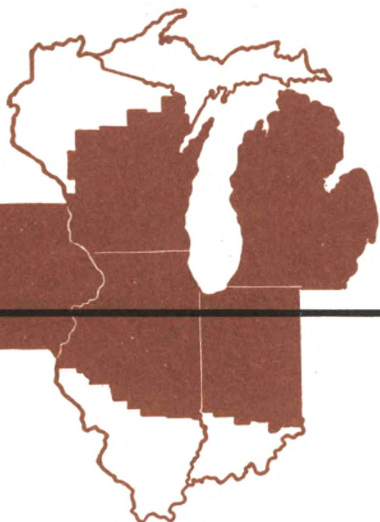
A review by the **Federal Reserve Bank of Chicago**

Business Conditions

1957 November



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THE Trend OF BUSINESS

Developments in the July-September period, and so far in the final quarter of 1957, have failed to support either the "fall upsurge" generally predicted about midyear or the measurable dip widely foreseen somewhat later. Most dollar measures continue to evidence expansion while physical activity remains relatively stable. Growing margins of capacity and an easier labor market have stemmed the rise in prices of many finished goods, but the consumer price index was still tilted upward in August as prices of most foods and services advanced further. On the other hand, commodity prices at wholesale declined somewhat from mid-September to mid-October.

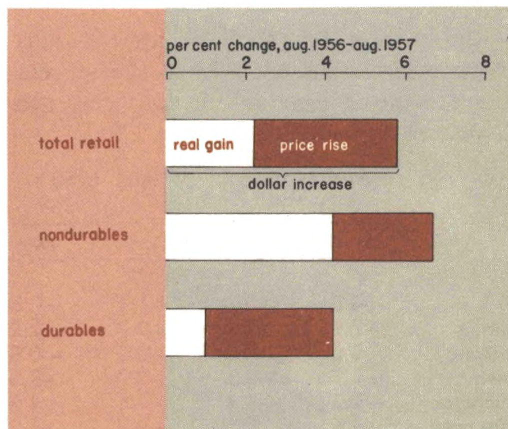
The nation's total output of goods and services is estimated to have edged close to an annual rate of 440 billion dollars in the third quarter. This represents a rise of 22 billion dollars, or more than 5 per cent, from last year. Personal income and retail sales showed similar gains.

Factory and mine production, in physical terms, was 2 per cent above 1956 in the July-September period. This rise largely reflected the dip caused by last year's steel strike. Industrial production for September alone was even with the same month in 1956. Nonfarm employment, nationally, also averaged nearly 2 per cent over 1956 in the third quarter despite a drop in production jobs. But, the margin of gain over year ago had narrowed from over 1 million early in the year to 500,000 in September. Over-all output and employment continues to be sustained by advances in the service industries —finance, utilities, trade, Government and others.

The above comparisons suggest that half or more of the rise in activity since the third quarter of 1956 has been caused by higher prices. A more direct comparison can be made for retail sales and prices paid at retail (see chart).

In the third quarter, over-all retail trade exceeded 1956 by 6 per cent—about the same margin as for the year to date and somewhat more than the increase in personal income. One of the strongest retail groups has been the automotive stores where sales were up 10 per cent and prices were

Over half of retail sales gain reflects higher prices



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about 6 per cent higher. Somewhat more than half of the 8 per cent gain at food stores has been due to price increases. In the case of apparel, by way of contrast, all but 1 per cent of the 7 per cent rise in sales was "real."

Over-all retail trade in September and early October was dampened by a poor performance on the part of the general merchandise group, mainly department stores, mail order houses and variety stores. Sales of all retail stores, adjusted for seasonal, declined between August and September by about 2 per cent. However, since a similar decline occurred in 1956, the year-to-year gain was not far below that of August.

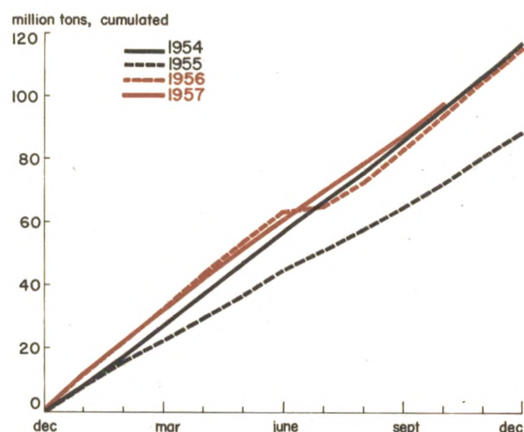
Unemployment creeps up

October is almost always the year's low for unemployment, with 20 per cent fewer jobless than the average month. Unemployment was 2.6 million, nationally, in September—a slight increase from August on a seasonally adjusted basis. As compared with the total labor force, the proportion of unemployed was 4.3 per cent in September compared with 3.7 per cent a year earlier and 4.2 per cent in August. For the earlier month, Michigan's unemployment rate at 6.8 per cent was substantially above the national average.

The market for nonfarm jobs in most Midwest states has not been as strong, relative to either a year ago or two years ago, as that of the nation.

