private borrowers—corporate bonds and mortgages—and to a smaller degree, in common stock. These investments make possible increases in the nation's fixed capital. Even when they invest heavily in securities issued by such public borrowers as school districts, cities and states, this does not mean the dollars are running to waste. Investment in long-lived physical assets like roads, schools, and water works is essential to a growing economy. Nor is the money sterilized if the trust funds buy public securities which previously have been held by other investors, like banks, since the sellers of these securities also try to be "fully invested" in earning assets, and therefore will replace the securities sold with other loans and investments, thereby making funds available to other borrowers for the purchase of goods and services. Even if the trusts held their money in the form of bank deposits, ordinarily the money would be "used"; in this case via bank loans and investments.

At least this has been the case in the economic environment of the past fifteen years. The demand for funds for private and public investment purposes has been heavy, and has easily absorbed the savings induced by trust fund accumulations since the inauguration of the social security programs and the expansion of industry pension plans. It is, however, conceivable that, were the economy to enter a stagnant period like the Thirties, investment opportunities might not match the nation's savings plans. Ordinarily, in depressed periods when incomes drop, savings which are a residual item also drop sharply. However, the savings which take the form of additions to re-

Employer contributions to private pension and welfare funds . . .

increased sharply after 1942, as new plans were adopted in response to liberalized Federal tax treatment of the funds and to the policy of granting fringe benefits in lieu of wage rate increases during World War II . . . and jumped even more after 1949, as major employers started pension plans, as a result of the courts' upholding NLRB decisions requiring collective bargaining over pensions.



tirement funds are relatively stable. Like other contractually-set savings, they are apt to continue even in bad times when investment opportunities are more limited. But as long as the economy keeps growing and changing, trust fund accumulations as well as other savings will find useful and profitable outlets.

When the funds disgorge

The other major economic impact of the trust funds will occur when they disgorge. This will occur when the unemployment funds, because of economic conditions, are on a substantial net payment basis. In the case of the retirement plans, disinvestment may take place when they reach maturity—that is when, because of the large number of retired persons drawing benefits, the growth in the funds slows down or stops. The problems are of two kinds: first, the liquidation of parts of the trust funds' investments may occasion expansion of the country's money supply. If heavy liquidations leading to monetary expansion occur when inflation threatens the economy, they will complicate the job of keeping the economy on an even keel. On the other hand, there is the second problem: if pension funds must sell some of their holdings of equities or obligations of private borrowers when business is poor, that added selling pressure might disturb the country's security markets, or at least the specific market for the security being dumped.

Under present plans, the Federal Old-Age and Survivors Insurance Trust Fund ultimately will have to be drawn down somewhat, since scheduled contributions plus interest on the Fund's holdings will not be sufficient to meet benefit payments.

The Fund will get cash for this disgorging by reducing its holdings of U. S. Government securities. It holds two types of Governments: Treasury issues specially tailored to its needs, which the Treasury must redeem on demand, and marketable Treasury issues, which it can sell as needed. Whether bonds are redeemed or sold, the effect on money and credit conditions is the same, for the Treasury can get the funds to redeem the special issues only by borrowing more than it would otherwise have done. In either case, investors other than the OASI fund will have to hold more Treasury securities than they might otherwise want to. If competing demands for borrowed money were extensive, the monetary expansion needed to facilitate greater sales of U. S. Government securities could generate too great a pressure on the economy's resources. Or, if there were no monetary expansion, Treasury issues might crowd out private borrowings, possibly borrowings for the new enterprises and products that make our economic system so dynamic.

Actually, this dilemma would have to be faced only if inflationary pressures were rampant at the same time that more people were retiring earlier and fewer people were entering the labor force at the younger end (resulting in lowered contributions and higher benefit payments). Ordinarily, when business conditions are booming, labor force participation is very high and therefore so are contributions. So these problems are not apt to accompany OASI Fund disgorging.

