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

Business Conditions

1958 July

Contents

THE Trend OF BUSINESS

Enough statistical markers of a promising nature now have been cast in the wake of economic activity to suggest that a change of direction occurred in the second quarter. This development was not unheralded. There was evidence earlier that the momentum of the decline had slowed. The transition from small declines to small increases in business measures can be accomplished as easily as a retardation in the speed of a downswing.

The months ahead, of course, may bring further bad news. But if recent developments do not presage a sustained generalized upturn, the 1957-58 recession probably will be characterized as having had a "double bottom." Documentation of a "turn" is found in the performance of a number of broad measures of activity:

1. Employment, after allowances for seasonal trends, rose in May and unemployment declined.
2. Personal income rose in May for the third straight month.
3. Retail sales improved markedly in April and apparently maintained that pace in May.
4. Construction activity continued down in April and May, but increased hiring of construction workers and the upturn in contract awards and housing starts suggest that this decline will soon be reversed.
5. Total industrial production increased slightly in May after a steady eight-month decline.
6. Steel production rose substantially in May and June from the April lows. This suggests that inventory liquidation in one major area, at least, was ending or slowing down.
7. Although data is not yet available, it is probable that national security outlays, which had been declining since the second quarter of 1957, started up in recent months.

It is now widely believed that the April-June period produced a larger volume of total spending (the gross national product) than did the first quarter of the year. Previously in the postwar period, the reversals of declines have always been sustained in subsequent periods.

Employment. Wage and salary employment declined by an average of 300,000 per month, seasonally adjusted, between August of 1957 and last March. In April, the decline was only 135,000, and preliminary reports indicate a *gain* of 115,000 for May. This rise, however, leaves the total 2 million or about 4 per cent below last year.

The seasonally adjusted rate of unemployment dropped from 7.5 to 7.2 per cent of the labor force between April and May. This change represents a significant betterment, although at 4.9 million, unemployment was 2.2 million more than last year when the rate was 4.1 per cent. Unemployment may rise more than seasonally in June when graduates looking for permanent work and students and others seeking summer jobs enter the labor force. The easing of labor markets almost everywhere has made summer jobs much scarcer than in previous years. As a result, those seeking summer work may swell the ranks of the unemployed for a month or two until they obtain positions or withdraw from the labor market.

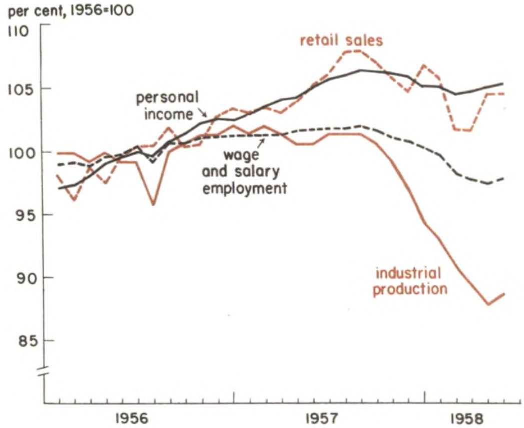
In the Midwest, all District states appear to be enjoying some slight improvement in job conditions, at least of seasonal proportions. New claims for unemployment compensation were still running well above last year in May in all these states except Iowa. In Indiana and Michigan, May claims remained substantially in excess of the national trend; whereas in Illinois and Wisconsin they were about the same. But in all of these states and in the U. S. as a whole, the rise over last year was much smaller than in March.

Personal income. Between February and May, personal income rose by 2.6 billion dollars on an annual rate basis, thereby making up about half of the loss from last August. Significantly, wage and salary receipts shared in the rise in May for the first time since the recovery began. Of course, the improvement was aided by the rise in employment. Also, the average factory work week rose in May, and wage and salary increases are still commonplace despite attempts of management to reduce costs.

Retail trade. Over the past year consumer buying, as evidenced by retail trade estimates, has been volatile. Last spring, retail sales moved up strongly to a seasonally adjusted record high of 17 billion dollars in July and August. After a slowdown in the fall these outlays rebounded in December only to drop again to a rate of 16.1 billion in February and March. April and May witnessed a recovery to 16.5 billion.