	Aug. 1955 to Aug. 1957		Aug. 1956 to Aug. 1957	
	Total	Mfg.	Total	Mfg.
	(per cent change)			
U. S.	+4.6	+0.8	+1.1	−0.3
Illinois . .	+2.6	−0.9	+0.3	−2.2
Indiana . .	0.0	−4.4	+0.2	−0.8
Iowa	+1.7	−3.5	0.0	−3.5
Michigan	−2.3	−7.1	+2.3	+4.0
Wisconsin	+2.6	0.0	+0.3	−1.7

Steel output through October exceeds previous years



Nevertheless, unemployment remains moderate except for Michigan, where the automobile industry has been swinging into production of 1958 models, and for some other centers where the problem has been chronic throughout much of the postwar period.

By mid-October, most of those laid off in the auto cities in late summer were back at work. In Michigan, total employment is now about the same as a year ago. Car production began to rise in October and in the final quarter of the year it should just about equal the 1956 period.

Steel supplies ease

Steel production was about 13 per cent lower than last year in both September and October. The steel operating rate held in the low 80's, compared with about 100 per cent of estimated capacity in the year-ago period when the losses of the July-August strike were being made up. In part, the lower operating rate relative to last year reflects the 4 per cent increase in the industry's rated

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capacity announced January 1, 1957.

Even with the lower operating rate, a very large amount of steel is being poured and consumed. In the first ten months of this year, 97 million tons of steel were produced for ingots and castings. This compares with 94 million tons in the same period of 1956. Assuming no rise from the September-October rate of operations through year end, 115 million tons would be produced. This total would equal the 1956 output. It would lag only the 117 million in 1955—a year of substantial inventory building.

There is a general belief that steel inventories have been reduced over-all in recent months. This is doubtless true in the case of light products, principally sheets and strip, where holdings had been overample. But holdings of the heavy types, such as structurals, plates and line pipe, which had been short, have risen substantially. The typical ratio between light and heavy steel products by tonnage is about 2 to 1.

The easier supply situation for steel used in building and construction has caused a reduction in fabricators' lead times from twelve to eighteen months earlier this year, to three to six months. Moreover, price premiums demanded by some producers of heavy steel items have been reduced.

Although operating below capacity in the current year, the steel industry will have added more facilities during 1957 than during 1956. There have been suggestions that the rated capacity will be about 140 million tons at the turn of the year.

Profits under pressure

During 1957, for the first time since the years before World War II, virtually all segments of American industry faced a buyers' market. Many of the shortages of a year or so ago have disappeared, and some industries now possess a substantial margin of capacity over current operating rates. Price advances continue, but managements generally are moving more cautiously on proposed increases. One consequence of the more competitive market for goods has been a narrowing of corporate profit margins which, in turn, has contributed to the bear market for common stocks in progress between mid-July and the fall.

It is not that profits have declined significantly in the aggregate. In fact, final results for 1957 should approximate last year's record of 43 billion dollars before taxes. But sales will be higher this year and profits are not keeping pace.

In the first half of this year, manufacturers' sales topped 1956 by 6 per cent, but profits were 1 per cent lower. The railroads, with revenues almost exactly equal to last year's level, reported a 14 per cent decline in profits. Only the utilities among the major business groups can point to a rise in earnings. Moreover, in the second quarter, these comparisons were considerably less favorable than in the January-March period.

A decade of decline?

The trend toward lower corporate after-

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tax profit margins has been causing concern in financial circles throughout most of the postwar period. A pronounced improvement was recorded in 1955 after recovery from the 1953-54 recession. But profit margins declined again in 1956 despite a substantial advance in dollar sales volume. Recent results appear especially unfavorable when contrasted with experience in the early postwar years. In 1947 and 1948, corporate profits after taxes equaled 5.2 per cent of sales. In 1956, this ratio was only 3.5 per cent.

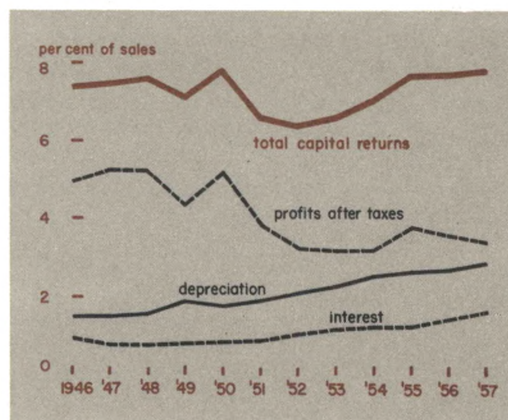
Unfortunately, the determination of the level of a corporation's profits is a far more elusive matter than the cold figures prepared in the conventional manner would indicate.

Theoretically, the best way to compare corporate profits over time would be to relate them to the value of the assets employed in business. Unfortunately, this process is often misleading because book values throughout the postwar period have far understated the worth of American industry.

Price levels are now at record highs, but the bulk of the land, mineral reserves, buildings and equipment held by business firms are kept on the books at original cost less depreciation. Moreover, depreciation schedules, particularly if they reflect accelerated amortization arrangements for tax purposes, tend to be conservative. Inventories also are usually carried at a value below the current market. Traditionally, inventories have been valued for statement purposes at "cost or market, whichever is lower." This convention tends to give some understatement of asset values in a period of rising prices. Under LIFO, and similar methods of charging inventories to sales at current prices, there is a much stronger tendency to undervalue inventories on the balance sheet.

Finally, the value of intangibles—copyrights, patents, trademarks and, most important of all, "going concern value"—are seldom reflected fully in book value figures. Evaluation of the true value of a firm, therefore, is often based upon "capitalizing the earnings," a function performed more or less by the stock market.

