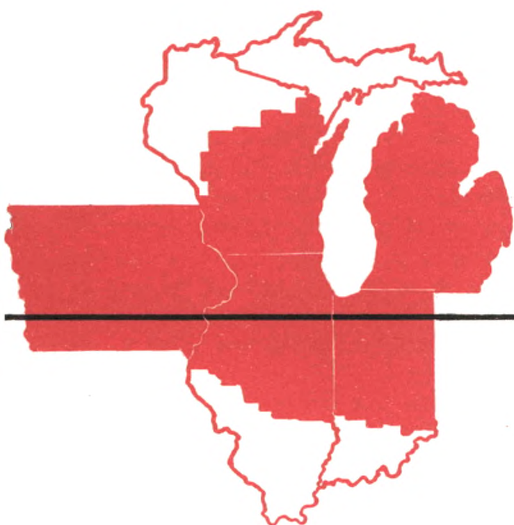
A review by the **Federal Reserve Bank of Chicago**

Business Conditions



1956 May

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THE Trend OF BUSINESS

Business firms are moving ahead with their plans to spend an unprecedented 35 billion dollars on new plant and equipment in 1956, and these proposed expenditures have been playing a major role in shaping credit developments in recent weeks. The need to finance the large-scale capital outlays programed for this year has intensified competition among borrowers for the available funds. The over-all demand for credit has tended to outstrip the supply, with the result that the money and capital markets have tightened considerably, and interest rates have been forced upward.

In addition to the growing demands for funds to finance capital outlays, rapidly rising inventories and receivables have swelled business credit requirements. Moreover, many firms have felt it necessary to increase their indebtedness to boost their working balances. Despite greater retained earnings and rising depreciation allowances, a large part of the additional financial requirements must be financed externally. One result has been to push yields on long-term obligations to their highest level since May 1953; another has been to boost the cost of bank credit to all but a few borrowers.

Business loan totals have clearly reflected this expanded demand for credit. During March, leading city banks increased their outstanding commercial and industrial loans by 1.5 billion dollars, more than four times the boost recorded in the same month last year. The loan surge this March more than offset a 350 million dollar drop in January and February, thus resulting in a contraseasonal rise of 1.1 billion dollars, or 4 per cent, through the first quarter of the year.

Some of this increased borrowing was of a temporary nature, in order to mee the March 15 corporate tax bill and to pay regular quarterly dividends. In early April, the borrowing tide began to recede. Business loans at New York City banks, which accounted for about 60 per cent of the March boost, dropped by 355 million in the first three weeks of April. The very fact that the tax date bulge in credit was so large, however, suggests that assets expansion is exerting pressures on the cash position of many firms.

Metals and metal product manufacturers have accounted for by far the largest portion of business borrowing in recent weeks. Increased outstandings of these firms represented over one-third of the March rise in business loans and almost three-quarters of the increase since the start of the year. Moreover, borrowing by the metals group has continued to rise in April.

Sales finance companies, heavy borrowers throughout 1955, have reduced their outstanding loans thus far this year. Through March, borrowing by the finance companies declined by more than 300 million dollars, compared with a 100 million increase in the first quarter of 1955.

Government security holdings of these leading city banks were drawn down to accommodate a portion of the surge in loan demand. Treasury issues in the portfolios of such banks declined by about 300 million dollars during March, to a point almost 5 billion dollars or 15 per cent below the year-earlier level. This reduction caused further downward price pressure in the Government security market. The fall in prices naturally boosted market interest rates especially in the intermediate-term range.

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Yields on the 5- to 10-year U.S. bonds soared between the second week of March and early April. Some issues rose from about 2.8 per cent to the 3.2 per cent mark, the highest in the postwar period. This pushed the rate on most of the intermediate-terms above the prevailing rate on all other Treasury issues, even the 40-year bond maturing in 1995. This is the first time since the late 1920's that the market rate on medium-term maturities surpassed all other Treasury issues for more than a day's interval. Prices on some of the 8- to 10-year maturity issues declined about 2½ points, thus "freezing in" many investors unwilling to sell at these reduced market prices. The boost in discount rates announced by eleven of the Federal Reserve Banks on April 12 augmented somewhat the price weakening forces. By mid-April, the yield on a 6-year security reached 3¼ per cent, just under the 3.32 per cent return recorded in June 1953 on the newly issued 25-year bond. In fact, by the third week of April, issues maturing as early as 1958 had a market yield above that of long-term Treasury obligations.

Rates on the long-term Governments also have risen significantly during the past two months. The 40-year bond maturing in 1995 fell to its lowest price since it was issued some 15 months ago, with the result that the yield on this issue rose to 3.09 per cent in early April, a substantial rise from the 2.96-2.98 per cent range in which it had moved during January and February. During most of April, the rate has hovered about the 3.10 per cent point.

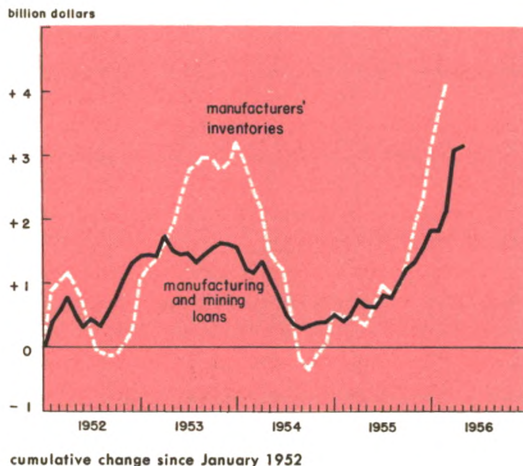
The corporate demand for long-term funds played a big role in the rise in yield on the long-term U.S. issue. During the last several weeks, two large corporate flotations to be marketed before midyear were announced—one totaling 300 million dollars and the other for 250 million. These two proposed issues alone are equal to one-half of the net change in corporate debt obligations outstanding during the second quarter of 1955.

