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Business Conditions

1957 January

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THE Trend OF BUSINESS

As 1957 begins, American business is operating at record levels and appears to be pushing toward still higher ground. In the final months of 1956, employment was running ahead of year-ago figures by more than one million. Sales of manufacturers and trade firms were at new highs, and the backlog of orders indicated continued strength in the months immediately ahead. Inventories were rising, and business outlays for new plant and equipment were still moving up. In the early fall, industrial production exceeded the previous high point established in December of 1955 and appears to have continued its advance.

Over-all demand has been so strong as to keep inflation in the news as the nation's number one economic problem. By October, wholesale prices had risen about 5 per cent since the current uptrend got under way in mid-1955. The rise in consumer prices, as usual, has lagged behind the advance at the wholesale level. It was not until February of 1956 that the over-all stability which had been evident in the consumer price index for three years began to give way to a persistent uptrend. From then to October, consumer prices had mounted 3 per cent on the average, and it was generally expected that subsequent figures would reveal further boosts.

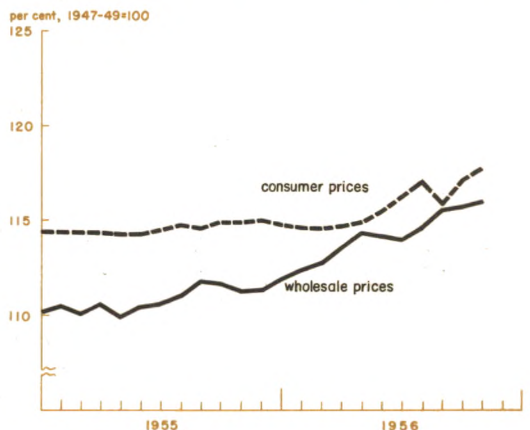
For how long?

Few observers doubted at the turn of the year that good and perhaps rising business was in prospect for three or six months to come. Short of some drastic, unforeseen curtailment of consumer buying, the volume of spending commitments indicated by unfilled orders, construction contract awards and governmental budgets insured that existing momentum would not be dissipated soon. But, as so often before, the insight into the future becomes increasingly fuzzy as the range is lengthened.

In some respects the situation is similar to that of a year ago. It was generally believed at that time that 1956 would be a record year, but there was some concern that a reduced level of automobile sales and a decline in residential construction coupled with the end of inventory building might produce a slowing of over-all activity in the final half of the year.

At the present time the factors making for strength are fairly evident. *Federal Government spending* which had declined in 1954 and 1955 and leveled in 1956 is expected to rise by at least 1 billion dollars and possibly considerably more as a result of increased military outlays, farm income supports and other programs. *State and local governments* are expected to boost their expenditures on goods and

Consumer prices lag upswing in wholesale prices but reach new high



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services by almost 3 billion dollars as they did between 1955 and 1956.

Personal income has risen steadily, and a higher rate of savings relative to income suggests that a significant increase in consumer buying could occur. Aside from certain household appliances, the one really weak spot in retail sales in the past year has been automobiles. However, industry executives now believe that domestic sales of new cars can be expanded from 5.8 million in 1956 to around 6.5 million or more in 1957.

Wages and salaries have been supplying the main push to personal income, but dividends and interest payments are also higher. Moreover, farm income is expected to rise about 5 per cent in 1957. Mainly because of higher farm income, farm machinery manufacturers say that they are planning on a sales increase of possibly 15 per cent in the coming year.

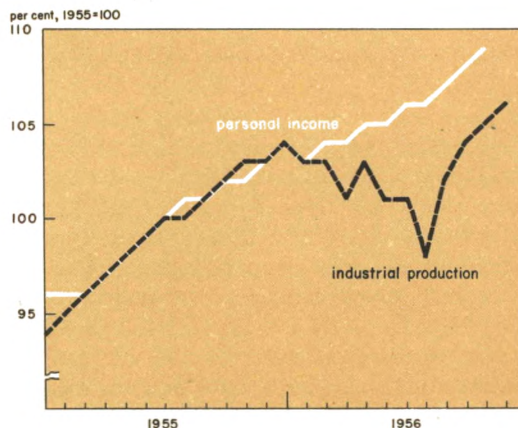
With improvement indicated for farm machinery and autos, the prosperity projected for 1957, if realized, is likely to be spread more evenly in the Midwest than in the past year.

Business spending on plant and equipment provided an important stimulus to over-all activity in 1956. There is little question that this area will see even greater expenditures in 1957, but there is doubt that a substantial further gain from present advanced levels is in prospect (see article p. 4).

Construction, over-all, is slated for a 5 per cent rise in 1957, according to a recent Government estimate. Except for residential building and certain commercial types, all construction categories are expected to rise or remain stable. In housing, a projected drop of almost 10 per cent in number of new units probably would result in a decline of only 3 per cent in expenditures because of higher prices, larger houses and increased outlays on additions and alterations.

There are still many individuals who believe that business growth will halt temporarily some time during the year. Arguments for this view are somewhat vague in contrast to a year ago, however. Rather than an enumeration of specific markets that might suffer declines, pessimists point to developing indications of excess capacity, smaller corporate profit margins, tight money and a less than spectacular volume of early Christmas sales. There is also the belief that a general upswing cannot continue indefinitely and that the present "boom is tired."

Gain in personal income outpaces industrial production



Where is the ceiling?

In recent years business executives, government agencies and private economists increasingly have made their predictions on prospective business activity available to the public. The great majority of these estimates indicate a gross national product for 1957 somewhere between 428 and 435 billion dollars, or 4 to 5 per cent above 1956. The range in these forecasts is unusually narrow, indicating a high degree of unanimity as to the outlook.