Most private pension plans are based on the assumption that current contributions plus investment earnings will about balance withdrawals when the programs are fully matured. However, as the average life span lengthens, retired workers over their lifetimes may draw higher total payments than planned, and this will tend to deplete reserves somewhat unless contribution rates are raised. Also, if companies have declined or disappeared, their retirement funds will be gradually liquidated to meet pension obligations incurred earlier, when their labor forces were larger.

Withdrawals may occur in recessions. Then contributions, which are tied to employment or payrolls, will drop. Meanwhile, withdrawals may rise, due to earlier retirement, where permitted. The job stabilization funds contemplate large withdrawals in these periods. If the funds are sufficiently liquid—that is, they have large stocks of assets like Government securities, which are readily convertible into cash—the liquidation is not likely to pose difficulty either to the fund or to the economy. In a recession, monetary policy measures will seek to provide an abundance of bank reserves, and result in low yields and high prices for Government securities. Thus the trust fund holdings of Governments will be readily saleable and the accompanying net cash outflow from the fund would help the economy recover from the slump. For the economy, then, this is an automatic stabilizer, which goes into action immediately and without deliberate policy changes to reduce the severity of a drop in business activity.

Fund diversification

Some of the pension funds—depending on their investment policies—might have to sell equities, as well as Governments, corporate bonds, or mortgages. With Government props for the mortgage market and a monetary policy appropriate to recession, the debt securities should be readily saleable, but the funds might run into real trouble trying to sell corporate stocks in a declining market. The funds might experience some principal loss, as well as add to the stock market's probable difficulties.

The type of assets any particular fund should hold depends on the predictability of future claims on it and whether it is a public or private fund. Unemployment fund claims are highly unpredictable and hence this money should be in highly liquid assets. The Ford and General Motors unemployment supplement funds, for example, will hold only cash and Governments. On the other hand, benefit payments to the retired can be predicted long in advance with only a limited margin of error. Therefore, private pension funds can invest more heavily in less liquid assets, like stocks. The conversion of these assets into cash can be scheduled considerably in advance of needs for the funds, and timed to avoid principal loss. The pension funds, however, need not expose themselves to the risk of principal loss. Since their obligations typically are in stated dollar amounts, it seldom is necessary for the funds to buy equities as an inflation hedge. But the higher yields can reduce the contributions needed to assure a given level of benefits, or make possible increased benefits or expanded coverage in future years.

Since there may be times when liquidation is necessary under circumstances possibly unfavorable to disinvestment from the point of view of both the seller of the debt instrument and the debtor, investment policy must be cautious, and a firm or industry should not expect the pension funds in which it participates to invest heavily in that firm or industry. In practice, pension trusts buy mostly high-grade corporate bonds and some blue chip stocks, except for insurance company managed funds, which are used to a substantial extent for mortgage purchases, as well as for purchase of corporate bonds. In addition, Government bonds are held to provide some liquidity.

The investment policies of the various public funds are similarly dictated by their natures. The OASI funds go into Treasury issues; were they to be invested otherwise, the Government would soon have substantial owner or creditor interests in a large block of American industry.

Given the kind of over-all economic policy we have the right to expect, and given reasonably careful management of the many trust funds, we can feel with some assurance that this vast innovation in our economic institutions will neither increase the economy's tendency toward instability nor dampen its prospects for growth.

Money in the bank

Flows of goods, services and securities through our economy are matched by counterflows of money. As a result, the stock of money constantly changes hands, and the shifting pattern of ownership reflects the relative liquidity of individuals, businesses and governments. Demand deposits of individuals and businesses, which are spent by writing checks, make up around three-quarters of the active money supply—usually thought of as demand deposits plus coin and currency in the hands of the public. Annually, on the last banking day in January, the Federal Reserve System makes a survey of deposit ownership, which, in effect, momentarily stops the flow of these deposit funds and furnishes a cross section of their ownership pattern.

