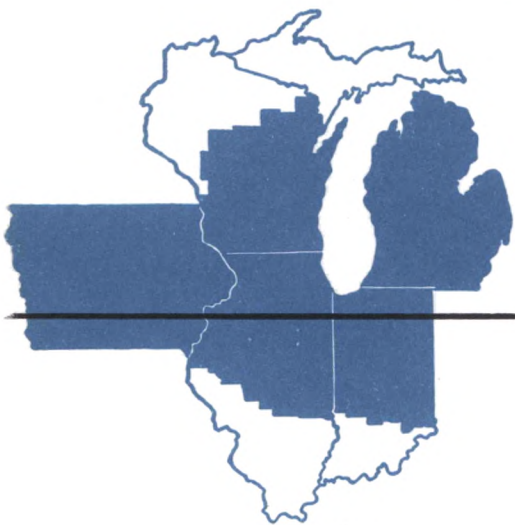


A review by the **Federal Reserve Bank of Chicago**

Business Conditions

1957 April



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THE Trend OF BUSINESS

There is now little question that the exuberant upward pressures on business activity which characterized the fourth quarter of last year were moderated in the first quarter of 1957. Average wholesale prices showed no appreciable month-to-month rise in February for the first time since last October. Industrial production, seasonally adjusted, held stable at the January level, and its counterpart, manufacturing employment, showed some decline in January and February from the high December level.

But not all measures showed leveling tendencies. Total employment continued its rise on a seasonally adjusted basis in February. Personal income was running 6 per cent above a year ago and, most important for manufacturers and merchants, consumers were spending at record rates. In fact, the year-to-year margin for retail sales broadened steadily from September, when there was a 1 per cent gain, to February which showed a rise of over 7 per cent. Last year, retail sales had declined appreciably on a seasonally adjusted basis in January and February.

Capital goods still rising

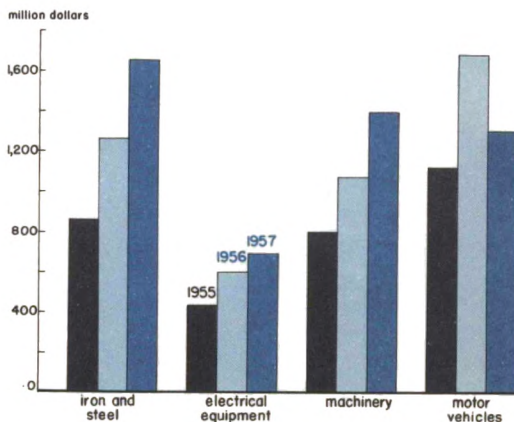
A preliminary, optimistic answer to one question which was clouding the outlook was provided in mid-March when the Department of Commerce released the results of its annual survey of business capital spending plans. There had been speculation that aggregate business spending on new plants and equipment would begin to decline in the second half of 1957 and that this sector, which had risen by 22 per cent in 1956 and had provided the principal stimulus to general business, would constitute a drag as the current year moved ahead.

The main points revealed by the survey were these:

1. Business firms plan to spend, over-all, 37.4 billion dollars on capital goods in 1957, a rise of 6.5 per cent from last year.
2. The planned level of expenditure was still rising in the first and second quarters of this year.
3. Capital spending scheduled for the second half is about equal to the first half, allowing for seasonal influence.

These results are backstopped with other evidence. Order backlogs in machinery, transportation equipment and heavy construction projects are at high levels although no longer rising; capacity limitations in the capital goods industries and last year's steel strike had pushed some planned outlays into 1957; contract

Capital expenditure trends in important Midwest industries



awards for new construction recently showed gains over year earlier following several months of decline.

The corresponding year-ago survey provided a very accurate projection of actual 1956 capital spending. The estimate for total capital outlays was "on the button," and projections for the major segments of spending also were very close to achieved results.

In 1957, the largest boosts in capital outlays are indicated for producers of steel, nonferrous metals, nonautomotive transportation, machinery and chemicals, and by public utilities and railroads. However, substantial declines are expected in the case of automobiles, textiles, building materials and commercial projects.

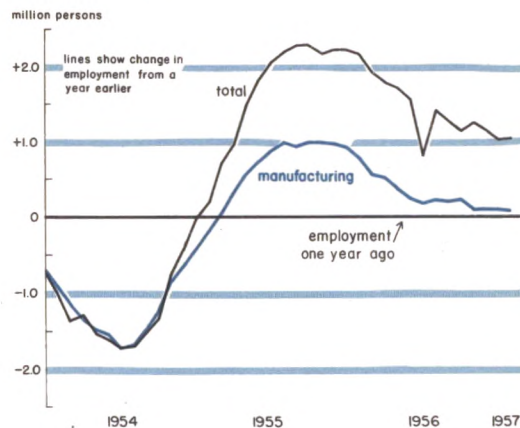
The inventory hurdle

The other important component of business investment, inventories, is still a question mark. From January of 1956 through January of this year, the book value of business inventories rose by 5.9 billion dollars or 7.1 per cent. During the same interval, total business sales rose by 6.8 per cent. The ratio of inventories to sales was 1.57 on February 1, almost exactly the same as a year earlier.

Nevertheless, an inventory adjustment has been under way for several months. Businessmen have been trying to keep their stocks on hand from rising, and in many individual firms there have been attempts to decrease inventories. This has resulted primarily from two factors: first, the need to conserve funds in the face of heavy demands for investment and working capital expansion, and second, the speeding up in the delivery of new orders and the generally easier material supply situation. In a few lines, slowing sales dictated smaller inventories. In general, since goods could be obtained readily, it has been desirable to keep inventories level or reduce them and thereby release funds for other uses.