Even a GNP of 435 billion dollars would not necessarily mean that the economy was working under as much pressure to boost output as in the past year. Over-all capacity in manufacturing is estimated by McGraw-Hill economists to have risen 8 per cent in 1956. Also, 1957 looks like a year of general labor peace. These factors suggest that a considerable increase in productivity — output per man-hour — could occur, in contrast to the meager gain in 1956.

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Capital expenditures— mainstay of the boom

A sharp uptrend in business investment in new plant and equipment played a leading role in the rise in over-all activity and the price increases which developed during 1956. Last year these outlays for buildings, machinery and other capital goods amounted to 35 billion dollars, 22 per cent more than the previous high in 1955. The rise of 6.2 billion dollars amounts to almost one-third of the gain in total output.

The current upswing began in the spring of 1955. Since then capital expenditures have continued to rise at a rate of 5 per cent a quarter. The current level is almost half again as large as it was at the start of the rise. The gross national product, meanwhile, has shown a rise of about 15 per cent.

Another gain likely in 1957

There is strong evidence that 1957 will see a further rise in the dollar volume of business capital expenditures. A recent McGraw-Hill survey of business expectations indicates a substantial year-to-year increase. One reason is the sharp uptrend in equipment prices and construction costs which may rise by 6 per cent on the average. Although there seems to have been some slippage in the volume of newly approved projects, order backlogs for machinery and new construction projects in the planning or contract-letting stage remain at high levels.

Many firms found that deliveries of equipment and the construction schedules for new buildings were delayed during 1956 because of shortages of materials and skilled man power. The steel strike was particularly important in slowing the rise in expenditures in the third and fourth quarter of 1956. But even before the shutdown, equipment producers found that obstacles to increasing production were delaying shipments beyond scheduled delivery dates.

Nevertheless, there is concern that business expansion may not add a further upward stimulus to general activity during the coming year. These outlays rose continuously during 1956, and fourth-quarter spending was 7 per cent above the average for the year. Mere continuance at the current rate, therefore, would result in a sizable year-to-year gain.

There is also some question that the announced programs will be fully realized. The squeeze on corporate profit margins evident during 1956, coupled with stringency in the credit markets, may affect the ability of business to finance further increases in the rate of investment. Moreover, capacity is catching up with demand in some basic industries.

Will capital expenditures peak out in the months ahead and begin to slide off? Those skeptical of the durability of the business boom expect weakness in this sector to constitute a drag on general business during the second half of 1957. To keep a clear view of the business outlook, therefore, it will be helpful to keep posted on capital expenditure plans as the year moves on. Fortunately, great progress has been made in recent years in analyzing capital goods trends and evaluating their contribution to total spending.

Spotlight on the future

At the start of 1956, rising capital expenditures were counted upon as a supporting factor. Those who looked upon inflation rather than unemployment as the nation's first economic problem believed that this sector would more than compensate for any drops in automobiles and residential construction.

Since decisions to buy equipment or construct buildings, for the most part, must be made well in advance of delivery, it follows that

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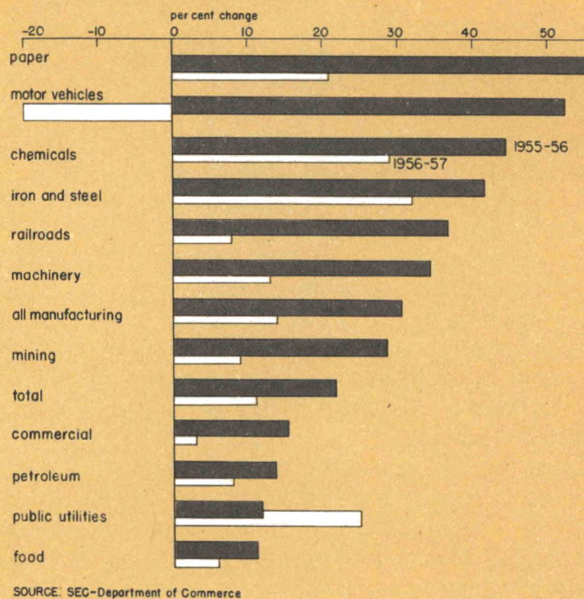
a survey of businessmen's spending plans can yield information on future trends. For the past decade, the Securities Exchange Commission and the Department of Commerce have conducted such a survey quarterly. Similar estimates are made at intervals by McGraw-Hill and other private organizations.



What the surveys show

In December, the SEC-DC report on capital expenditures indicated that capital outlays during the first quarter of 1957 would set a new high at an annual rate of 38 billion dollars. This level would be 16 per cent higher than a year earlier, but less than 2 per cent above the fourth-quarter rate.

The SEC-DC projection of capital goods spending for 1957 as a whole probably will not be available until March. The McGraw-Hill survey taken late in the year has usually presaged the Government figures with reasonable accuracy. It calls for an 11 per cent rise in total capital outlays in 1957, 14 per cent for manufacturing alone. If realized, this gain would be only half of the 1955-56 rise. Some categories, moreover, are expected to decline.

These results are fortified by other evidence. A *Fortune* poll of producers and buyers of capital goods indicates a year-to-year gain of 9 per cent. Regional surveys taken in New England and Philadelphia suggest a rise of 12-13 per cent.

These studies indicate that the largest increases are to be expected in iron and steel, nonferrous metals, machinery, petroleum refining, transportation and public utilities. Industries which expect declines include motor vehicles, which contributed heavily to the upsurge in 1956, textiles and building materials.

Optimistic as the results of these surveys appear, they provide little support for a further substantial advance in capital spending from current levels. Moreover, the National Industrial Conference Board's tabulation of projects newly approved by the managements of the 1,000 largest manufacturing firms showed a drop of 8 per cent from a year ago in the third quarter. Although this indicates a tapering off in new plans, it does not suggest an early demise for the capital spending boom. For the first nine months, approvals were up 23 per cent, and almost a year's backlog of previously approved projects remained. But the backlogs of orders of machinery producers also leveled in the third quarter as shipments rose and closed the gap between sales and new orders.