Corporate securities yields have also risen significantly as a result of this swelling demand for funds. Toward the end of March, a new Aaa-rate utility issue was offered to the public at 3.35 per cent, the highest rate on such an offering since 1953. Several utility issues have recently been marketed at rates from .20 to .30 of a percentage point above that at which they might have been sold only a few weeks earlier. According to Moody's Investors Service the market return on Aaa corporate bonds rose to 3¼ per cent in mid-April, the highest rate in almost three years.

Mortgage credit is beginning to feel the effects of the increased capital needs of corporate borrowers. Seasonally rising housing starts mean that the home-building industry this spring and summer will be an active participant in the market, competing for the available funds. The large-scale demand for long-term credit no doubt spells higher interest rates on mortgage loans in coming months.

Short-term issues, after a lag, are also showing the effects of the increasing demand for credit. Rates on these 3-month Treasury obligations during March were held down both by the decreased supply of short-term securities and by particular technical market influences. Retirement of tax-anticipation certificates and refinancing operations reduced the volume of

Continued rise in business loans at major city banks may indicate further inventory build-up



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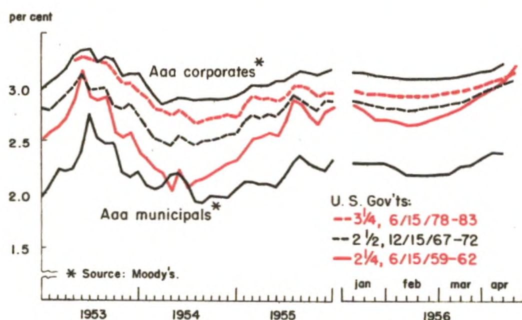
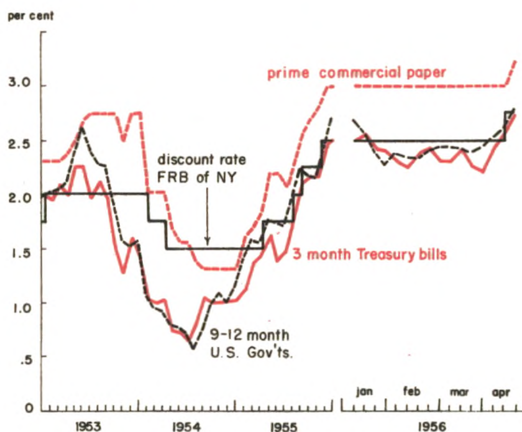
Bulging credit demands have helped to push interest rates above 1953 peak in longer-term issues . . .



and in the short-term area.



issues maturing within one year by almost 6 billion dollars. By the second week of April, however, interest rates in the longest-term Treasury bills moved up past the 2.50 per cent mark, and, in the following week after the hike in the discount rate, soared to about 2.75 per cent, its highest point since May 1933.

Firms borrowing on commercial paper have also seen their cost of borrowing rise. At mid-April, as the yield on Treasury bills rose sharply the rate on 4- to 6-month prime commercial paper was increased from 3 to 3¼ per cent. These notes, purchased mainly by corporations and small banks, must remain competitive with bills for the investor's funds.

Sales finance companies, which bypass commercial paper dealers and place their notes directly with the purchasers, have also had to raise the interest they pay on funds borrowed by the sales of such notes. Just after mid-April these rates were also boosted by an eighth of a percentage point.

Bank credit too has become more expensive for many borrowers. Effective April 1 most New York banks increased the rates on loans to corporate and municipal dealers and brokers for their own and customers' accounts from 3¾ to 4 per cent, the highest rate charged on such borrowing since March 1933.

Moreover, the prime rate, that rate charged firms having the top credit standing, was increased from 3½ to 3¾ per cent immediately following the rise in the discount rate. Even before this move, however, fewer and fewer firms found they were able to obtain funds at the 3½ per cent prime rate.

Money rates overseas have also moved up in recent months. Credit restraint policies which many foreign countries have instituted during 1955 have been maintained in many of the foreign financial centers and have been intensified in others. Most notable was the increase in the British bank rate, the equivalent of the Federal Reserve discount rate, by 1 per cent, to 5½ per cent, the peak level since February 1932. This attempt to combat inflation was further reinforced by a series of restraints on investment and consumption expenditures.

West Germany also increased its discount rate in early March. This action, which was taken in the face of mounting economic activity, brought the cost of funds borrowed from the central bank more in line with the rising short-term market rates.

Canada too has taken steps to restrain its booming economy and recently boosted its central bank discount rate from 2¾ to 3 per cent. This increase, the fourth in less than a year, was but one of a series of steps taken to restrain the rapidly rising level of outstanding credit.

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Strong demand for farm loans

Farmers continue to expand their use of credit. This is the story told by detailed information provided by country banks in hog, cattle and dairy areas in Illinois, Iowa and Wisconsin. While differing in many significant details, the broad outline of the story is very similar for each type-of-farming area.

Over 11 million dollars of farm loans were made in February by the 109 banks cooperating in a continuing review of agricultural credit trends. The number of loans made approached 7,000, for an average size of over 1,600 dollars. Preliminary figures indicate that the active loan demand was maintained during March.

Credit is used for many different purposes. But most farmers use credit (1) to bridge the gap between current receipts and current expenditures or (2) over a longer term, to finance a larger business than can be financed from their own funds. Most of the farm loans made by country banks are for the former purpose and, therefore, are seasonal in nature and are made for relatively short terms. However, as the seasonal flow of income and outlays differs by type-of-farming area, credit practices also differ.

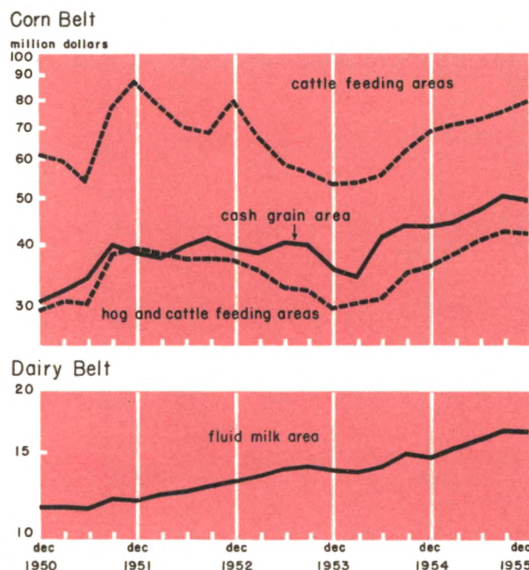
Loan maturity, repayment schedules

Loans to Corn Belt farmers are largely scheduled to be repaid out of income received from the sale of cattle, hogs or grain. Such sales usually are made only a few times each year. As a result, 75 per cent of the non-real estate credit used in Corn Belt agriculture carries a maturity of less than twelve months and about one-third is written for a period of six months. Furthermore, nearly 90 per cent of the loans are scheduled to be paid in lump sums (single payments).