In the fourth quarter, total business inventories rose by an average of almost 700 million dollars per month, after adjustment for seasonal factors. January showed a further gain, but of only 200 million dollars. Manufacturers,

Total employment 1 million above year ago, but manufacturing gain is small



who usually lead broad inventory movements, had virtually ended net inventory accumulation in December. Since part of the rise all through 1956 represented higher prices, it is quite possible that the physical volume of inventories has declined since the start of the year.

The slowdown in inventory growth has been a major factor accounting for the stability in industrial production, the lower level of freight car loadings and the scattered layoffs in appliances, TV, auto parts and steel, which occurred in the first quarter. Final takings by consumers and governments and business outlays on capital goods have continued to rise. The inference is obvious. Either the move to cut stocks will begin to undermine income and then sales of goods for final use or inventory liquidation will soon come to a halt and perhaps give way to renewed accumulation.

Consumers feeling "good"

Retail buying remains the key factor since it is widely believed that a slower rate of business investment will tend to offset a rise in government outlays as the year proceeds. A continuance of recent rates of consumer spending relative to income probably would underwrite a

continuing rise in over-all activity through 1957.

In March, the Federal Reserve Board released the preliminary findings of the 1957 *Survey of Consumer Finances*. A full report of the results will appear in the March and succeeding issues of the *Federal Reserve Bulletin*.

The *Survey* documents further the rise in money income which has occurred every year in the postwar period. Early this year, 41 per cent of the spending units were in the \$5,000 and over income bracket. Seventeen per cent were earning over \$7,500. These ratios had risen from 36 and 14 per cent, respectively, in 1955 and 32 and 11 per cent the previous year.

Forty per cent of the families considered themselves "better off" than a year ago, the same proportion as in 1956, and a similar proportion expected to advance their economic status further in the year ahead. The proportions of consumers expressing such attitudes are as high as any reported since the *Survey* was launched.

Consumer spending plans called for increases in outlays on home improvements, automobiles and other durable goods. Fewer families expected to buy homes, however. In summary, it appears that individuals will be active, if not aggressive, spenders during 1957.

Autos and the outlook

When optimistic appraisals of 1957 business prospects were drawn up late last year, the expected resurgence in demand for new cars usually was placed high on the list of stimulating factors. As a result, the failure of automobile sales to score gains over year-ago figures in January and February had a dampening effect on confidence.

In 1956, 5.8 million passenger cars were produced. This was a decline of 27 per cent from the 7.9 million figure for 1955 — far and away the highest year on record. Some drop had been expected, but most observers expected it to be confined to 10 or 15 per cent.

Although 5.8 million cars is a large number historically — it had been bettered only in 1950, 1953 and 1955 — the reduced level of production was one reason for expecting a rise in 1957. Another was that most "new" models were really new — longer, lower, more heavily powered and more fully accoutered than ever before. Moreover, dealer inventories were lower by 200,000 on January 1 than a year earlier, leaving a 28-day supply rather than 33 days.

All this led to hopes that 1957 would be a

"normal" year for new cars. Some industry experts believe that a domestic market of 6.5 million new cars is now the norm. This target contemplates that the annual total is to be reached by the addition of 2 million cars to the 53 million already on the road and by pushing 4.5 million on to the scrap heaps. In 1955, registrations were 700,000 over the mark; in 1956 they were below by a number almost as large. It has been suggested that the pronounced move to lengthen maturities and reduce down payments in the spring of 1955 coupled with the pressure stemming from the heavy additions to dealer inventories late in that year resulted in "borrowing" the extra sales from 1956.

Thus, a return to normalcy in the current year was expected to produce 6.5 million domestic sales and another 200-250 thousand cars for export. Assuming no change in dealer inventories, this would call for a production rise of about 15 per cent.

The spring push

In January and February production of new cars exceeded last year by about 4 per cent, but

new car deliveries, according to *Ward's Automotive Reports*, were 4 per cent less. Nevertheless, retail sales of 960,000 new cars in the first two months of the year are far ahead of all previous years except 1955 and 1956. In the former period, final results turned out to be fabulous. In the latter, sales were stimulated by the pressure of an early-year inventory of almost 900,000 cars, much the highest in history.

Pressure on sales early in the 1956 model year helped prevent the usual seasonal upswing in the April-June quarter. From the first to second quarter, deliveries rose by only 3 per cent. This is in contrast to an average rise of over 20 per cent in the four previous years. If a 20 per cent second-quarter rise were to occur this year, first-half sales would be 5 per cent above 1956 and second only to 1955. Moreover, in each year of the 1952-55 period, the first half of the year accounted for 52 per cent of the year's sales in contrast to 55 per cent last year. If this pattern were to be repeated, a total of 6.4 million of domestic sales would be reached in 1957. In any case, as judged by seasonal patterns of other recent years, it would appear that early-year data do not provide grounds for despair.

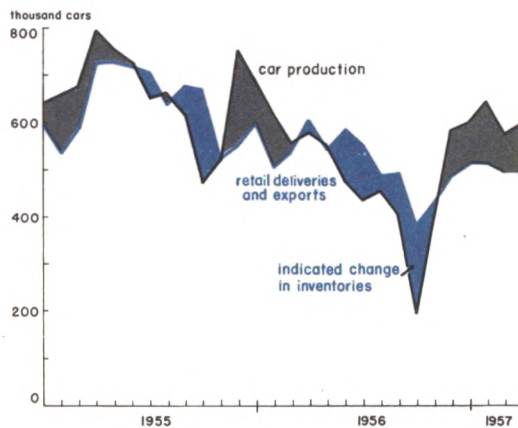
Higher prices an obstacle

Although the number of new cars sold in January and February lagged slightly behind last year, the dollar volume of sales of automotive retailers has been about 9 per cent higher, considerably more than the 6 per cent rise for all retail stores. In part, this surge is the result of strong used car sales, but probably most important has been the rise in new car prices.