Corporate profit margins decline as depreciation and interest rise



The concept of sales or revenues, the gross income of the firm generated through operations, is fairly clear. After deducting current expenses and income taxes, the residual amount can be considered the "gross return to capital." Included in this figure are interest, dividends, depreciation and retained earnings.

When the "returns to capital" are totaled and compared to sales, the earnings picture that results for corporations in the aggregate is modified greatly. Instead of a profit squeeze over the past decade, it appears that earnings have been slightly higher relative to sales in recent years than in the early postwar period. In 1946-48, this ratio averaged 7.4 per cent, and in 1955-57, it was about 7.6 per cent.

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The proportion of total earnings after taxes but before depreciation and interest going to the major categories, of course, has shifted substantially.

	Depreciation	Interest	Profits
1947	20%	10%	70%
1957	37%	20%	43%

One reason why the ratio of corporate profits to sales has been under pressure is the considerable use of debt financing in the past decade. If more funds had been made available by stockholders, a larger share of the sales dollar would have accrued to them. This does not mean that the use of debt financing has been against the interest of common stockholders. If corporate managers had used more equity financing, the ratio of net profits to sales would have been better maintained, but earnings relative to invested capital would have been influenced adversely.

In the past decade the long-term debt of corporations has increased from 41.3 billion dollars in 1946 to 97.3 billion ten years later. Short-term debt more than doubled during this period. Meanwhile, the trend in interest rates has been sharply upward. Offering yields on high-grade corporate bonds have risen from less than 3 per cent to 5 per cent or more, and the effective rates on commercial loans have advanced even more proportionately. More debt and higher charges have boosted total interest payments from 2.5 billion dollars in 1947 to perhaps 9 or 10 billion in the current year. This rise was more than twice as great as the relative gain in sales during the period.

The depreciation problem

Far more important than rising interest costs in exerting a squeeze on reported corporate profit margins has been the steady uptrend in depreciation charges. Compared with interest, depreciation is a complex matter.

The reason for taking depreciation is clear enough. But a number of crucial questions arise as to the write-off schedule: (1) How long will the asset continue to be used? (2) Should depreciation be spread out evenly over the expected life of the asset or concentrated at the beginning or at the end?

If write-offs taken currently are inadequate, net profits are larger than they should be. If they are greater than asset deterioration and obsolescence earnings are understated.

The determination of the "true" level of profits, therefore, is closely tied to the problem of asset valuation. If it were feasible to continually revalue buildings and equipment to reflect current costs, and facilities were depreciated on this basis, balance sheets would give a truer picture of the net worth of a business. But such evaluations are usually impractical.

Depreciation is a noncash deduction from revenues and, therefore, represents funds which have been reinvested in corporate business much in the same manner as retained earnings. The larger the depreciation, the lower the profits and vice versa. Because the determination of depreciation is an uncertain matter, it is necessary to add this amount back to profits and interest in order to make reasonable comparisons of returns to capital over time.

In large part, the apparent relative slide in net profits is a reflection of the situation which has led some observers to charge that profits throughout the postwar period, but particularly in the early years, have been overstated. This assertion is based upon the fact that depreciation, calculated on the original cost of plant and equipment in use, tends

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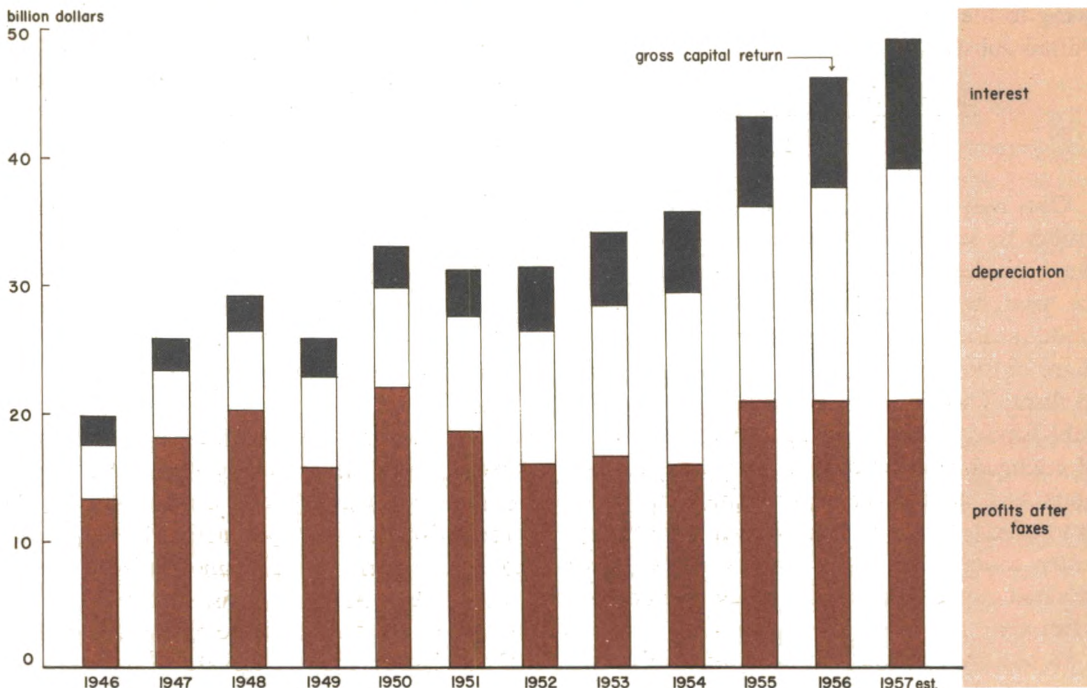
Gross capital returns mount, net profits stabilize



to lag behind other measures in a period of sharply rising prices. As a result of the large investment in new plant and equipment in the postwar period, the average cost of facilities is now much closer to the prevailing price level than was the case at V-J Day.