This ownership pattern is, to be sure, not complete. It does not take into account holdings of cash or less spendable assets, nor does it include the deposit holdings of government. It also has the disadvantages of any stop action photograph, giving no evidence of the nature of money flows from one class of depositor to another—in broadest terms from business to individuals and vice versa. But although the need for ready cash differs among businesses and between business and individuals, and some depositors simply prefer to hold assets in liquid form rather than tied up in securities, demand deposit holdings do measure, to some degree, the relative importance of their owners in the economic structure.

As of Monday, January 31, of this year, the largest share (28 per cent) of Seventh District demand deposits of individuals, partnerships and corporations rested in the personal accounts of individuals. Reflecting the importance of industry in the regional economy, manufacturing and mining concerns held another quarter (24 per cent). Public utilities, firms in wholesale and retail trade and construction together owned a fifth. Financial businesses accounted for a tenth and farmers owned about 6 per cent of the total.

Seventh District deposit ownership, as of January 31, 1955

	Per cent of 1955 total	Per cent change Jan. 31, 1955 from Jan. 30, 1954
Demand deposits of		
Manufacturing and mining	24	
Public utilities	4	
Trade	14	
Construction	3	+ 1
Other nonfinancial businesses	5	
Farmers	6	−12
Other persons	28	+ 6
Financial businesses	10	
Nonprofit associations ...	5	+11
All other depositors......	1	
Total	100	+ 3

These percentages are, of course, for all District banks combined. The pattern within the District varied widely between large banks and smaller ones, between banks in industrial and commercial centers, in residential areas and in predominantly agricultural counties.

Differences in the dominant type of deposit holder ordinarily make for differences in the investment and operating characteristics of a bank. Its investment policy is dovetailed to the volatility of its deposits. Seasonal deposit fluctuations, which vary by industry, and erratic variations, which are particularly evident in very large accounts, create exposure to clearing drains which must be accommodated. Floor facilities must comfortably handle the flow of depositors through the bank—a flow which increases relative to the dollar volume of deposits as personal and other small accounts become more important in the bank's deposit structure. And a significant link exists between deposits and loans, arising not only from managerial loan policy but also from customers' loan demands.

Deposits and loans

As might be expected, there is a good deal of correspondence between the customers who appear at a bank's deposit window and those who deal with its loan officer. In part, this arises because of geographical proximity; depositors and borrowers both seek banking facilities within a convenient distance. Once a bank and a firm establish a working relationship, it usually becomes permanent since firms ordinarily hold working accounts at the banks from which they obtain credit. Although the loan and deposit profiles never coincide exactly in any given bank, the similarity is quite evident when banks are grouped according to the economic characteristics of the areas in which they are situated. Some proof of this correspondence can be gleaned from the latest Deposit Survey figures.

In the five largest cities in the Seventh District, 60 per cent of the demand deposits excluding government and interbank deposits are held by nonfinancial businesses—by steel companies and meat packers, by producers of farm machinery, electronic equipment and locomotives, by the great automobile and accessory manufacturers, by breweries, by railroads and gas, electric and telephone companies, by department stores and a host of smaller retail outlets and by firms in the construction industry. At the same time, the banks in which these deposits are held have some 53 per cent of their total gross loans committed to commercial and industrial firms.

In the banks of the other cities of the District, demand deposits of nonfinancial business are less important, averaging only 39 per cent of the total, and commercial and industrial loans account for only 19 per cent of total loans.

To take another viewpoint we find that as banks decrease in size, personal accounts become a more significant portion of total deposits. A corresponding change in loan patterns can also be discerned. On the average, the accounts of persons other than farmers constitute 35 per cent of the deposits of banks not located in the five major cities; and these banks make about 57 per cent of their loans either to individuals or to finance the purchase of residential real estate. On the other hand, personal holdings average only 21 per cent in the five major cities, where the largest financial institutions of the District are located; and these banks have only 29 per cent of their total loans outstanding in the form of personal or real estate loans.