Wholesale prices of cars have moved up in virtually every postwar year, but in 1954 and 1955 the increases were not transmitted in full to consumers. In part they were absorbed by a squeeze on dealers' profit margins (see chart). In recent months, however, prices paid at retail have fully reflected the 6 or 7 per cent increase posted by manufacturers when 1957 models were introduced.

It is always easier for dealers to maintain their prices closer to "suggested list" early in

Inventory build-up slower in 1957 model year



SOURCE: *Ward's Automotive Reports*

the model year. Many purchasers like to buy as soon as possible after new models are introduced, and they are willing to pay for the privilege. Moreover, in the first months of production, inventories may rise slowly if engineering problems are encountered or if producers underestimate demand, thus restricting supply.

Now that stocks are building rapidly, the usual pressures have begun to develop which tend to force dealers to trim their gross profit margins. This process apparently proceeded very rapidly in the fall of 1955 after 1956 models were introduced.

Enter the cash buyer?

In some quarters, the "tight money" situation has been blamed for the decline in new car sales in 1956. Doubtless higher interest rates and the greater difficulties encountered by finance companies in obtaining funds played some part in restraining credit sales. Nevertheless, available data indicate that credit buying was relatively more important in 1956 than in 1955.

Of all new car sales last year, 68 per cent involved the use of credit. This was a new high and compares with 62 per cent in the previous year. The decline in the number of credit buy-

ers last year was 10 per cent; for cash buyers it was 30 per cent.

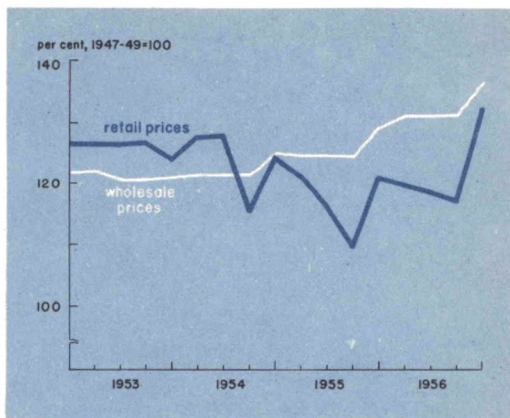
In some postwar years, 1954 and 1955 in particular, the amount of credit extended by all lenders for the purchase of automobiles rose and declined in about the same proportions as the sales of cars. In 1956, the drop in credit extensions was only one-third as great as the fall in deliveries.

If tight credit conditions adversely affected instalment buying, it was not apparent in the case of nonautomotive loans. Instalment credit extended for other purposes was 8 per cent *higher* in 1956 than in 1955 while automobile extensions were 7 per cent *less*.

Total purchases by consumers tell a similar story. Whereas consumer outlays on new and used automobiles fell from 17.2 to 14.6 billion dollars between 1955 and 1956, purchases of other consumer durables rose from 18.5 to 19.4 billion. Nonautomotive consumer durables such as appliances, TV and furniture, taken as a group, have shown a fairly stable upward growth during the postwar period.

Aside from the home, an automobile is by far the largest purchase made by most Americans during their lifetimes. Often credit is utilized, credit which might not be employed if the decision to buy a car is not made. In other words, the great bulk of the consumers' spending has been fairly closely related to his income. Automobiles comprise a special field in which consumer decisions are particularly

Passenger car price boost largest at retail level



important in influencing business trends (see chart).

Employment below last year

Although automobile output has been running ahead of last year, employment in the industry has been less than a year ago. As a result, virtually all of the Michigan centers together with South Bend and Kenosha have been described by the Bureau of Employment Security as moderate or substantial labor surplus areas.

—continued on page 10

Illuminating consumer credit

Released by the Board of Governors of the Federal Reserve System on March 20 were five volumes incorporating results of a broad background study of consumer instalment credit. Together with one additional volume, to be completed shortly, these publications make up a

report — *Consumer Instalment Credit* — which had been in preparation for more than a year.

The study was undertaken early in 1956 at the request of the Council of Economic Advisors, acting at the direction of the President. Initiation of the investigation followed on the

heels of the record-breaking expansion in consumer durables that took place during 1955 to the accompaniment of rapid and extended growth in consumer credit.

These developments heightened concern over the possibility that expansion and contraction in consumer borrowing intensify upswings and downswings in business activity and interfere with orderly economic growth. The policy question raised was whether control over terms ought to be provided for, on either a permanent or stand-by basis, for use as needed along with the traditional instruments of central banking action.

Clearly, answers to questions of public policy in consumer finance do not come easily, involving as they do a complex of economic, social and political considerations. The present study does not purport to reach final conclusions or to formulate concrete recommendations for action. Instead, it addresses itself to the task of fact-finding and evaluation. Some of the individual contributions to the survey, it is true, do present specific conclusions having definite policy implications. But these are the responsibility of individual contributors; the study as a whole maintains a spirit of neutrality, while illuminating as clearly as possible the factual and analytical prerequisites to judgment.

System staff studies. The report divides into four parts. The first, running to 675 pages in two volumes, gathers together a series of studies made by Federal Reserve System personnel. The first volume in this part presents an integrated study of instalment credit processes and the issues of regulation. The second is composed of a series of reports supplementing the papers in volume 1 and dealing with specialized aspects of instalment credit and its regulation.

Economists' views. Part II, covering 700 pages in two volumes, reproduces 14 formal papers and the discussions thereof at a conference on consumer credit regulation organized and conducted by the National Bureau of Economic Research at the request of the Board of Governors. Participating in the conference, which was held at Princeton last October, were

Consumer Instalment Credit

Copies of the five volumes of the report thus far released may be ordered from the Superintendent of Documents, U. S. Government Printing Office, Washington 25, D. C. A separate announcement will appear in the *Federal Reserve Bulletin* when Part IV becomes available.