Financing capital outlays

Rising investment in both capital goods and inventories has put a substantial strain on business finances during the past year. Security issues for new capital were 20 per cent greater in the first nine months of 1956 than in the comparable period of 1955. And a sharply higher proportion of the proceeds of these issues has been designated for plant and equip-

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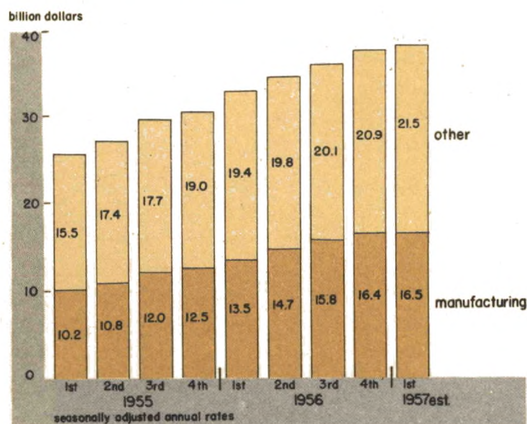
ment needs, 70 per cent in the third quarter of 1956 compared with 53 per cent in the same period of 1955. Moreover, a significant portion of the increase in bank loans in 1956 was necessitated by rising fixed investment.

In recent years depreciation taken on fixed assets purchased in the past has been the most important single source of funds for American business. In 1956 business firms accrued depreciation to the amount of 18.5 billion dollars, well over half of their total capital expenditures. Interestingly, it has been estimated that about half of all capital expenditure currently is needed to replace worn-out assets.

The Revenue Act of 1954 enables business firms to select alternatives to the straight-line method of depreciation which permit a faster write-off in the early years of an asset's life. Even more important in swelling depreciation totals has been the accelerated amortization program which permits the write-off for tax purposes of a large part of the amount spent on a defense-related facility in five years. As Government expansion goals have been largely achieved, this stimulus to new capital spending becomes less and less important. Moreover, in the years immediately ahead a large volume of the facilities covered by accelerated amortization will have been in place five years, and the portion of these projects covered by certificates of necessity will have been fully written off.

In some cases, business firms doubtless are unable to obtain funds to finance planned capital expenditure programs. Nevertheless, it is difficult to find specific examples. Business firms as a group have shown an ability to compete successfully for funds.

Capital spending continues up, but at slower pace



Consumer investment down

Business expansion has exerted a strong upward push on prices, especially prices of capital goods, over the past year and one-half. Machinery prices have advanced 15 per cent since mid-1955, more than double the rise in prices of all nonfarm commodities.

The strain on resources would have been greater had not consumer investment declined in 1956. Purchases of automobiles were off by one-fifth from 1955, and new housing starts dropped 15 per cent. Outlays on these primary types of consumer capital goods dropped by perhaps 3 billion dollars, almost half the rise in business capital expenditures. Consumer capital goods employ many of the same material resources as the capital goods of industry. Moreover, consumer investment is also financed heavily by borrowing from the same sources from which business obtains outside money.

In the first nine months of 1956 new finance company borrowing from banks declined sharply, and security issues did not rise substantially as did those of industry generally. Home mortgages absorbed about 13 per cent less money than in the year-earlier period.

If automobile buying rises substantially in 1957, additional credit will be channeled into consumer instalment loans. Under these circumstances heavy demand by business borrowers could mean continued stringency in the mortgage market. Institutional lenders are known to have been shifting commitments from mortgages to corporate bonds, a tendency which may be slowed by increases in permissible rates on FHA-insured mortgages.

Reasons for expansion

During 1955 and 1956, many business firms

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raised their sights in planning for expanded and modernized facilities. Throughout the postwar period, each upsurge in business activity has pushed production to capacity limits. Steel, nonferrous metals, cement and many basic chemicals have operated near capacity. A decade of experience with the postwar economy has convinced many executives that the future will see more or less continuous growth in output and sales. The desire to remove bottlenecks and prepare for this growth is therefore a prime reason for current strength in capital outlays.

The steel industry provides an excellent example of this attitude. At the start of 1946 the nation's steel capacity was rated at 92 million tons. By the start of 1950, this figure had risen to 100 million tons and there were fears of excess capacity in the years immediately ahead. Nevertheless, the expansion programs induced by the Korean war and the prosperous years which followed brought capacity to 132 million tons at the start of 1956. Moreover, industry spokesmen now speak of adding three to four million tons per year until 1970.

Can investment levels be sustained?

The recent increase in the stock of plant and equipment has raised the question of the sustainability of these levels in subsequent years. Already, there is talk of overcapacity in some lines which are contributing heavily to the boom. In some cases these industries will increase their spending in 1957, but easier markets for their products could affect outlays in future years.

Cement capacity was scheduled to rise 15 per cent in 1956, and further substantial gains are projected for 1957 and 1958. As 1956 moved on, cement joined other building materials in adequate supply. At least one cement producer has seen fit to postpone one of its projects, and other cutbacks may occur.

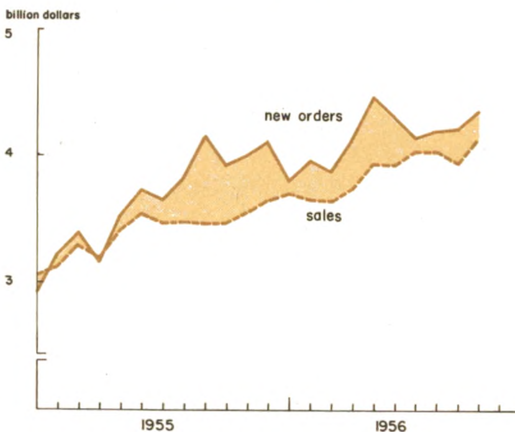
Steel continues to operate at capacity, but it is believed that about 10 per cent of current production is moving into inventory. When inventory building is completed, that margin of capacity will become available for other uses.