In 1947, depreciation taken by corporations amounted to 5.2 billion dollars. Last year it was 16.7 billion dollars, and preliminary estimates suggest a further growth, to 18.2 billion this year. Depreciation was only 1.5 per cent of sales in 1947. In 1956 it was 2.8 per cent. Corporate depreciation in 1957 will be double the total of 1951 and three times as great as in 1947 or 1948. It is now almost half as large as total profits before taxes.

The most important factor contributing to the rise in depreciation charges has been the volume of new investment. In 1946, plant and equipment expenditures began to rise sharply, and these outlays have remained at high levels ever since. In the twelve year period 1946-57, corporate investment in new fixed assets totaled over 250 billion dollars. Replacements, expansion and new products required substantial amounts of brick and mortar, machinery and equipment. Moreover, because of the demand pressures upon the capital goods industries, prices rose.

In the 1946-50 period, corporate plant and equipment outlays averaged 16.3 billion dollars. Between 1951 and 1955 the average was almost 24 billion. In the past two years the level has been about 31 billion. As these new assets are acquired they are

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added to the depreciation rolls, and tend to close the gap between original and replacement cost values.

Another factor tending to boost depreciation totals in the past decade has been the effect of accelerated amortization of facilities acquired in connection with the nation's military effort, first in World War II, and second, in the period since Korea.

During the conflict with the axis powers, assets acquired in connection with the war effort could be written off in five years or in a lump sum at the conclusion of hostilities. As a result, depreciation allowed in 1945, amounting to 5.8 billion dollars, was much greater than the 4.2 billion taken in 1946. To a large extent these fully depreciated assets continued to be used to produce goods, but no further write-offs were possible.

After the start of the Korean war a substantial portion of the cost of certain defense-connected facilities again could be written off in five years. The Commerce Department estimates that in 1956 the excess of rapid amortization over the amount that would have been allowed under alternative methods amounted to 2 billion dollars. Since the Defense Department is bringing this program to a close, these excess write-offs will begin to decline in the near future, with a resulting easing pressure upon profit margins.

However, the 1954 Revenue Act provides for generally applicable alternative methods of depreciation which also accelerate write-offs, particularly in the early years of life. Last year an additional 1 billion dollars of depreciation is believed to have been claimed under these provisions. These amounts probably will rise further in years immediately ahead, and tend to offset the effects of the exhaustion of fast write-offs under the defense amortization plan.

Corporation depreciation charges will tend to rise in dollar volume in the future, but it is doubtful that a further squeeze on net profit margins will arise from this source. The major factors causing the rise in the ratio of depreciation to sales are now waning. As a matter of fact, the rise in the ratio has been very gradual since 1954, after a rapid increase in earlier years.

The cost-price squeeze

The pressures exerted upon reported sales-profits ratios by depreciation and interest charges may be easing at the present time. This does not mean, of course, that the existing margin of "return to capital" relative to sales will be maintained automatically. The more competitive situation which now obtains through additions to capacity is real and requires that managerial vigilance be maintained and invigorated if deterioration in earnings is to be avoided.

This fact is indicated by results in the merchandising field where depreciation and interest tend to be small relative to sales. In the first half of this year, the National Retail Dry Goods Association reports that pretax profits of a large group of department stores amounted to 1.5 per cent of sales, compared with 1.9 per cent in the same period of last year. Enlarged merchandising capacity was cited as the principal cause.

Aside from the cost of purchased materials, a firm's wage bill constitutes its largest single cost item. In recent years the tendency has grown to grant wage increases on a basis which is virtually automatic, reflecting implied productivity gains, changes in the cost of living, length of employment and so forth. No such automaticity applies to sales and profits. Increases in wages, taxes, insurance and other costs can be offset only by greater efficiency or higher selling prices. Through last year, American business was

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fairly successful in meeting the challenge.

The fact that the profit squeeze has not been more severe, in the face of increasing unit costs and growing buyer resistance, can be attributed to the success of many managements in their drive to maintain earnings through various economies. Inventory reductions, introduction of more efficient facilities and methods and a closer scrutiny of expenditures of all kinds, together with price increases when markets permitted, have provided the means to defend profit positions.