Incidence of farm loans

Similarities between depositors and borrowers also stand out clearly when farmers' deposits and farm loans are compared. Among banks outside the five major cities and with more than 35 per cent of their loans in farm loans,[1] such loans averaged 57 per cent of total loans, and the Survey revealed that farmers owned 31 per cent of demand deposits at these banks. All other banks not in the major cities together held only 8 per cent of their total loans

[1] Loans secured by farm real estate, loans backed by the Commodity Credit Corporation, CCC certificates of indebtedness and other loans to farmers, as of June 30, 1954.

as farm loans, and only a bare 4 per cent of their deposits belonged to farmers.

Year-to-year changes

Beside the insight it furnishes into the present structure of deposit ownership, the cross section obtained by the Deposit Survey this year can be compared with its 1954 counterpart in order to check on major deposit movements. The most striking changes in the Seventh District ownership pattern have been a 12 per cent drop in farmers' deposits and a 6 per cent rise in the personal deposits of other individuals.

The rise in the total volume of personal deposits has been accompanied by an upward shift in account size. Throughout the District, accounts of $10,000 or more increased from 44 per cent of personal accounts to 48 per cent. This tendency was most conspicuous in the largest accounts of the largest banks. In banks with total demand deposits of individuals and businesses of $100 million or more, the percentage of deposits in accounts greater than $100,000 rose from 14 per cent to 20 per cent.

Many factors enter into the determination of the cash holdings of any given individual on any given date. He may feel that the present is not a good time to convert extra money into goods or securities. He may have liquidated an investment of some sort and be using his demand account for temporary storage of the funds received. He may have just deposited a pay check, which will build up his account; or it may be the day before payday, in which case he will probably have drawn his account down to its customary minimum. Or his account may have been built up gradually as the result of consistently higher income over the past year.

The 12 per cent drop in demand deposits owned by farmers may be partially explainable in terms of income flows. Subsidiary studies of the Deposit Survey data indicate that farmers' deposits, which are business and personal accounts at the same time, have suffered more in Corn Belt banks than in Dairy Belt banks during 1954. At the same time hog prices during the last half of 1954 averaged 14 per cent lower than during the last half of 1953, while milk prices were down only 7 per cent in the same comparison. In addition to this, farm income in the southern fringe of the Seventh District in Iowa, Illinois and Indiana was reduced as the result of last year's drouth. In any event, the decline in farmers' deposits has been accompanied by a 4 per cent drop in total demand deposits at banks in predominantly agricultural areas.

Commercial paper—new style

Since the end of World War II, commercial paper has emerged from virtual retirement to become once again an important source of business funds. At mid-1955 outstandings totaled a record 2.3 billion dollars—two and one-half times the figure of five years ago. Despite this rapid growth, the nature of commercial paper and the specialized role it plays on the financial scene is not widely known.

Strictly speaking, commercial paper refers to single-name, unsecured notes of business firms and finance companies which are sold on a discount basis to banks and other investors throughout the nation. These notes, usually in denominations of 5 thousand dollars or more, vary in maturity from one to nine months, with concentration in the four-to-six-months range. Borrowers use the commercial paper market mainly as a substitute for or as a supplement to short-term bank loans.

Lenders hold these notes as a part of their liquid reserves together with cash and short-term Governments. In the case of small and medium-sized commercial banks, they also serve as an alternative to loans where local demand is sparse or fluctuating.

Commercial paper is placed either directly, in the case of large finance companies, or is sold on a commission basis to "commercial paper houses" for resale to investors. Except for the directly placed paper there is little or no personal contact between debtor and lender. Dealers do not endorse the notes and, since holders may wish to dispose of notes before maturity, they must be readily saleable. Thus, only those firms with high-grade credit ratings can tap this market. As a result, rates are low, usually at least one-half per cent below the "prime rate" charged by big city banks on preferred-risk loans. Interest savings, obviously, are a principal reason for borrowing on commercial paper.