Scheduled increases in basic *aluminum* capacity in the United States indicate a rise of 30 per cent over 1956 in two years and a 45 per cent gain in four years. As a result, the president of the largest aluminum company has indicated that a rapid promotion of new uses for that metal will be needed. Similar statements have been made by producers of petroleum, paper and certain chemicals. All of these products have been in short supply during periods of full employment since World War II. Should the elimination of the basic resource bottlenecks provide cause for alarm?

Few of these industries operated within a hairsbreadth of capacity during the prosperous 1920's as they have during most of the past decade. And executives in many industries find capacity operation inefficient. They would like to plan on margins of 10-15 per cent over peak needs, so that obsolete facilities could be retired in an orderly manner.

The 22 per cent increase in private capital expenditures between 1955 and 1956 brought these outlays to 8.5 per cent of the gross national product. This ratio exceeds the proportion of previous years, but falls somewhat short of the proportions in 1947 and 1948. Moreover, it is probably not greatly in excess of the 1929 ratio, although directly comparable data are not available. Present levels of invest-

Machinery orders continued to exceed sales during the fall



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ment, then, are high but not unprecedented.

Ours is an expanding economy which continues to substitute capital for labor and which steadily provides new products requiring new facilities. The search for better goods and improved methods of production now involves outlays of 6 billion dollars per year on research and new product development. Increasingly, the belief is growing that capital goods outlays can be expected to march in step with total output almost indefinitely, moving up by 3 to 4 per cent per year. Past experience militates against the likelihood of a steady uninterrupted advance year after year. But evidence that most business firms are planning investment programs for several years ahead suggests that the extreme instability long associated with capital goods may be greatly mitigated.

Savings institutions less liquid

Americans have a considerable range of choice in deciding what to do with their personal savings. As the country emerged from World War II, the lion's share of personal savings was held in the form of U. S. savings bonds and time deposits at commercial banks. During the past ten years, however, other savings media have gained in popularity. Large relative gains have been experienced by savings and loan associations, credit unions, mutual savings banks, life insurance companies, pension funds and open-end ("mutual") investment companies.

Over the decade, nearly all savings institutions have become very much less liquid. This was to be expected, for there were few outlets for wartime savings accumulations other than Government securities. Institutions quickly applied their funds to the higher yielding investment opportunities which arose as soon as the war ended. Moreover, competition among institutions results in a quest for higher returns to be passed on to owners and savers.

An organization entrusted with the savings of others must maintain liquid reserves adequate to cover anticipated cash drains, notably recurring expenses and expected withdrawals. In addition, if anticipations prove overly optimistic—that is, if loan repayments or savings receipts are less than expected or withdrawals more than forecast—a properly managed institution should be able to cover such obligations short of precipitous liquidation of investments. Since the various types of savings institutions perform rather different functions and specialize in different types of assets or claims, their cash needs and the degrees of liquidity required differ considerably.

"Passbook" savings

Liquidity needs are greatest for the "over-the-counter" institutions—mutual savings banks, savings and loan associations, credit unions, and the postal savings system. For these organizations, both savings inflows and outflows are highly unpredictable. In practice, savers expect to be paid on demand, and the institutions by and large make their plans on the assumption of being able to meet such demands. Also, savings inflows have none of the regularity of

This article continues a series generally dealing with the shrinkage in the economy's liquidity in recent years. Articles in the November and December issues of **Business Conditions** have dealt with corporate and commercial bank liquidity. Future articles will discuss particular types of savings institutions in greater detail.

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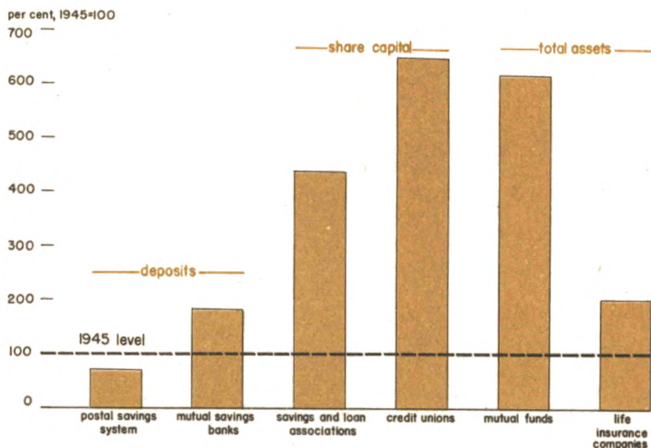
seemingly contractual obligations like insurance premiums or periodic payments in connection with installment purchase plans for mutual funds.

Therefore, the amount of cash and short-term Government securities required to meet any potential excess of withdrawals over new inflows is normally a higher proportion of assets. But even among these "passbook savings" institutions, liquidity positions differ. The postal savings system, for example, has almost absolute liquidity, since investments of the system are restricted to U. S. Government securities. The assets of the system consist, therefore, only of cash and Governments. Mutual savings banks have generally maintained a relatively high liquidity level, probably because accounts tend to be active. At the end of 1955 the ratio of cash and Governments to total deposits stood at 33 per cent. Historically, savings bank deposits have shown considerable over-all stability. Over the last fifty years, total deposits in mutual savings banks have declined in only three years, and in only one of these years, 1933, did declines exceed 1 per cent.