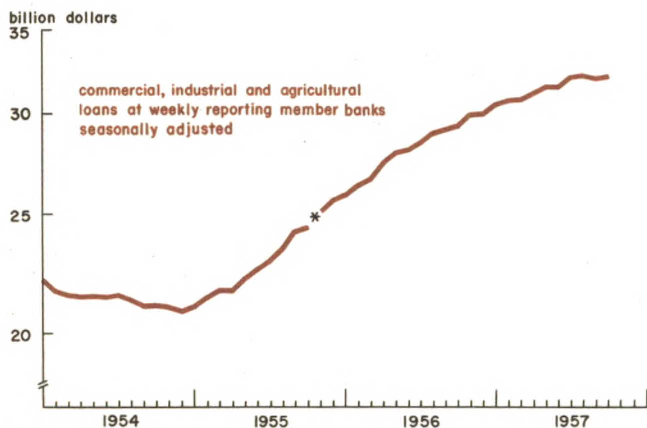
It is well, moreover, to remember that present concern relates to the amount of *profit*. Very few firms have faced the spectre of a deficit. Among the 500 largest manufacturing corporations listed by *Fortune* magazine, only nine lost money in 1956 and only seven in 1955. Even in the "recession year" of 1954 the number was only 14.

Business loans show less vigor

The fall upswing in business loans this year has been mild, especially when compared with the large increases in other recent years. During August and September, outstanding commercial and industrial loans rose 700 million dollars, well below the 1.1 billion dollar gain in the same 1956 months.

This slower growth in business borrowing from the nation's big commercial banks is a continuation of a trend that has been in evidence throughout 1957. In fact, at no time this year, with the exception of June, a period in which corporate treasurers borrowed heavily to meet their quarterly income tax bill, have business loans measured up to their performance in the comparable 1956 months.

Business loans show slowing rise in recent months



*Revision in series

Furthermore, on a seasonally adjusted basis, the rate of growth in business loans from quarter to quarter has been slowing. For the third quarter of this year, outstandings rose less than a half of 1 per cent, compared with the peak gain of over 6 per cent in the third quarter of 1955.

Widespread slack

Most of the major kinds of business borrowers have evidenced a

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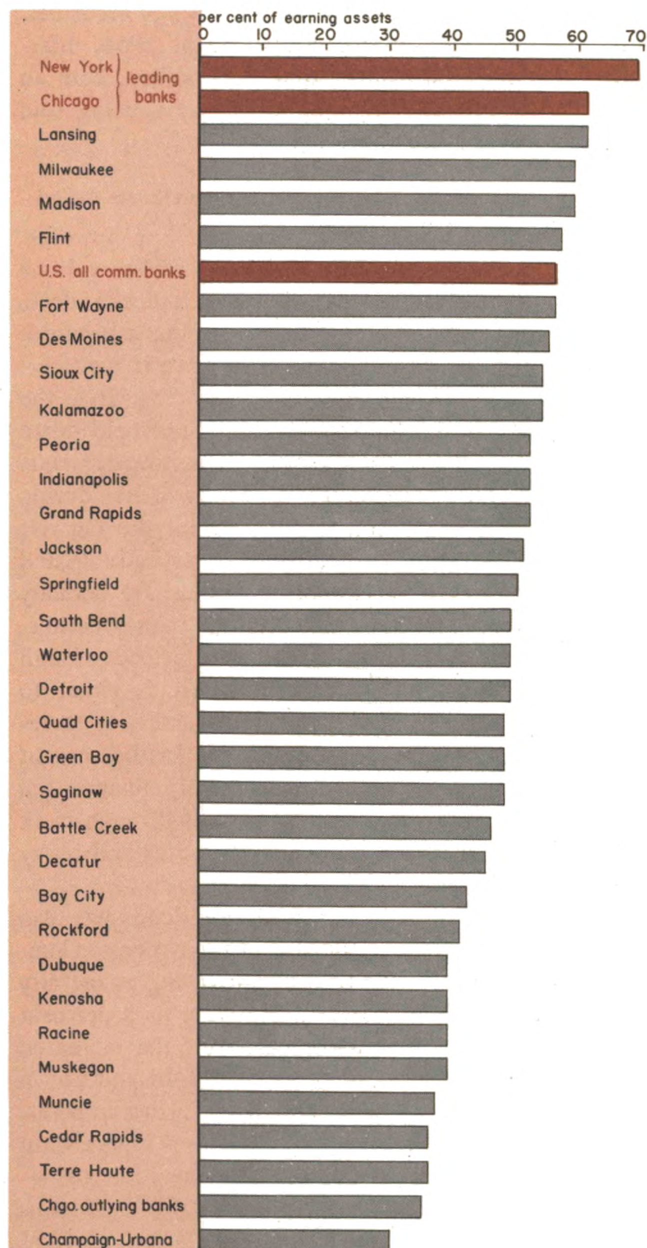
Loans constitute varying proportions of earning assets in District member banks



relative slowdown in their use of bank credit this year. Petroleum, coal, chemical and rubber companies, for example, increased their borrowing at leading city banks by only 60 million dollars since the end of July, about one-fifth of the gain chalked up in August and September last year. Metals and metal product firms have reduced outstandings by 180 million over the same period, compared with a 100 million drop in August and September 1956. Firms in both of these industry groups, however, while turning to bank credit less extensively this year than they did in 1956, have made up the difference by raising an expanded volume of funds in the capital market. Hence, at least through the first half of the year, the combined borrowing at the nation's big banks and in the securities markets by the metals firms and fuel and chemical producers topped the year-earlier level.

Public utilities, a major influence in the rise in business loans in 1956 and the first half of 1957, have also slowed the pace of their bank borrowing. In August and September, the gain in borrowing at the leading banks was but half of the 100 million dollar rise in the like period a year ago.