On the other hand, in dairy areas, where the production period is seemingly continuous, loans typically carry a longer maturity. In the fluid milk area of Wisconsin, over two-fifths of the dollar volume of credit extended to farmers in February was written with a maturity of twelve months or longer. And, reflecting the regularity of farm income, about one-half of the agricultural loans made by commercial banks in the Wisconsin dairy area are scheduled to be paid in instalments. In many cases these instalment loans are repaid by assignment of a portion of checks received by farmers for their milk.

While changes in scheduled repayments and maturity go a long way in providing credit to farmers on terms that coincide with their seasonal flow of income and expenses, seldom are these practices completely adequate by themselves. Unexpected variations in income

Outstanding farm loans reflect contrasting seasonal credit demands in different types of farming areas



Note: Excludes loans secured by farm real estate or guaranteed by CCC.

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due to abnormal weather and unexpected shifts in market prices may cause departures from plans at the time loans are made. Final adjustment of payments to coincide with actual receipt of income is often made by renewing loans, i.e., extending their maturity.

Loan renewals

In the Corn Belt, where cash farm income has lagged year-ago levels by 10 per cent and net income is down by possibly one-fourth, renewals made up over 35 per cent of all the credit granted during February. But even in the fluid milk area of southeastern Wisconsin, where farm income was maintained near the year-ago level, one-third of the credit extended in February represented renewals. However, the greatest portion of renewals in the dairy area were for farm machinery, purchase of dairy cows and land and building improvement programs. Only one-third of the total volume of renewals was for operating expenses compared with over half in Corn Belt areas.

Extensions of operating loans would seem to be particularly associated with repayment difficulties as these loans normally would be paid out of current income. Repayment of machinery, farm improvement and dairy cow loans can reasonably be extended over a longer period in keeping with their longer productive life.

Renewals in specialized hog areas were the highest of any type-of-farming area in the District. During February, banks located in eastern Iowa and west central Illinois reported that about 40 per cent of the credit granted represented renewals. This compares with a ratio of renewals to total credit granted of 30 per cent in the cattle-feeding areas of western Iowa and northern Illinois. With improvement in hog prices from the winter lows and prospects that prices after late summer will average higher than a year ago, loan pay-off should improve in these areas.

Renewals provide flexibility

The practice of renewing or extending loans provides considerable flexibility in repayment terms that cannot easily be provided in the contractual terms of farm production loans at the time they are made. Hence, renewals have become an integral part of the farm credit picture and are often used to carry borrowers over periods of temporary setbacks, such as those experienced in the cattle and hog areas last fall and winter. However, loan renewals cannot provide an appropriate remedy for prolonged or serious loss of income due to "permanent" shifts in prices or costs.

Operating expense loans topped bank loans for all other purposes made to farmers in both the Corn and Dairy Belts in the past winter

Purpose of loan:	Livestock feeding areas of Illinois and Iowa		Fluid milk area of southeast Wisconsin	
	Per cent of credit granted	Average size of loan	Per cent of credit granted	Average size of loan
Farm operating and miscellaneous expense	33	$1,201	27	$ 980
Buy feeder cattle	27	3,625	12*	7,804*
Buy other livestock	10	1,480	19	1,672
Buy farm machinery	9	1,598	25	1,691
Buy and improve land and buildings	11	3,592	5	2,950
Consolidate debts	6	2,009	9	2,017
Personal expense	4	571	3	580
	100	1,612	100	1,491

*Figures reflect the influence of a few large loans to finance purchase of feeder cattle.

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Firming up the softer spots

In a dynamic economy, industries and communities advance at unequal rates. Some may even decline while the rest grow rapidly. The American economy's freedom and flexibility—its aggressive adaptation to change—in large part explain its spectacularly successful performance in recent years. But the changing nature of the economy also explains the existence of soft spots, that is, of areas where hard times persist amidst record prosperity.

Apart from agriculture's difficulties, which are not considered here, throughout the postwar decade there have been several dozen urban communities in which unemployment has been heavy and chronic. Most often this has occurred in places where the local economy has been heavily dependent on exploiting a natural resource which is either giving out or no longer in heavy demand. In other cases, key firms have moved their operations, and the gaps in employment opportunities have been too large to fill quickly. In still other cases, a community's principal industries have experienced technological changes which reduced man-power requirements substantially. In nearly all these cases, the changes that have led to local distress have been by-products of shifts in the national economy which lead to greater efficiency and higher standards of living for Americans generally.

This is cold comfort to the communities which have borne the brunt of the changes. Most of them have tried hard to overcome their difficulties, mainly by attracting new industry, but with varying degrees of success. Now there are proposals that the Federal Government lend a hand on a considerably larger scale than previously. The President, in his Economic Report presented to Congress in January, suggested a program of financial and technical aids, suggestions which are embodied in a bill (S.2892) introduced by a group of 26 Senators. Somewhat different proposals were included in a bill (S.2663) introduced last July by Senator Douglas and seven other Senators. Both bills are in the hearing stage.

Who's depressed?

These two sets of proposals differ in their definitions of a "depressed area," for there is wide room for disagreement here. But, wherever the line is drawn, persistent and substantial unemployment must be evident. There are close to 70 labor market areas which, according to the U.S. Department of Labor Area Classification Summary, have had "substantial labor surpluses" for the better part of the last two years, a period including a year of mild recession and a year of record prosperity.