Prices of the completed volumes are as follows:

Part I,	Federal Reserve staff studies	}	volume 1	\$1.25
			volume 2	1.00
Part II,	Conference on Regulation	}	volume 1	1.75
			volume 2	.60
Part III,	Views on regulation			1.00

46 academic and other professional specialists in consumer credit economics from 28 different universities and research institutions.

Survey of industry opinion. The third part of the report is a one-volume, 225-page digest of the opinions and judgments of the consumer credit industry and other interested parties on the questions and issues of policy involved in consumer credit regulation. This segment of the study was prepared independently by Mr. George D. Bailey, acting as a special consultant to the Board.

Interviews with buyers. The fourth and final part will report the results of field interviews with 4,600 individuals who bought new cars in 1954 and 1955 and also present findings based upon lenders' records on 5,700 credit purchases. This survey was made for the Board of Governors by National Analysts, Inc., of Philadelphia, under direction of the Board's research staff.

No brief summary could do justice to the wealth of material which the study presents. All who are seriously interested in or concerned with consumer credit will want to examine the volumes carefully. On the two pages following are volume and chapter references to the highlights of the study, organized around some of the more pertinent questions concerning the scope and significance of consumer credit and the issue of its regulation.

Consumer instalment credit—a reader's guide

On key issues . . . the findings and opinions of experts were assembled

	Federal Reserve staff	Academic scholars	Industry
1. Why do consumers want credit?	Users of instalment credit—Part I, vol. 1, p. 85 National survey of households, 1954-56: debt status, car purchase, and home ownership—Part I, vol. 2, p. 173	Attitudes toward saving and borrowing—Part II, vol. 1, p. 450 Factors associated with the use of consumer credit—Part II, vol. 1, p. 487	Finance company—Part III, p. 89 Department store—Part III, p. 144 Manufacturer—Part III, p. 131
2. How can the burden of consumer debt be judged?	The burden of consumer instalment debt—Part I, vol. 1, p. 189	Consumer debt and spending: some evidence from analysis of a survey—Part II, vol. 1, p. 521	Commercial bank—Part III, p. 25 Trade association—Part III, p. 20 Department store—Part III, p. 145
3. How and why has consumer credit grown?	The changing role of consumption—Part I, vol. 1, p. 7 Growth of consumer instalment credit—Part I, vol. 1, p. 140	Consumer credit expansion: Macroeconomic analysis and data requirements—Part II, vol. 1, p. 254	Commercial bank—Part III, p. 36 Department store—Part III, p. 145 Finance company—Part III, p. 76
4. Will consumer credit continue to grow?	Prospects for long-term growth in consumer instalment credit—Part I, vol. 1, p. 325	Consumer credit expansion: Macroeconomic analysis and data requirements—Part II, vol. 1, p. 254	Department store—Part III, p. 142 Finance company—Part III, p. 68 Mail-order company—Part III, p. 160
5. Has consumer credit helped the economy to grow?	Instalment credit and aggregate demand—Part I, vol. 1, p. 164	Consumer credit and economic growth—Part II, vol. 1, p. 169	Finance company—Part III, p. 83 Manufacturer—Part III, p. 119 Department store—Part III, p. 144
6. Does consumer credit aggravate business ups and downs?	Consumer credit and economic instability—Part I, vol. 1, p. 205 Theories of consumer instalment credit in relation to economic stability—Part I, vol. 1, p. 235	Instalment credit and business cycles—Part II, vol. 1, p. 3	Finance company—Part III, p. 81 Trade association—Part III, p. 19 Manufacturer—Part III, p. 120 Automobile dealer—Part III, p. 170
7. How are consumer credit terms and rates set?	Types of instalment credit and credit institutions—Part I, vol. 1, p. 22 Operating characteristics of consumer credit institutions—Part I, vol. 1, p. 43 Effects of changes in instalment credit terms—Part I, vol. 1, p. 119 Automobile instalment credit terms and practices—Part I, vol. 2, p. 143	Market practices in the consumer lending industry—Part II, vol. 1, p. 424	Finance company—Part III, p. 77, 92 Manufacturer—Part III, p. 116 Furniture store—Part III, p. 191
8. What is the repayment record?	Operating experience—Part I, vol. 1, p. 66	Changes in the quality of consumer instalment credit—Part II, vol. 1, p. 70	Finance company—Part III, p. 78 Manufacturer—Part III, p. 122 Mail-order company—Part III, p. 162
9. How is consumer credit affected by general credit conditions?	Consumer instalment credit and the credit market—Part I, vol. 1, p. 257, vol. 2, p. 43 Financial characteristics of principal consumer lenders—Part I, vol. 2, p. 5	Sources and costs of funds of large sales finance companies—Part II, vol. 1, p. 324 The financing of consumer credit institutions—Part II, vol. 1, p. 298	Finance company—Part III, p. 108 Manufacturer—Part III, p. 128 Commercial bank—Part III, p. 46
10. Is consumer credit regulation needed?	Conflicting viewpoints—Part I, vol. 1, p. 356	The pros and cons of consumer credit regulation—Part II, vol. 2, p. 3	Views on regulation—Part III, p. 13
11. Is specific regulation of instalment credit terms practical?	Experience with consumer instalment credit regulation—Part I, vol. 1, p. 286 Consumer instalment credit and its regulation abroad—Part I, vol. 2, p. 245	The pros and cons of consumer credit regulation—Part II, vol. 2, p. 3	Trade association—Part III, p. 21 Finance company—Part III, p. 77, 80, 102 Commercial bank—Part III, p. 43 Furniture store—Part III, p. 190
12. What are the alternative techniques of consumer credit control?	Alternative statutory approaches to instalment credit regulation—Part I, vol. 2, p. 279	The pros and cons of consumer credit regulation—Part II, vol. 2, p. 3	Commercial bank—Part III, p. 38 Finance company—Part III, p. 82 Manufacturer—Part III, p. 132 Department store—Part III, p. 150 Automobile dealer—Part III, p. 178

The references in the columns headed "Federal Reserve staff" and "Academic scholars" are not exhaustive but include major discussions of the topic in question.