Throughout this year public utilities, too, have raised a substantial volume of funds by way of security issues. In order to finance an increase in plant and equipment expenditures of more

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than 20 per cent, utilities sold a hefty 3.2 billion in new issues in the first half of the year, two-thirds more than the volume in the initial six months of 1956.

Even those industries whose borrowing pattern is dominated by seasonal demand for funds have contributed to the slower growth in business loans. Food, liquor and tobacco processors, in particular, have turned to commercial banks to a lesser extent this year than last. The seasonal gains in loans to these firms during August and September of 220 million were substantially less than the 600 million boost in the same 1956 months.

Commodity dealers, with much the same seasonal credit pattern as farm product processors, since August, have matched last year's upturn. Loans to trade firms, on the other hand, have shown recent strength. Through July retailers and wholesalers reduced their bank indebtedness, compared with a substantial gain in the same 1956 months. Since then, however, as the inventory build-up in preparation for the fall and Christmas selling periods has gotten under way, net borrowing by trade firms has topped last year's performance.

Relative strength

Sales finance companies are the major exception in this picture of relative slackening in the use of bank credit. In August and September last year, loans to finance firms by big banks declined. In the same two months this year, outstandings increased by 200 million as rising retail inventories of autos added to finance company receivables. The declines that have occurred in finance company borrowing in early October reflect, in large part, the decline in auto dealers' new car inventories associated with the cleanup of the 1957 models.

Another reason for the strength in loans to finance firms has been the reduced volume of funds these companies have obtained in the long-term market. In the first half of the year, sales finance companies issued approximately 450 million dollars of securities. In the January-June period of 1956, offerings totaled more than 700 million, with an additional 300 million of issues being sold during the third quarter.

Extensions up, repayments up more

The slowdown in business loans, however, has not been reflected in a smaller volume of transactions at the loan officer's desk. Since the seasonal upturn in loans began at the end of July, extensions have topped new loans a year ago by 9 per cent. But, the growth of outstandings has been held down by a 20 per cent increase in loan repayments.

The large volume of capital issues during 1957 is in part responsible for the big rise in pay-backs. Securities are typically floated well before most of the funds are actually needed. Instead of letting the money lie idle, most companies, especially in periods of high interest rates, will use the funds either to invest in short-term earning assets or to repay their bank indebtedness. In the case of public utilities, firms generally finance the initial stages of capital outlays through bank credit, then raise long-term funds and repay their bank indebtedness.

The growth in outstanding loans has also contributed to the rise in repayments. Commercial and industrial borrowing at big city banks is now over 2½ billion or 8 per cent above a year ago. Moreover, the increased concentration of new loans in the short-term area has given repayments a further impetus. Based on a sample of the largest banks, term loans — those maturing in over a year — dropped from 23 per cent of the new loans extended in the first three quarters of 1956

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to 17 per cent through September of this year.

The big Chicago banks

During 1957, Chicago banks have increased their loans to business at a more rapid pace than did their competitors in other sections of the country. The August and September gain at banks in the Windy City measured almost 4 per cent, compared with a 3 per cent gain in New York and less than a 1½ per cent rise for the leading banks in other cities.

The growth in recent months brought the rise for the first three quarters of the year in commercial and industrial outstandings at Chicago banks to 9 per cent. In the same period, the increase in business loans for the nation as a whole amounted to 4 per cent.

Last year, New York banks took the lead in boosting business lending. The substantial 17 per cent gain during 1956 for the nation's commercial banks was topped by the 25 per cent increase in New York and the 19 per cent gain in Chicago.

Hence, the Chicago banks, although they account for only about 7½ per cent of total business loans, have provided a big share of the 1957 rise. Almost one-quarter of the gain during the first nine months of this year was concentrated in the large Chicago banks. Borrowing by trade firms, public utilities and metals and metal product manufacturers were mainly responsible.

Supply restricted

The rise in business borrowing during 1957, albeit at a reduced rate, increased further the ratio of loans to total earning assets at the nation's banks. At the end of 1954, loans accounted for 45 per cent of combined loans and investments at all commercial banks. By the close of 1956 the proportion had risen to 55 per cent. Today, 56 per cent of the earning assets at the nation's banks represent loans to business, consumers and farmers.

This national average hides wide variations, as the chart indicates. In the large New York banks, for example, loans represent 70 per cent of earning assets and investments only 30 per cent. For Chicago banks, the figure is 60 per cent for loans, while in Detroit loans and investments are about equal.

Despite this diversity, almost all banks have experienced a sizable increase in their loans-to-earning-asset ratio since the boom in credit demand began in late 1954. Undoubtedly, many bankers feel that the proportion of funds in loans has about reached its maximum, and have looked to deposit gains as the major source of funds for increased lending. While the limits, established formally or informally, on the share of earning assets in loan portfolios are subject to revision in light of the volume of loan requests, the higher ratio of loans to earning assets has surely made many lenders more selective in their extensions of credit than they otherwise would be.

Moderate gains in store

During the final quarter of 1956, loans to business registered a 1.8 billion dollar rise. Slightly over a billion dollars of that total represented an increase in big bank indebtedness of seasonal borrowers—farm product processors and dealers, trade firms and textile and apparel companies. Metals firms, public utilities and sales finance companies were responsible for most of the remainder.