About two-thirds of the areas of "substantial labor surplus" are in the Middle Atlantic or southeastern states. Three states alone—Kentucky, Pennsylvania and West Virginia—contain over 30 such communities. In contrast, there are virtually no pockets of heavy, chronic unemployment in the Great Lakes region or west of the Mississippi. In the five states which lie partly within the Seventh District, only southern Illinois has the characteristic long term depressed area problem.

The reason for the Midwest's relative good fortune, and the comparative misfortune of the states to the east and south, lies in the differing industrial makeups of the regions. Midwestern cities by and large are concentrated in hard goods manufacturing, mainly metals and products made of metal, and farm product processing. These are industries which have done very well in recent years. On the other hand, in coal mining, textiles and apparel, and the furniture, lumber and wood products industries sharp increases in productivity or slow growth in demand have led to reduced employment, and these industries are considerably more important elsewhere in the country.

As a matter of fact, in 30 of the close to 70

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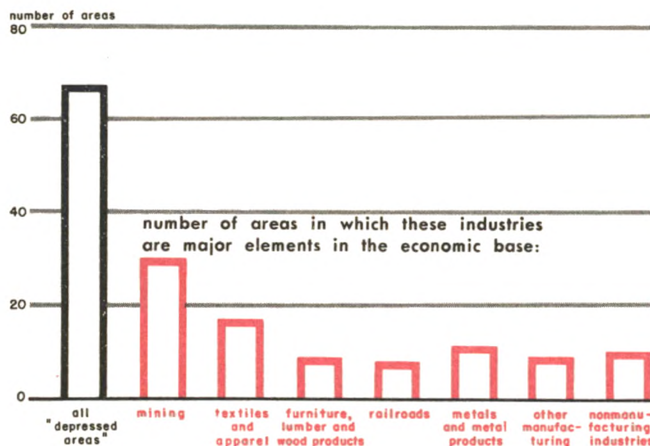
depressed areas, mining is or has been one of the major sources of local employment. In most of these areas, coal mining has been virtually the only important industry. Coal has faced stiff competition from alternative energy sources over the past twenty-five years—oil and natural gas for home and industrial heating, diesel fuel for railroad motive power and hydro for power generation—and coal production has suffered. Last year bituminous production was about an eighth below that in 1929 and nearly a fourth lower than the World War II peak. The anthracite communities have been even worse off, since anthracite output is little more than a third that of the 1920's. Along with the declines in total output have come marked improvements in efficiency, so that employment in mining has declined sharply. Last year mining, except for oil and gas, employed nearly 45 per cent fewer people than in 1929 or during World War II. Even though increasing electric energy requirements and increased steam generation of power may be reversing the trend in bituminous production, it is highly unlikely that output will rise enough to substantially increase employment in the industry. Thus, the depression in coal mining areas is no temporary affair.

A number of the mining communities have had very substantial railroad employment in the past, but this element of diversity has not helped. Railroad employment is now only about two-thirds as great as in 1929 and about three-fourths as high as the wartime peak. Loss of traffic to competing transport media is not the villain here, for in total the physical volume of rail traffic is close to 40 per cent greater than 25 years ago, although it is one-fourth below the swollen wartime peak. Increased efficiency, notably through dieselization, has tremendously reduced the railroads' labor needs, especially for equipment maintenance.

Increased efficiency and geographic shifts in industrial location, rather than reduced output, are responsible for the spotty employment picture in both textiles and apparel and the wood products industries—industries in which quite a few of the depressed areas are specialized. In these industries, employment nationally is not far below the all-time peaks. On the other hand, job totals are not very much greater than they were a generation ago when the population and the economy as a whole were considerably smaller. This is in the face of expanded output in these industries, expanded even from wartime peaks. What has happened is that the demand for the products of these industries has not expanded sufficiently rapidly to offset improvements in efficiency. To make things worse for individual communities, the industries have changed their products and moved their factories to new locations, leaving the older centers exposed to chronic unemployment.

Other industries also have changed their product-mix, branched out in new locations and greatly increased physical output per man-hour. But the demand for their products has grown by leaps and bounds and consequently they have provided continually more jobs, in the older centers as well as in new locations. For example, a

Depressed areas—the industries they specialize in



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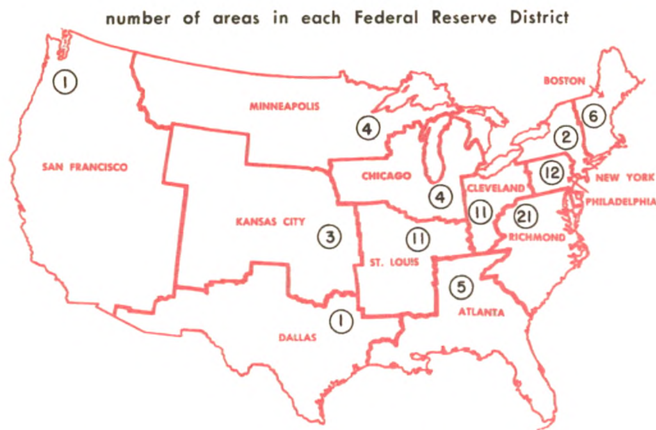
"Substantial labor surplus" areas in March



little more than twice as many employees today are producing more than three times as much machinery as 25 years ago. Nearly 70 per cent more employees produce 150 per cent more motor vehicles. About 33 per cent more employees handle close to 250 per cent more nonrail traffic.

Spontaneous adjustment

Quite a few of the depressed areas have stayed depressed for so long because they have specialized in not one but several industries without much growth. For example, in a number of Pennsylvania communities, the old mainstays were anthracite mining, the railroads and textile and apparel factories. All these have been hard hit, and the position of the communities involved is serious indeed.

The "weak" industries have also been represented in communities which are not depressed today. But in these places, growth industries have expanded to take up the slack and now form the basis of a prosperous local community. Decatur, Illinois, for instance, was heavily dependent on railroads and the wash dress industry years ago. Rail employment dropped precipitously with dieselization, and the wash dress industry has not grown. But a variety of durable goods producing firms have expanded or newly located in the community, and the area is now among the Midwest's more prosperous and rapidly growing centers. Decatur has done well not because of diversification—for some of the Pennsylvania cities were more diverse 25 years ago—but because of concentration in rapidly growing industries. The adjustment process in Decatur—and in Waterloo, Iowa, —is discussed in the Bank's *1955 Annual Report*.