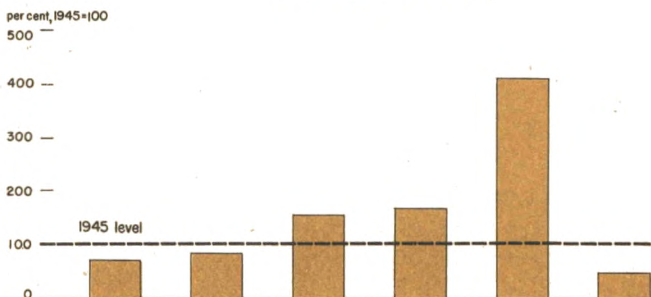
Share capital institutions

Liquidity needs of savings and loan associations and credit unions are inherently lower than those of banking institutions. This is for two reasons. First, because individual savers tend to make withdrawals less frequently, day-to-day cash needs are smaller. Second, because the savings they hold constitute the institutions' capital rather than deposit liabilities, in the worst event they can delay payment without becoming insolvent.

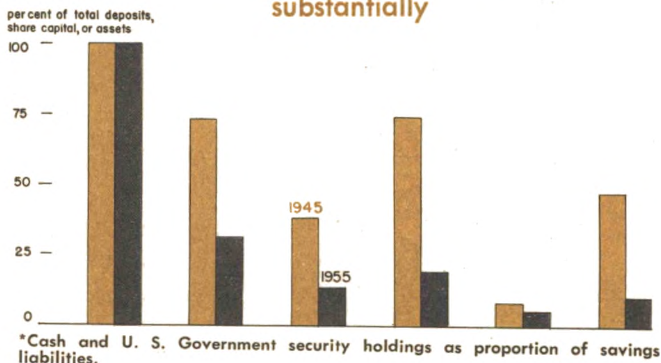
Major savings institutions have had considerable growth in the decade since 1945 . . .



but holdings of cash and U.S. Government securities have increased much less and, in some cases, even declined . . .



so liquidity positions* have declined substantially



*Cash and U. S. Government security holdings as proportion of savings liabilities.

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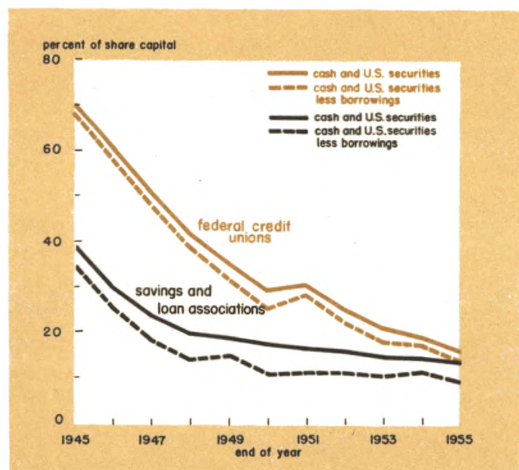
Borrowing accentuates decline in liquidity of "share capital" thrift institutions



Savings and loan associations at the end of 1955 held 14 per cent of share capital in cash and Government securities. Savings and loans' liquid assets have always been well in excess of the statutory minimum of 6 per cent of savings capital.

Credit unions hold a slightly higher proportion of savings capital in liquid form, 20 per cent at the end of 1955. Liquidity ratios vary greatly among individual savings institutions of the same type, but the variation is particularly noticeable among credit unions since no legal requirement exists. Some credit unions pare down cash items to almost nothing and rely on borrowing to meet unusually high withdrawals. Other credit unions keep in liquid form an amount equivalent to the share capital of their largest depositor.

More predictability

Cash needs of the other types of savings organizations are quite different. Life insurance companies, for example, can do with smaller liquid balances, since some of the inflow and outflow of funds can be predicted by the use of actuarial tables. The life insurance policy is a long-term contract which specifies both the amount and timing of premium and benefit payments. In recent policies, which stipulate cash upon surrender or policy loans on demand, a delay clause has been included which gives companies the legal right to postpone payment for a period of six months; and this, too, has tended to regularize the outflow of funds.

This partial predictability of outflow, which pension and retirement funds share, is in sharp contrast to the unpredictability of withdrawals from "over-the-counter" savings institutions. Premium and interest income of life insurance companies normally is more than sufficient to cover benefit payments and expense disbursements. Furthermore, these firms hold large amounts of short-term U. S. Government bonds which can be readily converted into cash and which further strengthen their liquidity position. It should be remembered, however, that Governments are not cash; that is, their liquidity may be neither riskless nor costless, since large capital losses can be incurred.

Though open-end investment companies—mutual funds—are, like life insurance companies, a medium for personal saving, their liquidity problem is quite different. An investor purchases mutual fund shares at a price equivalent to the net asset value of outstanding shares at the time of purchase, plus commission charges. The mutual fund agrees to repurchase shares from the investor, upon demand, by paying the investor in cash the net asset value of shares at the time of redemption. The net asset value is daily determined by the current market value of the fund's investments, which generally tend to consist principally of stocks. Since gross income of the fund is entirely derived from earnings on the security portfolio, assets of mutual funds are usually fully invested with only small amounts in cash.

The liquidity position is somewhat influenced by stock price movements. In periods of rising stock prices, investment company managers reduce cash balances, particularly if balances are large. On the other hand, sharp downward price fluctuations tend to discourage sales and induce investors to redeem shares in more than

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ordinary amounts. These considerations prod investment company managers into keeping moderate amounts of cash resources and short-term Government securities.

Since stock prices have irregularly risen from a postwar low in 1949, mutual funds have decreased the proportion of assets held in cash and U. S. Government securities from a ratio of slightly under 10 per cent, where it had remained with only minor fluctuations in 1938-51, to around 5 per cent in 1955.