The references in the column headed "Industry" are primarily illustrative.

Autos *continued from page 6*

The South Bend and Kenosha situations are traceable to the sharp decline in output of the independents. Michigan's difficulty appears to arise from a gradual transfer of assembly and, to a lesser extent, component manufacturing to other states.

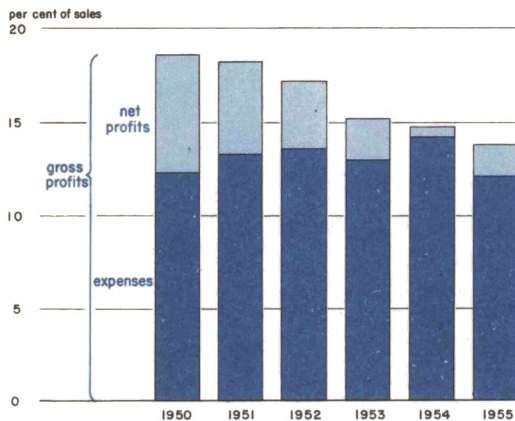
Michigan still accounts for over half of total auto industry employment, but the proportion has dropped fairly steadily from 59.4 per cent in December of 1949 to 50.5 per cent in December of 1956.

Expansion program over the top

In recent years the automotive industry has been contributing very heavily to the capital spending boom which has taken place in most hard goods lines. In 1956, the industry spent 1.7 billion dollars on new facilities, exclusive of new model tooling. This was a gain of 50 per cent over 1955. In the current year, however, these firms are cutting back planned outlays by almost one-fourth. Moreover, the slide will be particularly sharp after midyear.

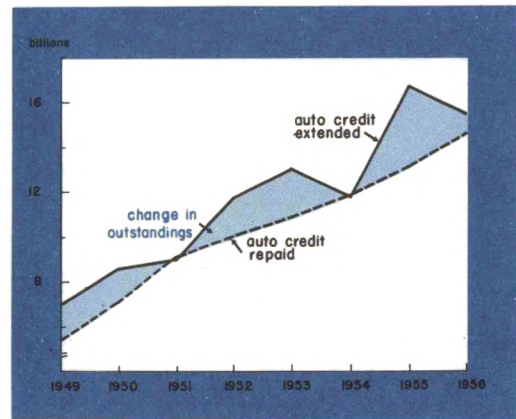
General Motors has announced the indefinite postponement of two large assembly plant

Auto dealers' profit margins under pressure in recent years



SOURCE: National Automobile Dealers Association

Auto borrowings declined in 1956; repayments continued steady rise



projects. However, the prospective decline in automotive plant and equipment outlays is due primarily to the completion of planned programs. The long-run nature of these plans was indicated by the fact that no cutbacks occurred in 1956 despite the substantial drop in sales.

Trucks decline, too

There was a drop in truck output in 1956 of 11 per cent. In fact, the number of trucks turned out last year was the lowest for any year in the past decade except 1954.

Nevertheless, manufacturers of heavy trucks benefited from the rise in capital expenditures. Production of trucks of 16,000 pounds capacity and over amounted to 220,000, about 26 per cent more than 1956 and well in excess of any previous year. Output of vehicles below this weight group declined by 18 per cent.

In the first quarter of 1957, truck output dropped 10 per cent from last year, in part because of strike-caused shortages of axles. The relative strength of demand for heavy vehicles, used in large numbers by road contractors and extractive industries, appears to be continuing.

Automotive producers are reported by trade

sources to be planning second-quarter production near the first-quarter rate, depending of course upon satisfactory sales in the period ahead. In any case it is unlikely that the industry will have to reduce output as drastically as it did during the second quarter of 1956. This is because of the smaller build-up of inventories early in the current model year. In virtually all previous postwar years, there has been a substantial rise in output during the second quarter.

Just what the contribution of automobile production will be toward general prosperity

and steady growth during 1957 remains to be seen. Projections of demand by the "experts" based on such factors as credit use, cars per family and scrappage rates have been notoriously faulty. One clue to the size of the passenger car market is provided by the *Survey of Consumer Finances*. It appears that consumers plan to buy about the same number of new cars this year as last. But past experience has revealed that the intentions of individuals on buying cars which are ascertained while snow is on the ground are subject to change as the year proceeds.

Location of business borrowers

Businesses, both large and small, depend upon the nation's banks for an important share of their credit needs. Some businesses satisfy all their credit requirements at banks in their home community. Many firms, on the other hand, borrow from banks "everywhere."

Similarly, some banks accommodate primarily local borrowers while others lend to borrowers "everywhere." Until recently, little information has been available indicating where borrowers are located relative to their banks, how far afield banks go in seeking customers and the kinds and sizes of businesses either accommodated primarily by local lenders or those heavily dependent on nonlocal sources. A special survey by the Federal Reserve System of bank lending to business, however, sheds a good deal of light on these questions. This article presents such information for commercial and industrial borrowers at Seventh District banks.

The degree to which an individual bank lends outside its immediate area is, of course, a matter of management policy. Out-of-town loans can provide a geographic diversification of credits. This reduces the risk inherent in a loan portfolio in much the same way as does a policy of

spreading loan funds among firms in several industries.

Banks, however, are not always the prime movers in building up a portfolio of out-of-town loans. Borrowers' demands help to push the banks into nonlocal lending. Large businesses have credit requirements which can only be satisfied either by dealing with one of the largest banks or with several smaller ones. Diversification is an important factor on the borrower side, too; if there are a number of credit sources, little inconvenience is suffered if one of several lenders finds it necessary to cut back its accommodation. The public relations aspect is important also; the national concern which "does its banking locally" is more likely to be favorably received by the local community.