Essentially, to keep growing and to keep its growing labor force profitably employed, a community needs to be specialized at least in part in the production of goods and services the demand for which is steadily and substantially growing. It is not enough to make things for which demand is stable, for improved techniques of production will cut employment over the long run. As the figures indicate, the so-called "weak" industries have found it possible to adopt labor-saving methods.

There are of course other explanations for chronic unemployment aside from specialization in industries which have not grown much over-all. In some communities, the local firms in otherwise successful industries have done poorly. In a number of smaller cities, the removal of a single large employer—a factory or perhaps a large Government installation—has had disastrous effects on local employment. Since people are reluctant to abandon their homes and local ties of all sorts, they tend to stay on in such cities for long periods at reduced living standards, rather than promptly move out in search of jobs elsewhere. Any individual city is always exposed to hard times despite nationwide prosperity. A major issue, then, is what can be done to help hard-hit localities attract offsets to their misfortunes.

Curing local depression

Americans constantly use a tremendous variety of goods and services. Moreover, they are spread over an area of continental dimensions. Thus, nearly every community is close enough to some raw materials or some markets

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to be a good place for one or more types of industrial activity. However, to capitalize on its natural locational advantages and succeed in attracting industry from outside or developing indigenous producers, an area must have a number of prerequisites. The basic community facilities must be adequate for industry and for the increased population which usually follows industrial expansion. These include ample supplies of water and power, adequate transport and sanitary facilities, and a variety of similar services often provided by local public agencies. Moreover, the labor supply must be trained—or capable of being trained—for work in modern industry. In addition to these prerequisites, private firms may require an initial stimulus to locate in a depressed area via some sort of financial inducement.

Federal assists

These types of cures are proposed in the legislation now in the Congressional hopper. The bills differ in detail, but broadly they suggest similar remedies. The bill which follows the proposals in the President's Economic Report first of all would set up an Area Assistance Administration in the Department of Commerce. This unit would provide technical assistance directly or through grants to communities for studying their resources and preparing plans for industrial development.

It would also make capital improvement loans for projects that give promise of improving a community's long-run outlook—such as the construction of industrial facilities, the purchase and alteration of existing facilities, or the consolidation and development of tracts for industrial sites. The loans would be made only when financing "on reasonable terms" from private sources is unavailable. The Federal loan would not exceed 25 per cent of the project's cost while the state or local government share would not be less than 15 per cent. The loans would be made from a 50 million dollar revolving loan fund. Maturities would be restricted to 20 years and loans would have to have a "reasonable assurance of repayment." They could not cover working capital or machinery and equipment purchases nor help a company relocate a plant if that resulted in substantial unemployment in the community abandoned.

Another major provision would give depressed areas priority in access to the 100 million dollar Federal loan fund set up last year to make loans for needed public works which could not be otherwise financed. Still another would waive the requirement that a section be primarily residential in character to be eligible for Federal financial participation under the urban renewal program. In other words, in depressed areas, public agencies might, with Federal help, acquire and redevelop blighted commercial or industrial areas for commercial or industrial uses.

Senator Douglas' alternative would set up an independent Depressed Areas Administration, which could make types of loans similar to the proposed Area Assistance Administration, but up to 100 million dollars in total, up to 40 years maturity, and with two-thirds Federal participation and no requirement for state-local government participation. Other conditions of the loans are similar in the two bills. The same agency, in the Douglas bill, is authorized to make grants as well as loans to local public agencies to construct needed public works, the size of the grant or loan depending on the funds which can be raised otherwise locally. The Douglas bill also provides for a broader program of retraining the unemployed in depressed areas and for Federal supplementary unemployment insurance payments to unemployed workers undergoing retraining for 13 weeks after they have exhausted their benefits under state laws.

Subsidizing private industry

Public financing to stimulate private industry is not new in the United States. In the pioneer period, canal, turnpike and railroad developers were heavily subsidized from public funds and public credit, largely because capital was generally scarce and private credit unavailable on the frontier. More recently, public credit has been employed to bolster private industry in

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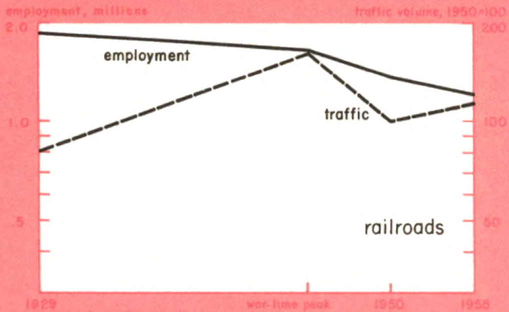
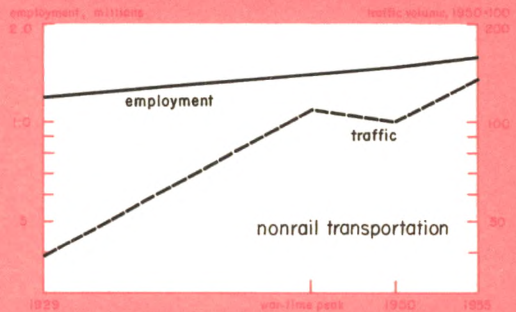
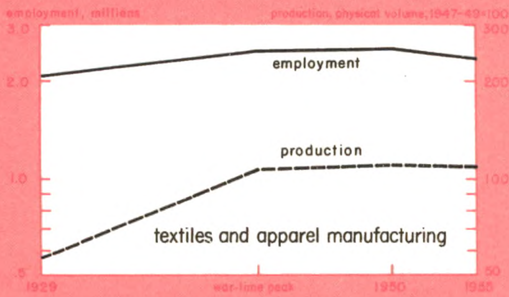
Jobs and output in industries . . .