The postwar shrinkage

The postwar decline in liquidity, that is, the ratio of cash and U. S. Government securities to deposits or share capital, has been sharpest for credit unions, from a high of 74 per cent at the end of 1945 to 20 per cent at the end of 1955. Holdings of Government securities have declined relative to savings capital, while cash on hand and in banks has remained at about the same proportion of assets. For life insurance companies and mutual savings banks, the *absolute* amount of Governments holdings has been reduced from their high wartime levels. But holdings of U. S. Government securities by savings and loan associations are at record levels, 4.7 billion dollars in 1955 compared with 2.9 billion ten years earlier. Credit unions also have increased their *absolute* holdings of Government securities.

The decline is emphasized if the ratio of cash and Governments less borrowings to savings capital is used. Life insurance companies and mutual savings banks borrow very little in relation to total assets. Savings and loan associations, however, have in recent years resorted to borrowing as a source of funds. Between 1954 and 1955 advances from Federal Home Loan Banks and other borrowed money increased from 1 billion dollars, approximately the level since 1950, to 1.6 billion. Federal credit unions, too, increased their borrowing by nearly 50 per cent in this 12-month period. State-chartered credit unions probably had similar experiences. Increased borrowing sharpens the decline of the liquid asset ratio. Data for savings and loan associations indicate a decline in the ratio of cash and Governments to savings capital from 14.6 per cent in 1954 to 13.8 per cent in 1955, a loss of .8 per cent. If borrowed funds are subtracted, the decrease is 2.1 per cent, from 11.1 to 9.0 per cent.

During the past few years, withdrawals relative to inflows have been increasing. Assets of the postal savings system actually have been decreasing since 1947. Withdrawals from postal savings accounts in 1955 exceeded deposits by about one-fifth. Personal savings accounts—at commercial and savings banks—are usually very active. In 1954, withdrawals were 92 per cent of deposits in savings accounts at commercial banks. Withdrawals in relation to savings inflow have been larger for commercial banks than for mutual savings banks and savings and loan associations, but the ratios have been rising for all types of institutions.

Liquidity ratios, of course, are not the only indicators of an organization's ability to meet expected and unexpected cash drains. Savings institutions receive a continual and rather predictable stream of funds from their investments, for most if not all of their loans are repaid on an instalment basis, as is the interest on them,

Withdrawals as per cent of new savings deposits or share purchases

	Commercial banks[1]	Mutual savings banks[1]	Savings and loan associations	Postal savings
	(per cent)			
1952	86.5	81.1	60.7	111.7
1953	90.5	82.0	61.4	111.9
1954	92.2	82.2	60.0	117.2
1955			63.7	121.3
Jan.-June 1956			64.7	

[1]Special study made by Savings and Mortgage Division of the American Bankers Association, Banking, August 1955.

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and shorter-term Government securities are constantly maturing. Furthermore, an institution momentarily strapped for cash can cut back the scale of its new investment activity, at least in those cases when it has not made forward lending commitments of its expected available funds. All this tends to mitigate needs for cash and near-cash assets. The decline in liquidity over the past decade may not have been any greater than was to be expected in an environment of economic expansion, and no doubt the institutions are in no great danger of insolvency. Nonetheless, this important source of capital for expansion has much less "give" than a few years back. In common with other sectors of the economy, lenders and investors alike, its reduced liquidity means that it depends more than ever on the inflow of new savings if it is to meet the substantial demand for investment funds a growing economy will produce.

Business loans at small banks

Who are the borrowers at small Midwestern banks? What interest rates do they pay? And what is the maturity pattern of their loans? A survey of business loan portfolios conducted late last year by the Federal Reserve System provides answers to questions like these. Though the amount of loans outstanding has increased since the survey was taken, the broad structural characteristics of the portfolios probably have not changed greatly in the interim.

Retail trade an important borrower

Retail firms were the most important borrowers at the small banks—those with deposits under 20 million dollars. Furthermore, loans extended to retail firms represent a larger percentage of the loan portfolios of small banks in rural areas than small banks in metropolitan areas. This is in sharp contrast with the loan portfolio of large banks—those with deposits over 100 million dollars—where manufacturing and mining firms are the major borrowers and account for about half of the business loans. For the small banks, manufacturing and mining firms account for less than 20 per cent (see chart).

The differences in the business loan portfolios of the small and the large banks reflect a number of factors but can be traced largely to the effects of size and location. The small banks, usually located in suburban or rural areas, have close contact with a great many small and moderate-sized firms in their communities. Furthermore, it is convenient for the local firms to "do their banking" in the community where they are well known if the local bank has the resources to accommodate their needs. For the large banks it is difficult to maintain a close personal relationship with a large number of small borrowers. Moreover, the resources of small banks are necessarily limited: in the nature of the case, they cannot accommodate the credit needs of the larger manufacturing and mining firms. Consequently, while manufacturing and mining are the most important borrowers of the large banks, retailers—the automobile dealers, service stations and grocery stores—are the most important borrowers of the small banks.

Industry groups

This holds true even when the loans are sorted by individual industries, with loans to manufacturing and distribution firms combined. Reflecting the importance of retailing, firms engaged in the manufacturing and distribution of consumer goods are the most important borrowers of the small banks both in rural and

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metropolitan areas, but with sales finance companies also being important in the metropolitan area banks. Most of these loans are made to finance inventories, and mature in less than one year. Some loans, however, particularly those extended to grocery stores and restaurants, are for a longer term and are used largely to replace equipment or to modernize business establishments.