Automobile deliveries rose to a daily rate of 15,200 in May. This is the best pace since

Broad measures of activity "bottomed out" in second quarter



last December and compares with 14,000 in March and April. Towards the end of May the selling rate was close to 17,000—still far below last year, but sufficiently high to relieve some of the gloom in the industry.

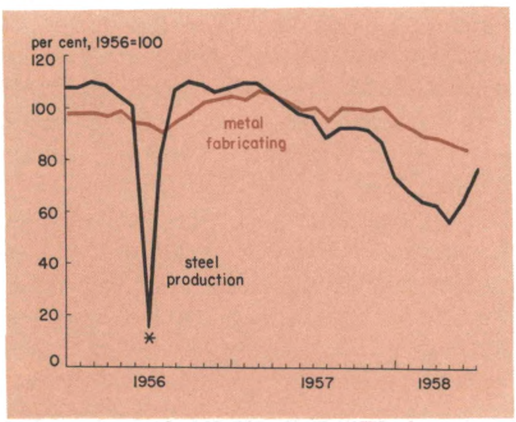
The only useful retail trade data available currently on a regional basis is for department stores. Midwest results except for Iowa have been markedly poorer than the nation as a whole. In May, department store sales had performed better than in earlier months, both in this region and in the nation. In June, however, cold and wet weather dampened consumer buying vigor, and some weeks saw department store sales sharply below last year in virtually all of the nation's northern and eastern centers.

The hope that the higher level of retail trade can be maintained or improved in subsequent months is based on a number of factors. Personal income, as noted above, is on the rise. In addition, consumers are adding less to liquid savings funds than was the case earlier in the year, and greater confidence in the outlook doubtless is partly responsible for this trend. Finally, the decline in consumer debt has put many individuals in a position to resume credit buying if they are so inclined.

Construction. The construction industry has played an important part in the recent improvement in over-all business prospects. For an example, between February and May, contractors' employment increased by 300 thousand or 10 per cent, after allowance for usual seasonal factors. The February total was depressed by severe weather, but those conditions had been responsible for deepening the general drop in activity as well. In May, the number of production workers in factories making building materials also rose slightly despite declines in most manufacturing lines.

In the first quarter of the year, construction contract awards, according to F. W. Dodge, lagged last year by a wide margin. April, however, showed a 4 per cent gain for the nation, and a slight increase was also reported for May. The type of awards which have been strongest include commercial buildings, large residential structures, schools, hospitals and public works. More recently, there has been evidence of a pick-up in home-building activity.

Steel output rises sharply, suggesting end of inventory liquidation



*Production curtailed by strike.

Housing starts exceeded last year nationally in May for the first time in 1958. Easier money is playing a large role in stimulating the construction industry. Requests for FHA and VA mortgages have increased very sharply because these obligations have become attractive to lenders once again. In the Midwest, conventional home mortgages now can be obtained at rates a full one-half per cent below the levels of last fall.

Inventories. More and more firms are reporting inventories to be well in line with current sales, and the rate of inventory liquidation probably is moderating at the present time. One important piece of evidence pointing in this direction is the uptrend in steel production which had been running far below usage by fabricators.

Nationally, steel production in early June was 34 per cent above the level of April. A similar gain occurred in Chicago and an even sharper rise in Detroit. In June, steel pourings were above 60 per cent of capacity in the U. S. and Detroit, and over 70 per cent in the Chicago area. The low point in utilization relative to potential in April was 47 per cent for the U. S., 12 per cent for Detroit and 54 per cent for Chicago.

Some of the improvement in steel production doubtless represented a desire to beat the price increases which some expected at the end of June. However, the fact that the uptrend became noticeable early in May, and the knowledge that holdings of many steel users are rather short indicate that speculation on price is only part of the reason for larger orders.