A look at the lenders

Chicago — by virtue of its size — is the dominant Midwestern supplier and user of bank funds for business. Half the volume of business loans made by Chicago banks goes to nonlocal borrowers, if nonlocal borrowers are defined as those headquartered beyond the borders of counties adjoining the lender's metropolitan

area or county. Moreover, a third of Chicago's dollar total is extended to borrowers outside the Seventh Federal Reserve District. In other Midwestern areas the geographic distribution of customers is sharply different (see chart).

In the largest banks — those with deposits of 100 million dollars or more — about half of the total dollar volume of loans is extended to out-of-town borrowers, but in individual large banks this proportion ranges from zero to nearly two-thirds. In the smaller urban banks the proportion of out-of-town to total business loans averages about 13 per cent, and in rural banks it averages about 5 per cent. In general, the smaller the bank and the smaller the center in which it is located, the greater is the proportion of local loans in its portfolio.

A variety of reasons may contribute to this tendency. In some small industrially oriented cities and towns, demands for loans on the part of the firms within the community are more than sufficient to absorb all the funds the local banks are willing to lend to business. In other cases, smaller banks find themselves without

the contacts and servicing facilities to attract distant borrowers, even if they desire to do so. Moreover, the cost to small banks of making business loans outside their area may be relatively high. In these circumstances, many a small bank finds it more advantageous to gain balance in its earning assets by increasing its investment holdings rather than seeking out-of-town loans.

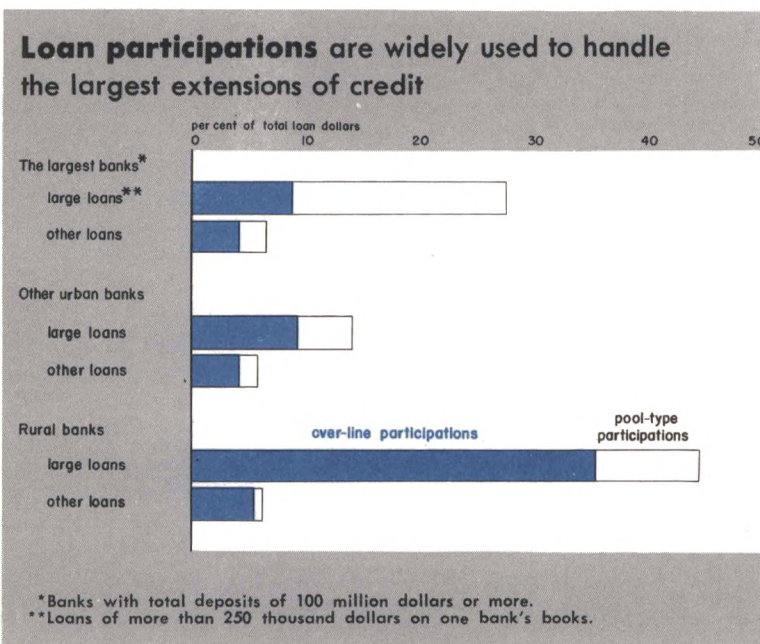
The borrower's viewpoint

In the less populous centers, of course, small firms dominate the business picture. These small businesses are small borrowers¹ and are primarily accommodated by their local banks, which are themselves "small businesses."

Small loans, those of \$38,500 or less, account for 80 per cent of the local loan volume in rural areas. However, in the Chicago area they account for only one-tenth, and in other Midwestern cities about one-fifth to one-third of locally borrowed funds. In terms of the numbers of loans the small credits are, of course, a much higher proportion of total.

While it usually is the largest firms that need to supplement their local borrowing with outside funds, the smaller firms do it as well. This situation arises frequently in the purchase of machinery or equipment in a distant city, financed by a bank in the seller's area. Such arrangements are often made through the seller rather than by direct contact with the borrower.

In the leading metropolitan areas virtually every line of business secures the bulk of its



¹See "How Small is Small?" *Business Conditions*, August 1956, pp. 8-9.

funds from banks within the community. In the smaller metropolitan centers and in the rural towns the pattern of borrowing from banks outside the immediate area varies more sharply. Manufacturing firms and sales finance companies, reflecting their large size, are notable for out-of-area borrowing. The proceeds of such loans, of course, may be disbursed locally for the procurement of labor, materials and services provided by the community.