Lenders have been willing to increase their purchases of commercial paper because of their wish to improve earnings on funds that would otherwise be held in cash or invested in Treasury bills or tax-anticipation certificates. Bills yield approximately one-half per cent less than commercial paper. In view of the heavy tax accrual reserves and generally high level of corporate liquidity in recent years, it is not surprising that business corporations have become a major buyer of paper. One of the striking aspects of the commercial paper surge, therefore, is the fact that through this means business firms are lending funds to other concerns in competition with banks and other financial institutions.

New wine in an old bottle

The resurgence of commercial paper recalls to many old financial hands the extensive use of this device in the early 1920's. A national market for these notes had existed from the money panic of 1907, but the speculative boom of 1919-20 pushed outstandings to a peak of 1.3 billion dollars. Dollar totals in recent years have been much larger, but the number of borrowers—450 in 1954—lags far behind the 3,000-odd firms which used this market in those earlier years.

One of the significant differences between the commercial paper market of today and that of 30 years ago is the importance of direct placement. Prior to World War I, all commercial paper was sold through dealers. Shortly thereafter, however, General Motors Acceptance Corp. began to employ its own sales force to deal directly with customers. Commercial Credit Company and CIT Financial Corp. followed in the mid-Thirties. Associates Investment Company and General Electric Credit Corp. are recent additions to the group, beginning in 1952 and 1953, respectively. In 1929, all but 20 per cent of commercial paper passed through dealers' hands. At the present time 70 per cent is placed directly by these five large borrowers.

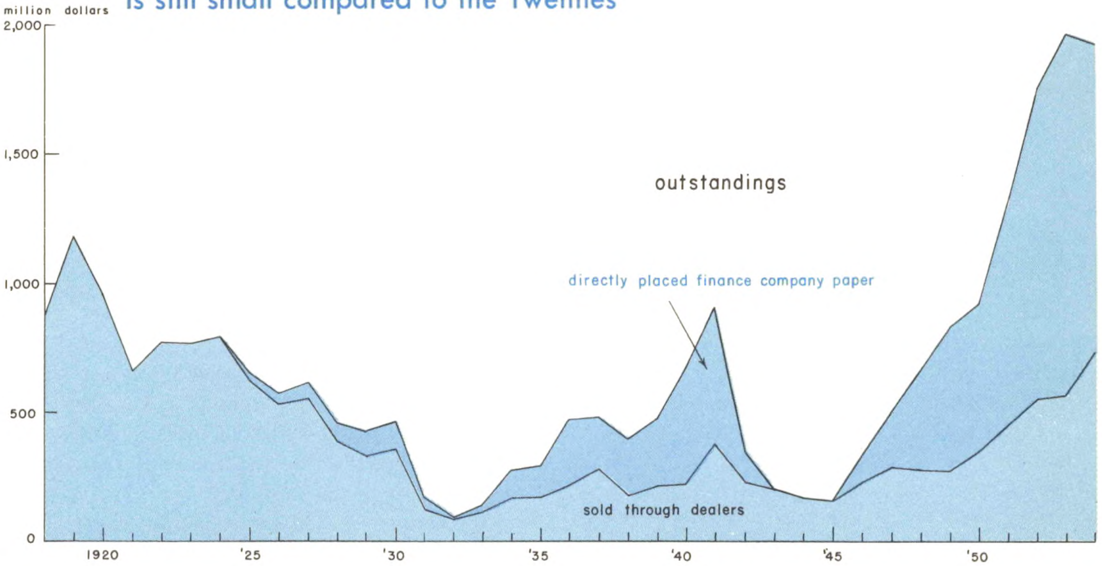
The dominance of consumer finance companies as a class is another distinguishing mark of the current commercial paper picture. All of the directly placed paper is in this group. In addition, a substantial portion of the dealer-placed paper is composed of obligations of smaller consumer finance or small-loan companies. Thus, of the total outstanding, perhaps four-fifths springs from a single type of borrower.