If the pattern of the third quarter continues, those firms that borrow heavily to meet seasonal credit requirements will probably boost their borrowing by an amount close to the rise registered last year. The

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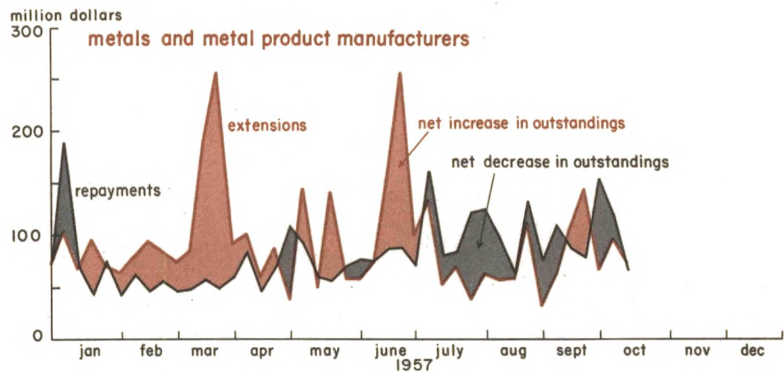
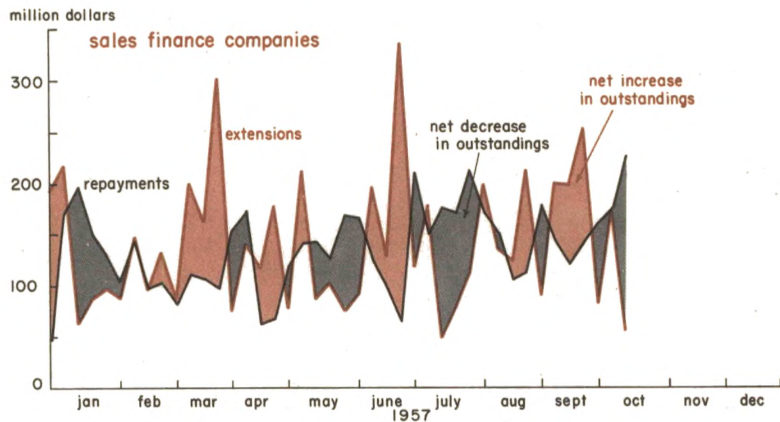
New loan and repayment patterns vary with type of borrower

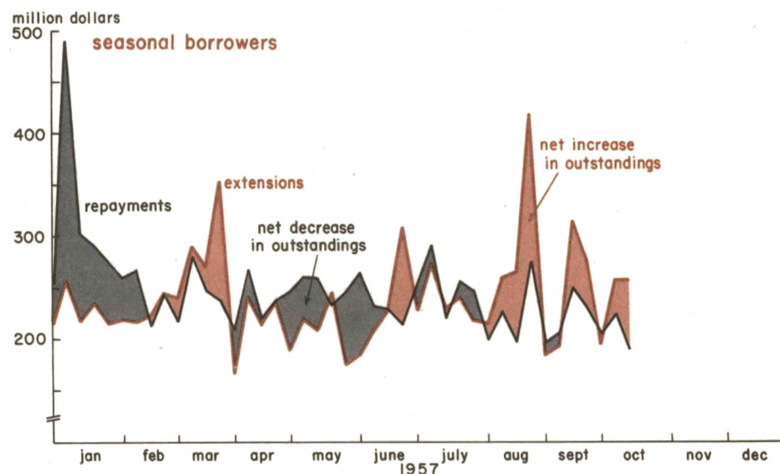
Metals and metal product firms rely heavily on bank loans to meet their quarterly corporate tax bills; repayments of these loans are made gradually over succeeding weeks.



Sales finance companies also increase borrowing sharply at tax dates; repayments are more sensitive to ebbs and flows in money requirements and availability of funds from other sources.



Seasonal borrowers — mainly processors and dealers in farm commodities and trade firms — boost their requests for new loans in late summer and fall, repaying in large part after the start of the new year.



Based on reports from major city banks.

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amount added by the remaining industrial groups will depend on several factors. The reception of new model autos and the willingness of consumers to add to their instalment debt to acquire new cars, the increase or decrease in business inventories, and the availability of funds in the capital markets will all bear heavily on the business loan pattern for the remainder of the year.

In addition, two new factors probably will have an important influence on the course of business loans during the closing months of 1957. The stretch-out in payments on defense contracts will no doubt force many producers to substitute bank credit as a source of funds. Essentially, this means replacing Treasury borrowing by business indebtedness. Second, corporations will be required to pay 15 per cent of the income tax on their 1957 earnings at mid-December, compared with 10 per cent a year earlier. The higher proportion due next month, together with increasing reliance on bank credit to meet corporate tax bills, should help to bulge outstanding commercial and industrial loans at year end.

On the issue of credit for small business*

The Federal Reserve has responsibility for the supply, availability and cost of credit—a responsibility which it discharges primarily by influencing the reserves of commercial banks. Left unaffected by an agency such as the Federal Reserve, the total pool of credit would become excessive in boom times and lead to inflation through the supplying of excessive amounts of short-term credit. In brief, the aggregate demands of credit-worthy bank customers would result in a total that would be inflationary unless restrained.

Allocation of credit

The apportionment of the credit supply among individual borrowers, in contrast to the governmental influence over the total, is a matter for private lenders operating through free markets. The selection of the particular customer to whom loans are to be made is, and should be, left to the discretion of private institutions. Unless the allocation is left to the operation of free markets, it will be arbitrary and inequitable.