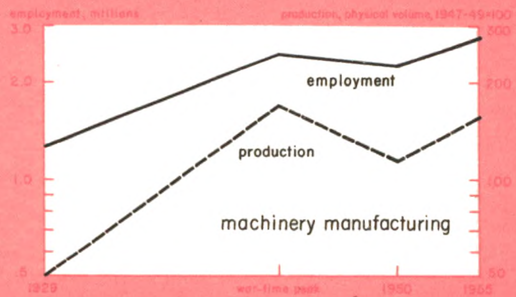
which are growing slowly or declining

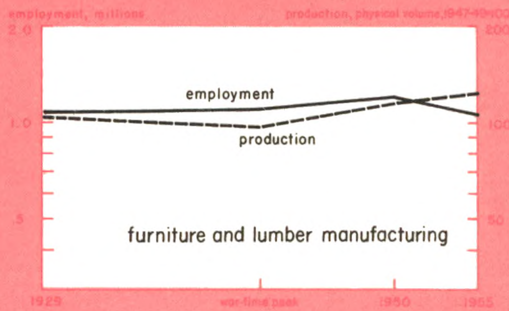
which are growing rapidly

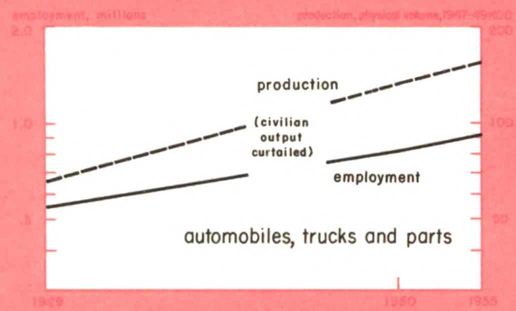


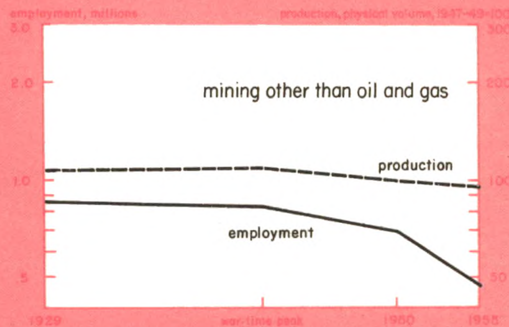


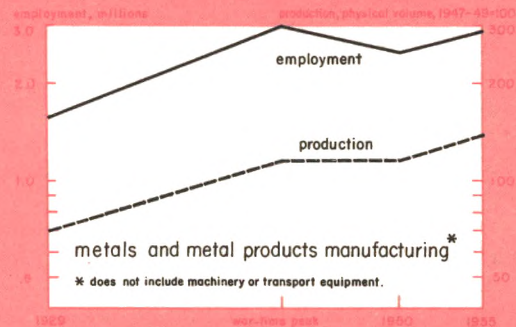












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depression and to enable it to convert rapidly to war and defense production. Still more recently, a number of states, mostly in the South, have permitted their cities to borrow to build new factories which are leased to private operators, thus attracting new industry to underdeveloped communities.

The new proposals are akin to this. Though most companies can raise funds at reasonable rates on their own, some still have enough difficulty so that the offer of public credit may be able to induce them to expand in depressed or underdeveloped areas. But a more important attraction for established companies is apt to be the savings in interest costs made possible by borrowing from the Federal and local governments at the lower interest rates public debt commands. In essence, this is a subsidy, though perhaps only a small one, to firms which expand in depressed areas.

While there is no doubt that the depressed area which thereby receives a lasting addition to its economic base is benefited, for the country as a whole, the effects of this type of subsidy may be "good" or "bad" in individual cases. Often, the use of public credit with a relatively small element of subsidy may have great leverage in increasing output and employment, nationally as well as locally. This could be the case when unemployed resources can be quickly put to work in high value production.

On the other hand, output and income may be increased locally at the expense of the nation as a whole. Firms normally locate expanded operations where over-all costs are lowest. However, Government financial participation may induce firms to expand in cities where total costs would be higher were it not for the element of subsidy via lower interest rates. In such a case, costs to the firm will be lower in the subsidized location, while costs to the economy will be higher, since the company's costs plus the value of the subsidy are greater than the total unsubsidized costs would have been in alternative locations. In this instance, the country would be better off if workers were encouraged to migrate to the truly lower-cost locations where industry is naturally expanding.

Improving local public facilities

The impact of the other chief remedy—Federal aid in improving public facilities in depressed cities—is not nearly so equivocal. Companies seeking new locations for their expanded operations have become increasingly sensitive to the condition and adequacy of a community's physical plant. For one thing, rundown and overloaded schools, roads, sewers and water works make it more difficult both to engage in large-scale industrial operations and to attract to the area the key technical and managerial personnel needed. Then too national companies are sophisticated about local public services and local taxes. A new large plant in a community is likely to bear a heavy part of the future tax load needed to finance replacement of poor public facilities.

Moreover, in a depressed area, tax rates are often already high because of high public assistance and similar costs and an inadequate property tax base caused by the low level of operations of local industry. To do much about the inadequacy of the public facilities, such a city often needs outside help. If the public facilities are bad enough, firms may refuse to locate in the area despite the fact that costs of operation there would otherwise be low. Unless the location of the community is so bad that nothing can induce employers to locate there, special assistance to help it improve rundown public works is apt to be in the nation's as well as the area's long-run interests.

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A birthday for savings bonds

May 1 marked the fifteenth anniversary of the savings bond program. Still very much alive, this program is currently raising cash for the Treasury. For most people Series E bonds still epitomize the savings bond effort. Millions of savers continue to buy and hold these securities. The most dynamic factor in the program today, however, is not the E bonds —born in the shadow of war and nurtured by patriotic zeal—but the newer H series, designed to fit the vastly different motivations of savers and investors under peacetime conditions.

Two kinds of customers

There have always been two fairly distinct groups of buyers of savings bonds with different motives and widely varying patterns of purchases and redemptions. Denominations of $100 and under are for the most part bought by small savers, who accumulate bonds fairly regularly, principally through payroll deductions. Sales of these small denominations thus represent current savings. On the other hand, large denomination bonds—ranging from $200 to $10,000 maturity value—are bought by "investors" and are more likely to reflect shifting preferences among alternative uses of funds, largely determined by the desire to maximize investment yields.