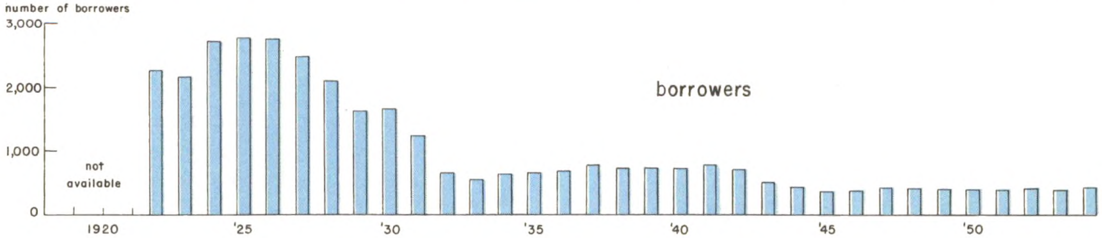
Another characteristic of today's market is the mix of buyers. In the Twenties, banks were virtually the sole customers for commercial paper. While banks are still important buyers, business corporations now are probably in the lead. Trust funds, particularly college endowments, as well as financial institutions also take sizeable amounts.

The ebb and flow

Why did commercial paper fall away so sharply from the 1920 pinnacle, and why was its resurgence so long delayed? The answer is to be found mainly in the easier availability of alternative sources of funds and reduced needs during much of this period. Rising prices and growing inventories during the 1919-20 boom had caused borrowers to tap this

While total commercial paper in recent years has risen substantially above previous peaks, the number of borrowers is still small compared to the Twenties





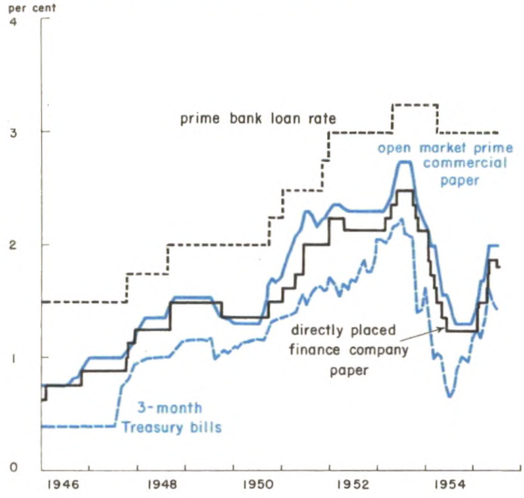
credit source to an unusual degree. After the 1920-21 collapse, the business upswing was marked by relative price stability, and business needs for funds were provided more completely by ordinary bank loans and through heavy sales of stocks and bonds.

As a result, outstandings in 1929 were only one-third as great as at the start of the decade. And this despite a pronounced rise in automotive finance paper. The sharp drop in credit needs associated with the 1929-32 downturn practically wiped out the remaining commercial paper. The revival from the depression low was closely associated with the growth of consumer finance companies, and these firms have been the major source of commercial paper ever since.

Through the 1930's and until 1950, bank loans were available at such low rates that some potential users of commercial paper with high credit standing had little incentive to seek cheaper credit sources. The prime rate on commercial loans moved from 1½ to 2 per cent from 1946 to 1948, but there were no further increases until September 1950. Thence a series of jumps brought it to 3¼ in 1953. During 1954, the spread between the open market rate on commercial paper and the prime rate was as large as 1.7 per cent.

Interest rates in the commercial paper market are determined in much the same way as in the bond market. The quoted open market rate, therefore, is a sensitive indicator of changes in the demand and supply for short-

Commercial paper yield above Treasury bill return, but below the cost of direct bank credit



term funds. Bank rates are usually far less flexible.