If the total supply of money is restrained with its allocation determined by private institutions and private money markets, criticisms must be expected from groups that feel restrained unduly. The way in which the available supply of money has been allocated among various sectors of the economy by rising interest rates and other market forces has been criticized sharply. It is argued that lack of availability has delayed the builders of schools, roads, and housing,

*Excerpts from an address by C. Canby Balderston, Vice Chairman, Board of Governors of the Federal Reserve System, at the annual fall conference of Robert Morris Associates, Washington, D.C., October 7, 1957.

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and has affected small firms more adversely than large ones. It has been urged that their financing be sheltered from monetary restraint by government action.

In fact, the government has tended increasingly in recent years to modify the private allocation of resources, including money supplies, in an effort to meet various worthy objectives. There are government aids for a whole range of desirable projects, including a special agency to offer aid to small business.

While the social and economic importance of these borrowers is not to be questioned, it has often been true that programs of national defense, school and church construction, road building and additional housing may, during boom periods, accentuate the over-all problem of achieving monetary stability and orderly growth. The problem of any democracy is to blend a whole complex of objectives, including more schools, better roads, better housing, greater national security, full employment, orderly growth and sound money. At certain times, one objective may receive more emphasis than another. When it becomes necessary to adopt a policy of credit restraint in order to maintain relative stability, the attainment of some desirable objectives may have to be postponed. It is a matter of simple arithmetic that we cannot have everything at once.

One of the chief complaints raised against monetary restraint is that it discriminates against small business. Like the other charges relating to the differential impacts of "tight money" on schools, roads, and housing, that relating to small business is very difficult to appraise. The information now available on small business financing does not appear adequate to provide precise conclusions as to the impact of monetary policy on small firms. If impressions are to give way to understanding and to appropriate policy actions, the following questions require answers:

1. What is a small business? Can the same definition embrace varied lines of activity, such as small steel mills and small grocery stores?

It is possible that the criteria used in earlier investigations may no longer be applicable in view of the enlarged scale of current business and the higher price level. The type of retail business that could be started for as little as $1,500 in the Thirties is likely to require $12,000 or more today.

2. What criteria does one use to determine the adequacy of financing facilities for small business? This question raises a host of others:

(a) If small business has a distinctive financial need, is it for short-term, intermediate-term, or long-term credit?

(b) To what degree is equity capital unavailable to small business? Is a scarcity, if any, the result of credit restraint, of taxes, or of some other influence?

(c) Even if small entrepreneurs need more equity financing, are they willing to raise more capital in this form?

(d) If those small firms with thin equity have to rely on borrowing of the more expensive types, is this difficulty aggravated by credit restraint?

3. To what extent does the credit standing of small business borrowers deteriorate with any slowing up in the rate of growth of economic activity?

We have some scattered evidence to indicate that small enterprises differ from large companies in that their sales and earnings fluctuate more sharply. Because of less diversification in their products, and more limited access to economies, they may be more vulnerable to changes in over-all business activity, shifts in demand, and regional changes.

4. If there is a problem of inadequate financing for business, does it focus essentially on small vs. large, or upon new vs. established firms?

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5. Are the capital requirements of new businesses such that they cannot be met by the available sources of loanable funds?

6. What significance is to be attached to the figures on business failures? How are they related, if at all, to credit restraint?

7. How is the problem of small business financing related to that of management?

The above questions concerning the status of small business are but a few that might be explored. They suggest the importance of a thorough inquiry. Until more light is shed upon these and other questions, the impact of monetary policy on the small business sector of the economy cannot be appraised adequately.

The Federal Reserve System is undertaking just such a survey of small business financing problems. This investigation is likely to cover three broad topics:

A. A review and analysis of existing material and data on the financing of small business.

B. Studies of the lending operations and policies of the principal types of suppliers of funds to such firms.

C. A study of the financial structure and financing experience of small enterprise, based on data obtained directly from a sample of typical small businessmen.

A study of such scope, important as it is to both small businessmen and to American financial institutions, calls for concerted effort by the financial community, the Federal Reserve, and others. In particular, many of you will again be asked to provide information as to your business loans. We will need to solicit interviews with some of you as to your lending policies. We will also welcome your views as to any aspect of the undertaking.

The question of the differential impact of monetary restraints on certain groups of the population involves the larger question of whether the social needs of the community for jobs, schools, roads, and housing are, in fact, in conflict with the maintenance of a sound dollar. Fundamentally, there can be no conflict. No matter how great is our need and desire for more and better schools, roads, housing and other facilities, the simple fact is that they must be fitted into our available capacity and resources.

In boom times, investment must be financed primarily by taxation or by real savings from current income. A small amount of investment may be financed out of bank credit expansion, but this amount must be kept within the margin of tolerance for a stable dollar. The advantages of sound money certainly outweigh the disadvantages of temporarily postponing some additions to housing or to plant and equipment that cannot be financed out of savings, or to schools and roads that the community is unwilling to finance out of taxes. To protect the purchasing power of the dollar and to foster stable growth in the economy are of supreme importance to those dependent upon jobs as well as to those dependent upon savings. This means that the well-being of our children and the future strength of the nation call for prudent decisions by both lenders and borrowers, private and public.

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