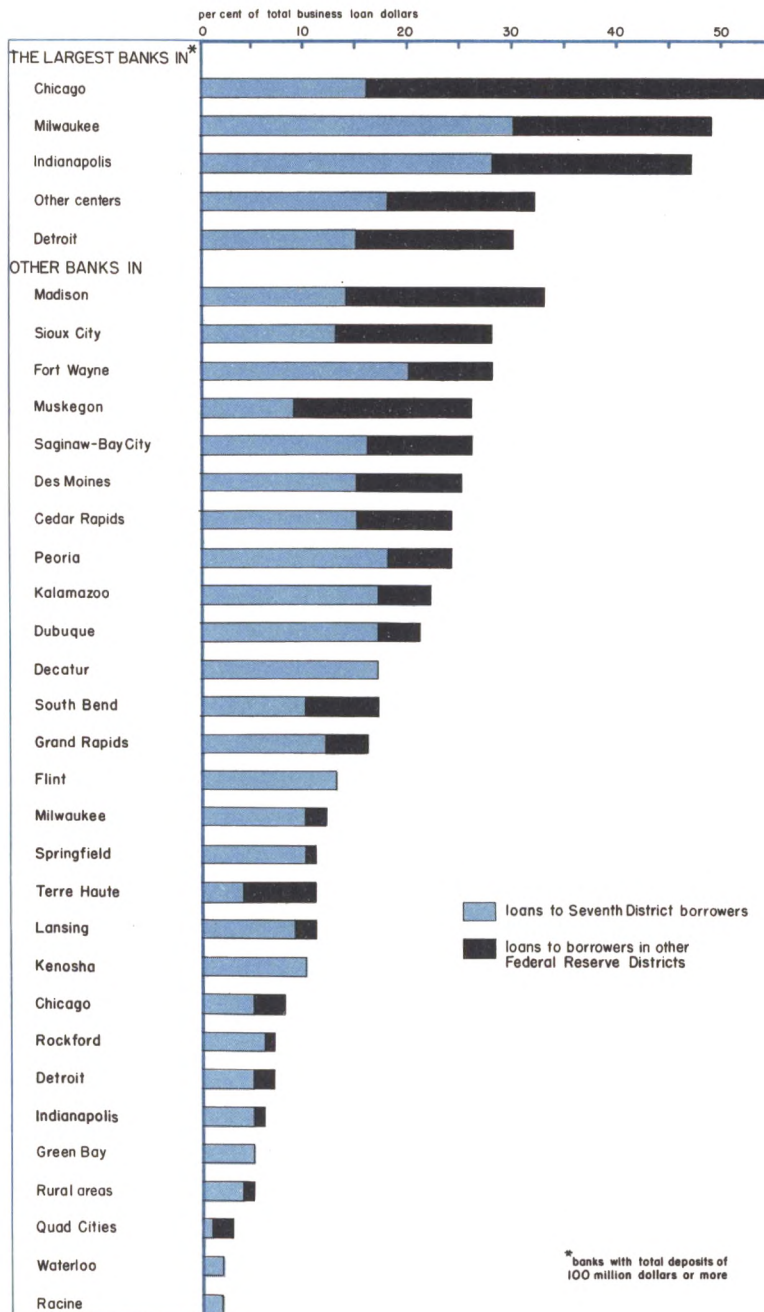
In the smaller cities, local manufacturers borrow as much from other Midwestern banks as from those in their own town, plus an unknown amount from banks beyond the borders of the Seventh District. In rural sections the out-of-area debt of these firms is at least half again as great as their local debt.

In the case of sales finance companies the situation is even more sharply defined — notes payable to out-of-area banks are three to four times as great as the debt to local banks.

Sharing loans

The bulk of any bank's loans are made directly to its own cus-

Loans to nonlocal borrowers vary in importance by size and location of banks



tomers (see chart). However, the maximum amount of credit extended to any one borrower is customarily limited by internally set policy as well as by law. Loans in excess of these limits are sometimes handled through "participations."

Loan pools, generally two or more lenders sharing a loan on equal footing, are the most important form of participation in the larger banks. In the smaller banks, particularly in rural areas, "over-line" participations are more common. In this case one or two banks take

only that portion of the loan which exceeds either the primary lender's legal limit or that set by policy considerations.

In summary, the smaller the borrower, the more likely its demands will be met locally. However, even when funds are not available locally, soundly financed and operated businesses may become customers of a bank located in a distant city, either directly or through participation arrangements between their local bank and its big city correspondents.

Interest rates on farm loans

During the past two years of expanding credit demands and rising cost of money, the interest rate change on farm loans has been relatively modest compared with the increases paid by many business borrowers.

The "prime rate," for example, that rate charged businesses with the highest credit rating, has moved up sharply in the last year and a half, from 3 per cent as late as August 1955 to its present 4 per cent level. In contrast, from records of farm loans made by Midwest banks over the past year, it appears that few farm borrowers have experienced an increase of more than one-half of one per cent in their borrowing cost and probably a majority have noted no change at all. In this respect it appears that both the farmer and his city cousin, the "small businessman," have been less affected by rising interest rates than have

large business firms (See *Business Conditions*, March 1957).

Rates on non-real estate farm loans

Data for a group of Midwest banks indicate the upgrading of charges has been confined largely to loans of \$1,000 or more (see chart). During 1956 there was virtually no change in

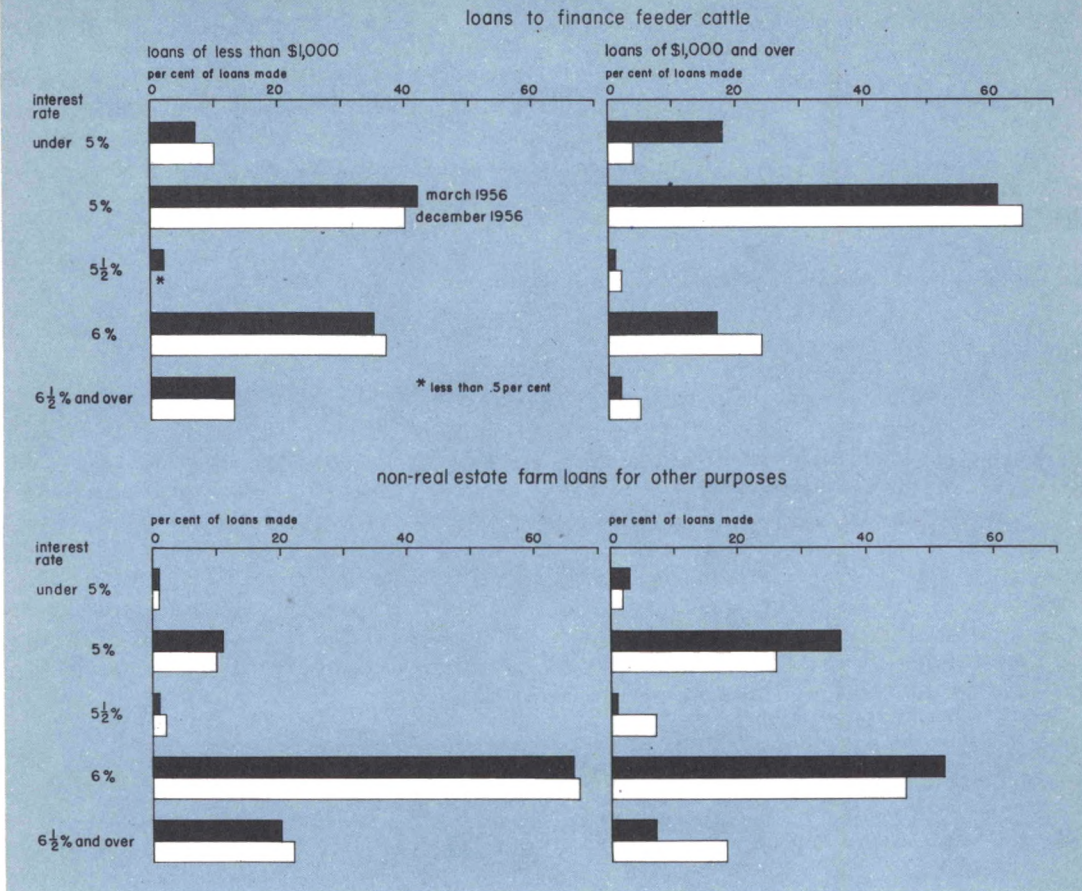
Large farm loans and loans to borrowers with large credit lines carry the lower interest rates