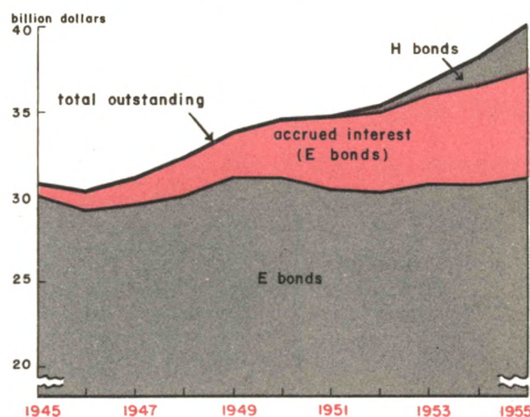
In the postwar years the Treasury has been faced with two major problems with respect to the program—to maintain a high level of savings bond sales and to hold down the volume of redemptions. Despite continued publicity stressing the importance of buying and holding savings bonds both as a national need and as a means of personal security, by 1951 redemptions were outrunning sales by a disturbing margin. In addition, the large volume of bonds sold in the war years were approaching maturity. Unless holders could be persuaded to reinvest the proceeds, a heavy cash drain would result from redemptions of these bonds.

In the absence of wartime incentives, savings bonds had to be made more appealing to both types of buyers. Inducements were offered in the form of higher and earlier interest returns. The annual limit on purchases by any one individual was doubled. The H bond—comparable to Series E in yield, but sold and redeemable at par with interest paid semiannually—was introduced. And, of course, holders were given the option to retain maturing bonds at a 3 per cent yield for an additional ten years. These features proved more attractive for large buyers than for small ones, and as a result the program now depends less on the small savings of wage earners and more on investment funds for its support.

For small savers—a smaller share

At the end of 1945 about two-thirds of the E bonds outstanding were in small denominations. Ten years later small savers accounted for only a little over 40 per cent of the total. Sales of small denomination bonds dropped

"Borrowed interest" accounts for most of the postwar increase in value of outstanding bonds



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severely in 1946 and 1947 and were exceeded by redemptions by more than 3 billion dollars. Since that time, however, annual sales have gradually risen and the margin of redemptions over sales has narrowed.

Perhaps the most striking achievement of the program in its struggle for survival is that of holding down the volume of bonds turned in for cash. With 30-odd billion dollars of demand obligations in the hands of more than 40 million people at the War's end, this was no mean task. Small savers, quite naturally, have always had a much higher rate of cash-ins before maturity than the big bond buyers. In fact, the higher the denomination of a bond, the greater its chances of being held to maturity. The preponderant volume of prematurity redemptions of the small bonds, however, occurs within the first year after purchase. Since the late Forties about 40 per cent of small bonds purchased each year have been redeemed by the middle of the following year. After the first year, however, the rate of cash-ins drops sharply.

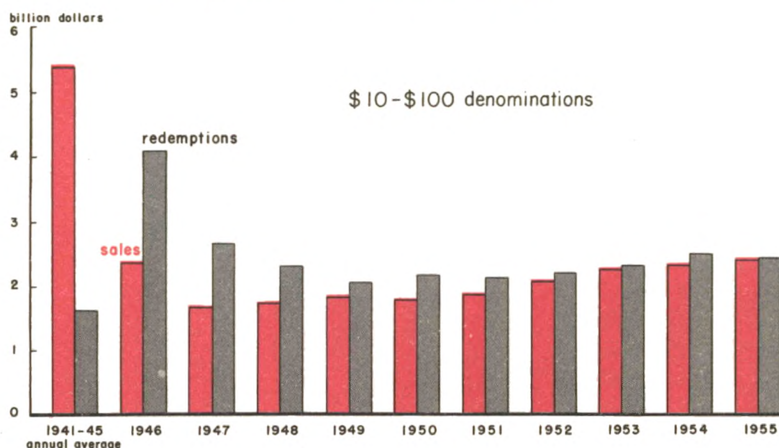
For large investors—renewed interest

The current interest of big investors in savings bonds stems largely from the revisions made in the program in 1952. Probably most important of all was the introduction of the H bond. This bond, in denominations of from $500 to $10,000, has proved attractive to large investors who find added convenience in the current income feature. Coupled with the downward swing of market yields during the business recession, this new program helped to bolster sales of large denomination bonds during 1953 and 1954. Most of the increased sales, however, were in the new H series.

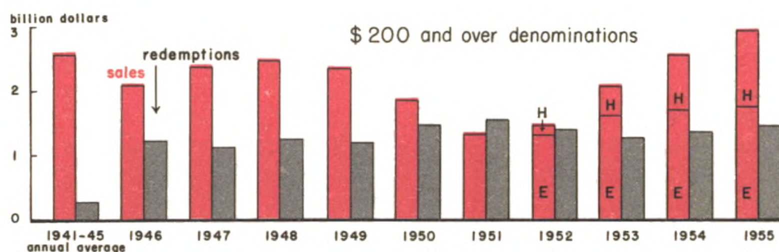
Despite the rise in market interest rates during 1955, large investors continued to increase their purchases. At the beginning of last year both E and H bonds were for the first time made eligible for purchase by personal trust estates. Such investors, for whom the H bond is singularly suited, undoubtedly accounted for a large portion of 1955 sales.

Although sales to big

Sales of small denomination E bonds are catching up with redemptions . . .



but large denomination E and H bonds are providing major support for the program



Note: Both sales and redemptions are at issue price.