Thus, during the 1953-54 recession when money became easier, the average open market rate on prime commercial paper dropped from 2.75 to 1.31 while the "prime rate" on commercial loans declined only one-fourth of a point to 3 per cent. This comparison exaggerates the differential because it omits the selling costs on commercial paper and does not allow for indirect cuts in borrowing costs at banks, such as reduced minimum balance requirements. Nevertheless, the greater-than-usual spread in cost doubtless was a major factor accounting for the 30 per cent rise in dealer-placed paper during 1954, a year in which bank loans to business declined. The open market yield does not measure the total cost of commercial paper to the borrower since dealers charge a commission, usually figured on an annual rate basis of one-quarter per cent of face value. This contrasts with the practice of the Twenties when the commission was quoted on a "flat" basis, regardless of maturity.

In the postwar years, directly placed paper has risen more or less continuously. During the War years this paper had dropped to zero because the supply of new automobiles was shut off. The greatest portion of the growth in commercial paper outstandings has been associated with the rise in automobile paper, and this will doubtless continue to be the case.

The largest finance companies are in effect forced to use commercial paper to supplement bank loans. Commercial banks are subject to regulations restricting the amount of loans to a single borrower. In the case of national banks, the limit is 10 per cent of capital and surplus. GMAC, by far the biggest, had outstanding short-term borrowings of 718 million at the end of last year. It has been calculated that the 400 largest banks in the country could supply lines of credit to a single borrower totaling only 650 million dollars. To increase that figure by only 10 per cent would require credit lines with at least 400 additional banks.

A mark of distinction

Qualifications for sellers of prime commercial paper are even more exacting than for firms eligible to borrow at the prime rate at large banks. First of all, prospective users must be relatively large. A million in net worth is about minimum, and at least 5 million is usual. Second, credit records must be excellent, and financial statements must indicate the means of assuring cash pay-out. Third, virtually all borrowers are expected to carry unused bank lines of credit equal to the amount of paper outstanding to assure repayment. Fourth, and perhaps most important, a firm must be widely and favorably known.

Since dealers' commissions are one-quarter of 1 per cent on an annual rate basis, a million dollars of six-month notes brings them a gross profit of only 1,250 dollars. If notes are to move out rapidly to investors, a "name" must largely sell itself.

Successful consumer finance companies easily meet these standards. Their profitability records are excellent, they have a continuous heavy cash throw-off from collections, and their long-term debt is often expressly "subordinated" to short-term borrowings.

After finance companies, the industries using commercial paper most extensively include those in the food processing, particularly meat packing, and textiles lines which have heavy seasonal needs. But last year users were scattered through various industries as reported by the National Credit Office:

	Number of Firms
Finance companies	95
Manufacturers	
Textiles	71
Food and related products	58
Metal products	34
Leather products	12
Lumber, wood, paper and rope	11
Chemicals	7
Other manufacturers	18
Wholesalers	88
Retailers	46
Miscellaneous	9

The Seventh Federal Reserve District led the nation in the number of commercial paper borrowers with 76 headquartered within its boundaries. The New York District, with 70, was close behind; the Boston District, encompassing New England, was third with 53.

Pros and cons—to borrowers

Despite the exacting requirements for commercial paper users, it is apparent that a substantially larger number of firms could sell paper if they so desired. Aside from interest cost savings, there are other advantages, such as the advertising value which may enhance a company's reputation in financial circles, thereby placing it in a more favorable position to raise longer-term capital. Since small country banks are frequent purchasers of commercial paper, firms producing goods of interest to rural customers sometimes take advantage of this means to keep their name before the public.

Some potential commercial paper borrowers, however, shy away from securing credit by this means. One reason is the relative inflexibility in terms. These notes, unlike bank loans, ordinarily cannot be renegotiated, prepaid or extended. In addition, many firms value longstanding relationships with commercial banks which they believe may be impaired should they utilize the commercial paper market.