Size of borrower's outstanding bank debt ¹ June 30, 1956	Original size of loan					All loan sizes
	Under \$500	\$500- 999	\$1,000- 4,999	\$5,000- 9,999	\$10,000 and over	
	(average interest rate)					
Under \$500	7.2	8.1	8.0	*	*	7.4
\$500-999	7.0	6.7	7.7	*	*	6.9
\$1,000-4,999	6.8	6.4	6.4	5.4	*	6.4
\$5,000-9,999	6.4	6.2	5.8	5.5	5.5	5.7
\$10,000 and over	6.5	6.1	5.5	5.2	5.2	5.3
All borrowers	7.0	6.6	6.3	5.5	5.2	6.1

*Amounts too small for significant average.

¹Excludes borrowers with any bank credit secured by real estate mortgages.

Rates on bank loans to Midwest farmers increased most on large loans



the interest rate pattern on small farm loans (under \$1,000). As loans of \$1,000 and over account for less than two-fifths of the number of all non-real estate farm loans made by District banks, and as the upward movement of rates has been small on these loans, it is apparent that relatively few bank borrowers experienced much increase in interest rates.

Larger loans generally bear a lower interest rate than those in the under-\$1,000 category. With the expense of interviewing and investigating applications, appraising security and closing and collecting loans ordinarily about the same

for large amounts as for small amounts, the larger the loan, the lower will be the per dollar servicing costs. In addition, the large loans and credit lines frequently are to the borrowers with larger net worths, indicating lower risk.

With lower per dollar servicing costs on the larger loans, the interest rates on these credits may reflect more closely changing conditions and the cost of money itself. To the extent that a "conventional" rate has been widely accepted in the community, boosting the rate to the larger and better credit risks may offer the line of least resistance in adjusting to increased credit

demands. Raising rates to the larger farm borrowers, of course, affects a substantial portion of the dollar volume of agricultural loans, but relatively few rural customers.

Rates vary by area

Country banks rely to a considerable extent on local savings for their loanable funds. Improvement in farm income last year in most Midwest areas combined with only a moderate increase in demand for credit at rural banks helped maintain easier credit conditions in many farm areas, and hence less pressure on rates than in major urban centers. In the main, "tighter" credit in agriculture has occurred in areas experiencing reduced income and large debt carry-over. The drouth-affected areas of western Iowa are the only Seventh District regions in which these conditions have occurred to a significant extent in the past year.

In most areas of the District, 6 per cent is the rate charged most farm borrowers. Yet, there are several areas in which charges vary significantly from this figure. For example, the most common rate on non-real estate loans reported by banks in western Iowa is 7 per cent, but in northern Illinois the largest number of loans carry a 5 per cent rate.

Local vs. national markets

While country banks rely to a considerable extent on their local trade area for loanable funds, Production Credit Associations, Federal Land Banks and insurance companies obtain their funds largely from other sources. PCA's and Land Banks rely heavily on the sale of securities in the national money and capital markets. Representative debentures of the Intermediate Credit Banks and the Land Banks which were yielding from 2.75 to 3.0 per cent a year ago are now priced to yield about 0.75 per cent more. The increases have been reflected in part in the rates charged farm borrowers. A majority of the Land Banks have raised their rates one-half of one per cent during the past year, and a number of PCA's have boosted their rates.

Insurance companies, which supply an im-

portant part of the long-term farm mortgage funds, have also been writing an increasing portion of their loans at higher rates. To a considerable extent this reflects the higher rates available on alternative investments, especially mortgages on residential and commercial properties. In the Midwest, a considerable number of farm mortgages written currently by insurance companies carry a 5 per cent rate. Relatively few are being written at 4½ or 4¾ per cent, rates that were fairly common in the Midwest a year ago. However, competition for high-quality, long-term farm mortgage loans continues strong and is a major factor restraining the rise in rates on such loans.

Credit availability

During the past year, farmers, consumers, businesses and governments have been aggressive borrowers. All have sought to draw more heavily on the pool of loanable funds. Farmers appear to have fared very well in this competitive situation. In addition to the relatively favorable position of country banks, in terms of their capacity to meet credit requirements, there is available better credit machinery than in some past periods for channeling capital from national markets to all farming areas. This has assured an adequate supply of agricultural credit. In addition, the supply of funds available to agriculture has been augmented by the Farmers' Home Administration. Utilizing funds appropriated by the Treasury, the FHA has provided credit and management services to farmers who have not established credit lines from commercial sources.

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