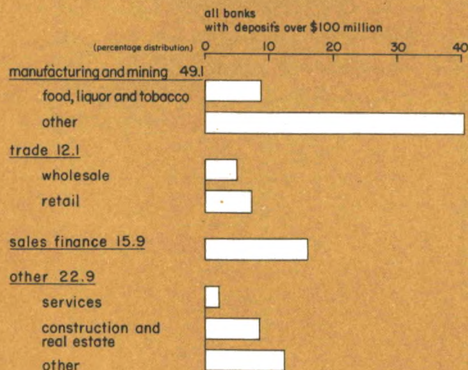
Construction and real estate firms, accounting for 23 per cent of the loans, are the second most important group of borrowers at the small Midwestern banks. Within this group, loans to real estate developers are the most important component in the metropolitan area banks while in the rural areas, where specialization is not as complete, producers and distributors of building materials are most important. However, even though home construction is not the primary business of the building material suppliers in rural areas, many do build a few homes each year, and in the aggregate they are important suppliers of new houses.

Firms engaged in the processing and distribution of agricultural commodities and the production and distribution of machinery and other farm equipment and supplies, of course, account for a larger share of the business loan portfolios of small rural banks than of small banks in metropolitan areas. However, the same agricultural industries are important to both rural and metropolitan area banks. Farm machinery and equipment, for example, constitute a large portion of the loan portfolio of both classes of banks as do farm supplies and dairy products.

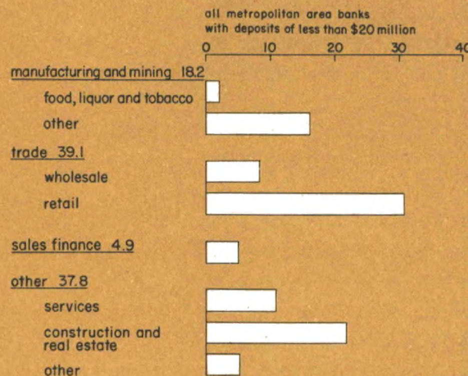
Interest rate differences

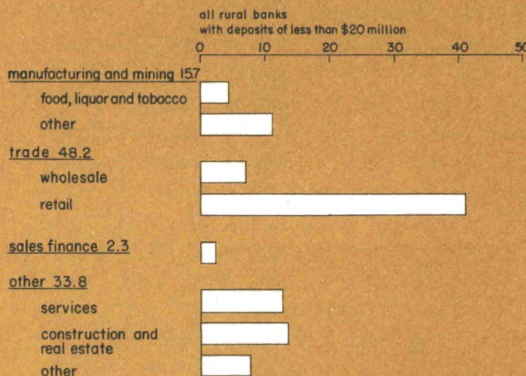
Banks in large urban areas have the oppor-

Manufacturing and mining is the largest component of business loans extended by larger banks



while trade is most important at the smaller banks whether located in metropolitan or rural areas





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tunity to grant loans to large firms more frequently than banks in small rural areas. Reflecting this difference in the asset size of borrowers, the banks in metropolitan areas grant a larger percentage of their loans at low interest rates.

Over three-fourths of the business loan portfolios of metropolitan area banks were at low interest rates—below 5½ per cent—while only 68 per cent of the loans of small rural banks were at low rates. Other things the same, the asset size of a borrower is a reasonable indicator of the credit risk. Since the metropolitan area banks grant a higher percentage of loans to larger firms, some of the differences in rate can be attributed to differences in risk.

However, this is not the whole story. The metropolitan area banks also made a higher per cent of their loans at high interest rates. Two and one-half per cent of the loans granted by metropolitan area banks were at rates over 9½ per cent while less than 1 per cent of the loans made by country banks were in this group. In large part this reflects the tendency for metropolitan area banks to grant small business loans through their instalment loan departments. A loan granted on a 6 per cent discounted basis yields approximately 12 per cent as interest is paid on the original amount of the loan throughout the life of the instrument and not on just the unpaid balance. Like consumer instalment loans, business instalment loans are extended more frequently in metropolitan than in rural areas.

The great diversity of the business borrowers of the small banks, as to type of firm, size and industry is clearly reflected in this survey of business loans. Small banks are providing credit to many kinds and sizes of firms in many different sectors of the economy and especially to the smaller businesses. Apparently occupation or size of borrower present no impediment to favorable consideration of credit-worthy borrowers at loan desks of small Midwest banks.

Municipal borrowing: green light

At the election in November, the voters of 10 states and 107 cities and other local subdivisions in 33 of the 48 states gave their blessings to proposed bond issues totaling a record 2½ billion dollars. In money terms, borrowings approved for the states outweighed by about 2 to 1 the propositions endorsed for smaller units such as city governments, school districts, counties, towns and special districts.

The big ones

The state borrowing approved was heavily concentrated. California and New York, with 800 and 500 million, respectively, accounted for over three-fourths of the 1.7 billion dollar total. All of New York's new borrowing will be earmarked for highway spending. California expects to borrow 500 million for veterans' benefits and 300 million for educational purposes. Other sizable approvals were two 100-million issues, one in Texas, where veterans will be the beneficiaries, and one in Kentucky, which expects to use its planned borrowings to pay for new highways.

One-fourth of the 800 million dollars in local borrowing ratified is accounted for by a large number of units in the state of Ohio. Almost as much, just under 190 million, was approved by the residents of communities in California. Other large amounts are 95 million for Baltimore, 47 million in Philadelphia and 46 million in King County (Seattle), Washington.

Approved proposals to finance school construction predominate in the local government

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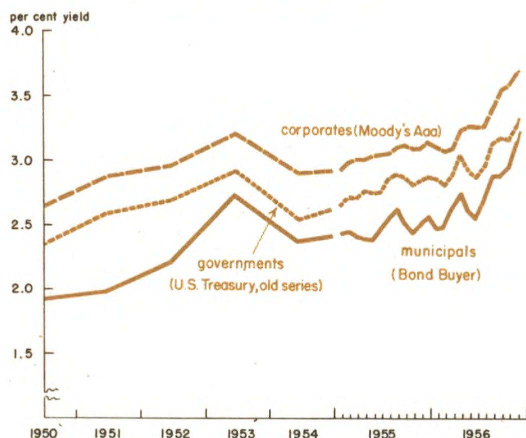
Yield spread narrows between tax-exempt municipals and competing investment media



category, with more than a third of the total. Water and sewer projects follow, accounting for nearly 200 million dollars of all the new local borrowing authorized.