Pros and cons—to investors

Commercial banks have long held a portion of their secondary reserves in commercial paper, and nonbank lenders have turned to it for similar reasons in recent years. In addition, many banks use this medium to diversify their portfolios. Since it provides a convenient vehicle for supplying funds to industries and firms located beyond the immediate vicinity, banks catering to predominantly seasonal borrowers, as for example, those in agricultural communities, often use commercial paper as an outlet for loanable funds in their "off-season." As might be expected, the largest city banks buy little or no commercial paper for their own portfolios, but do act as agents for their correspondents.

Some investors have reasons for avoiding commercial paper. A major consideration is that despite an excellent payment record—no losses since 1936—it lacks the near-cash liquidity of Treasury bills. Commercial banks which are members of the Federal Reserve System can discount commercial paper because it meets eligibility requirements. Other investors typically must depend upon resale to the seller or to the correspondent bank that handled the original purchase. In addition, if only small amounts are involved, some bankers find that the higher yield on paper relative to bills is not sufficient to warrant the personal credit check they believe is desirable.

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Meat for the dinner table

Retail counters are stacked high with all kinds of meat. For the past year or more, consumers have been eating near-record quantities of steaks, chops and poultry. Per capita consumption for 1955 will total about 185 pounds —3 pounds more than last year's record level.

Meat production during the first half of 1955 was about 7 per cent above the corresponding period of 1954. Nearly all of the increase was due to a 14 per cent gain in pork. Output of beef and lamb moderately outdistanced year-ago levels, and production of veal held about even.

Under the weight of large supplies, retail meat prices have sagged. Eighty-nine cents will now buy as much meat as was obtained for a dollar a year ago. The sharpest decline in retail prices has occurred for pork—down 16 per cent, but price weakness has appeared at the beef and lamb counters as well.

While lower price tags have added to meat's appeal, another key factor in moving the larger quantity of meat into consumption has been the rising level of employment and consumer income. With bigger pay checks in their pockets, consumers have spent freely at food stores. Since mid-1954, retail sales of food have averaged 6 per cent above their year-earlier level. Most of the increase, however, represents a shift to items which include more built-in maid service — prepared, packaged and "ready-to-serve" foods. In addition, increased sales probably represent an acceleration of the trend toward greater consumption of the more desired and often more expensive foods—quality vegetables, fruit and meats.

More meat to come

In the second half of the year, meat supplies are expected to continue to exceed their year-ago volume, although by a smaller margin than the 7 per cent gain shown in the first half. The output of pork perhaps will be up about 10 per cent, and the supply of beef and veal is likely to top year-earlier levels by a narrow margin.

Any substantial boost in beef production during the second half of the year probably will be due to a step-up in slaughter of grain-fattened cattle. Purchases of feeder cattle by Corn Belt farmers in the first six months of 1955 averaged 17 per cent higher than in the corresponding period of 1954. This is reflected in a larger number of cattle on feed. A July survey showed a gain of 13 per cent over a year ago, and it is expected that this will be reflected in a greater volume of marketings from Corn Belt feed lots during the fall and winter.

Under the pressure of increased marketings of cattle and hogs, livestock prices are expected to continue below year-earlier levels. The price impact of larger supplies will be softened somewhat by expected higher levels of consumer income. However, just how much of this additional income will be spent at the meat counter is uncertain.

Meat competes for consumer incomes

In 1954, consumers allocated a little more than 5 per cent of their income after taxes for the purchase of meat. This represents a smaller portion of their income than prior to World War II when incomes were considerably lower, and less than during the years following the War when other goods were in short supply.

If this trend continues—as some observers believe it will—additional increases in per capita income will not result in as large an increase in outlays for meat as was true when incomes were lower. This suggests that relatively greater price concessions may be necessary in order to move the larger prospective meat supply into consumption. This prospect is a favorable one for consumers. For farmers it may be less cheerful. Only those producers who match additional livestock price declines with lower costs and/or larger volume will be able to maintain previous net income levels.