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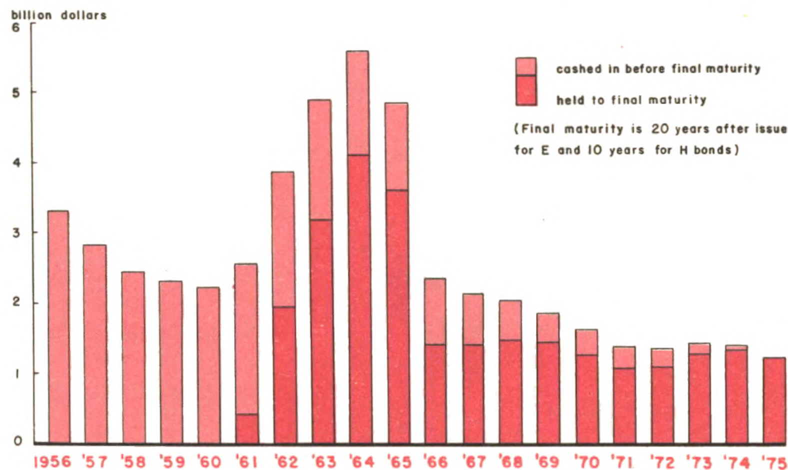
buyers have fluctuated more than those to small ones, once purchased, big bonds are less likely to be cashed. First-year redemptions of large denominations are about 10 per cent of the previous year's sales and have been getting relatively smaller. This improvement is partly due to the fact that the H bonds, on which cash-ins are very small, have accounted for most of the recent growth in the big bond sales.

Projected redemption pattern for 1955 holdings of E and H bonds under present law and at current cash-in rates



The difference in redemption practices of large and small holders largely disappears after bonds have been held for ten years, and at maturity the rate of redemption tends to be similar for both groups. By the end of this February, 20.3 billion dollars of E bonds had reached their original maturity. Of these, 14 billion, or almost 70 per cent, were still held under the optional automatic extension terms. The value of these retained bonds to date is equivalent to the total of all E bond sales during the past three and one-half years. Moreover, the percentage of each year's maturities retained has improved steadily. Of the bonds which matured in 1951, 27 per cent were redeemed in that year, whereas of those maturing in 1955 less than 15 per cent were turned in for cash by December 31.

Where do we stand?

Chiefly as a result of the developments of the past three years, the bond program is now in a healthier condition, judged by the net flow of funds into savings bonds, than at any time since the War. The cash value of E bonds outstanding at the close of 1955 was 37.5 billion dollars. Of this total, however, 6.3 billion was "borrowed interest." In addition, the public held 2.5 billion of H bonds. The growing interest accruals on bonds approaching maturity have resulted in a steady growth in the current value of outstanding E bonds. However, redemptions, including interest payments, have exceeded cash sales in every year since 1949. This cash deficit amounted to almost 400 million dollars in both 1954 and 1955. The drain from E bonds, however, has been more than offset by the performance of H bonds, which netted the Treasury over a billion dollars last year, not counting interest paid out currently on this series. Preliminary figures for the early months of 1956 indicate that sales of both series are running slightly higher than last year's record, but so are redemptions.

The outlook

If recent levels of sales can be maintained, even the small denomination bonds may well bring more new funds into savings bonds than are paid out, now that the peak years of initial maturities are past. This "if" depends largely on two things—the trend of total savings which, in turn, will reflect income and employment conditions, and the extent to which E bonds are able to attract savings in competi-

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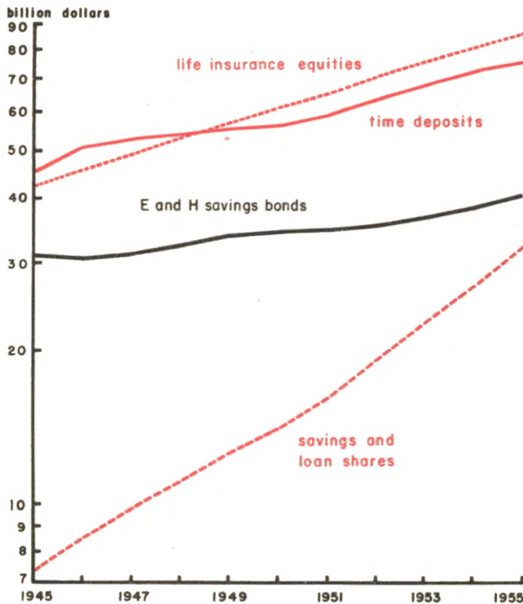
Savings bonds have not kept pace with the growth in other major types of liquid assets



tion with other savings institutions. Savings bonds have lost ground relative to other forms of savings since the War and this has been increasingly true in the last five years. Nevertheless, the Treasury's objective has not been to "compete" with other savings institutions in the sense of getting its proportionate share of total savings. Rather it has been merely to sell enough bonds to prevent a cash drain.

Now successfully over the peak period of initial maturities, the Treasury's problems in meeting redemptions can be expected to diminish until 1961 when the bonds held under automatic extension will begin to reach final maturity. The accompanying chart shows the estimated repayment schedule, on the basis of recent redemption experience, of bonds outstanding at the end of 1955. Amounts are the approximate value at the expected time of redemption.

This projection indicates that another bulge in redemptions will face the Treasury from 1962 through 1965. In these years the bonds originally sold during the War and retained for the full 10-year extension period will become due for payment, as will the H bonds sold in the past four years.

This schedule, of course, makes no provision for redemptions arising out of current and future sales. The Treasury's sales goal for this fifteenth anniversary year is 5,650 million dollars for E and H bonds together, or roughly 300 million greater than last year's record. The Treasury hopes for a continued level of sales at least sufficient to offset repayments. To the extent, however, that the trend for heavier participation by large investors continues, and particularly if their purchases are predominantly of H bonds, prematurity redemptions are likely to be substantially reduced. Relatively little will thus be added by new sales to potential cash-ins prior to 1965, while more will fall into the schedule at maturity in later years.

The heavy dependence of the bond program on large investors is in itself a factor which adds uncertainty to the outlook. Past experience indicates that these investment funds are fairly volatile and tend to move quickly into areas which provide more lucrative rates of return when the yield spread widens. Probably the worst thing which could happen to the bond program would be a developing inflation. This not only would divert big investor funds away from savings bonds but also might tend to discourage savings accumulations in any form.

Should a recession be in the offing, redemption of bonds by many small savers would be encouraged to augment falling purchasing power. At the same time, investors faced with declining market yields would be likely to find savings bonds an even more attractive investment. With large investors as the mainstay of the savings bond program, the Treasury thus stands to suffer a smaller drain in case the business cycle turns downward. But, by the same token, the program has lost some of the stabilizing influence which was one of its major objectives fifteen years ago.

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