A third of the state borrowing authorized will pick up the tab for veterans' benefit programs in seven of the states. Even now—three and a half years after the Korea cease-fire—these comprise a high-priority item on the budgetary agenda.

Receptive electorate

The bond proposals offered on November 6 came to something more than 2.7 billion dollars altogether. Acceptance by the electorate of all but a quarter-billion of this brings the approval ratio to about as high a level as it has ever reached in a general election. Voters, however, have been generously inclined for some years. At the nine November elections that have been held since 1947, they have approved the issuance of over 11 billion, or about 80 per cent, of the more than 14 billion dollars in proposals submitted to them. Back in the lean Thirties, results of borrowing referenda were more nearly a tossup. Awareness of the impact of population growth and redistribution upon the need for new public investment and, along with it, the climate of economic well-being doubtless account for the heightened inclination in recent years to ratify public borrowing plans.

It is not solely the November elections, of course, that register popular attitudes toward credit financing. In every year there are hundreds of local and special elections, some scheduled solely as bond referenda, at which plans to issue debt are offered for approval or rejection by the electorate.

Typically, about as much in proposed borrowing is exposed to referenda in the eleven months other than November as in that month itself. At these other regular and special elections, too, results have been generally favorable from the governments' viewpoint and by about the same margin as in the November elections. Since 1947, more than 13 billion in proposals have been offered; nearly 11 billion dollars—again four-fifths—have passed muster.

Non-referendum borrowing

By no means all of municipal borrowing is passed upon at the polls in the first place. Revenue bonds seldom are subject to ratification by an electorate. Such debt becomes the direct liability of undertakings of a "commercial" nature and thus the indirect liability of users or customers. The issuing authority's general credit usually is not pledged, so the financial interests of the community as a whole are not at stake. In the years since the war, revenue bonds have played an important part in underwriting public investment. Toll roads and bridges, air and water terminals, sewer and water facilities and some types of educational plant are leading examples. Elections generate only a part of public borrowing.

Municipals in a credit pinch?

Indications are that the volume of municipal offerings during the past year has been held in check by the prevailing climate of credit restraint. Along with other would-be borrowers, the state and local governments have been feeling the effects of a concerted effort to confine the volume of new credit to proportions con-

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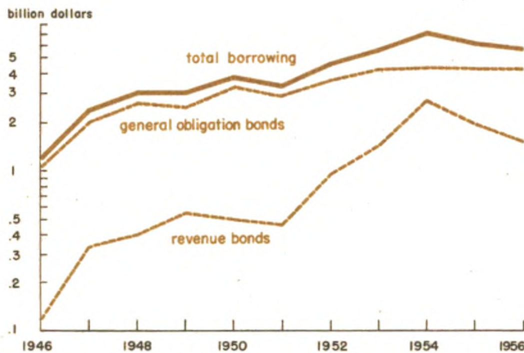
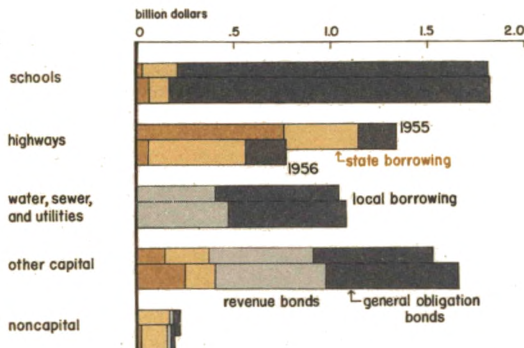
sistent with the economy's capacity to assimilate growing money expenditure.

The stringency has been especially noticeable in the municipals field because of the common practice of hedging borrowing authorizations with stipulations relating to the terms on which new debt can be contracted. Frequently, the law prescribes the maximum coupon rate and prohibits the issuance of bonds at a price under par. Commonly, too, the formal authorization specifies the terms acceptable in the proposed borrowing. When market conditions are undergoing change, therefore, there is always a chance that the specifications spelled out beforehand will prove unacceptable to lenders at the time the offering is made.

Municipal borrowing down again with second successive slide in revenue bond offerings



Drying-up of toll road financing chief cause of 1955-56 decline



The coming year?

How appealing the issues authorized in November will prove to be will depend, of course, on the state of the market when they are readied for formal offering. The state of the market, in turn, will depend upon a host of other factors, among them the intensity of credit demand emanating from other sectors and the size of the inflow of savings that will be available at the time to meet the demands of all potential borrowers. Any further upward pressure on money rates—symptomatic of intensified push against the economy's production ceilings—would doubtless prove an obstacle to the marketing of the new securities on the time schedule planned.

Another factor to be considered is the size of the *total* supply of municipals in the offing. The issues approved in November are, of course, only one part of this; there remain the many additional proposals voted upon earlier in the year and since the national election, as well as the many authorized without popular referendum. The fact that the volume of proposals approved in November reached an all-time high tells only part of the story.

The upward surge in municipal bond yields appears to have prompted many investors to take a new look at the merits of this class of security. The rate spread between yields on municipals and yields on alternative long-maturity media, corporate bonds and Governments particularly, has narrowed considerably. This fact, taken in conjunction with the tax-exempt feature of state and local obligations, has kindled interest in them among a widening range of prospective investors. Issues properly tailored to the demands of the market, therefore, can expect to command the interested attention of a larger and more diversified circle of potential buyers than has been the case for some years past.

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