The up and down in consumer spending—durables

The volatility of consumer hard goods expenditures is dramatically illustrated in the most recent rise and subsequent decline in business activity. Spending for consumer durables increased just under 8 billion dollars or about 26 per cent between the third quarter of 1954 and the same quarter of 1955. This largely reflected a whopping 6 billion dollar or 48 per cent increase in sales of automobiles and parts. Total personal consumption expenditures of all kinds, however, rose only a little more than 8 per cent.

Since the peak reached in the summer of 1957, total consumer spending has decreased less than 1 per cent, but outlays for hard goods have dropped 10 per cent. Again, it has been the automobile segment that has accounted for most of the movement in durables. Since 1957's peak, there has been only a small decline in "soft" goods—in both dollar and percentage terms—and a further rise in expenditures for services. These contrasts are characteristic of the general pattern traced by consumer expenditures during past business fluctuations.

Sharp ups and downs

A host of factors, not typically present in spending for most nondurables and services, permit or induce marked shifts in the pace of consumer hard goods buying. These are related to such factors as the nature of the goods, that is, their "durability," the relatively large initial outlays required for most purchases and the impacts of changing costs of living and swings in money income upon consumer resources available for durables buying. The changing rate of introduction of new products and the widespread rise of credit financing also account in part for the variability in spending for durables.

The long lasting nature of durables provides consumers considerable leeway in timing their purchases of them. Usually, the car, the appliance or the furniture piece on hand can be made to do for a while longer if there is any significant uncertainty about income or job prospects or if the available new models show no obvious advantages over the old.

The role played by credit in the course of wide fluctuations in consumer spending is undoubtedly an important one. About three-fifths of all new and used cars are financed in part by credit, while a substantial though somewhat smaller fraction of household durables are bought on the instalment plan.

Variations in the ability and willingness of borrowers to utilize credit and of lenders to extend it have resulted in wide swings in the volume of credit-financed sales. During 1955, instalment credit outstanding rose by almost 5½ billion dollars, while durables expenditures increased roughly 6 billion. Helping to attract consumers into the market and to boost their capacity to buy in 1955 was a significant easing in credit terms.

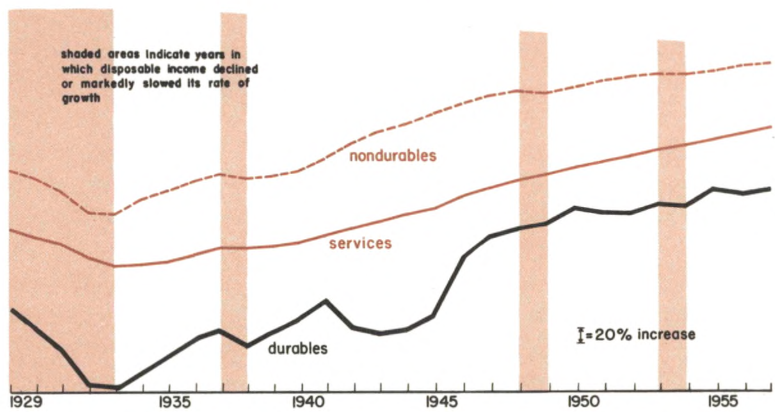
In retrospect, the easing that occurred during 1955 was largely "structural" in character in that it marked the acceptance on a broad front of 30- and 36-month financing for automobiles. Significantly, these terms continued to prevail through the ensuing period of reduced durables expenditure and tightening of credit. In the present business setback, the progressive outward extension of average contract maturities, within the context of essentially unchanged lender standards on terms, suggests that instalment credit has somewhat mitigated the severity of the decline. This it has done by enabling hard-pressed buyers to acquire new cars and other durables to replace old ones, even though they have had only nominal trade-ins to offer.

Credit extensions are a reflection of consumers' current ability and willingness to take on more debt, whereas repayments largely reflect past decisions concerning instalment purchases. Therefore, as extensions contract, repayments follow suit only sluggishly. The resulting decline in total instalment credit outstanding, thus, is achieved by a contraction in spending for current purchases. For example, 9.9 billion dollars of instalment credit (seasonally adjusted) was extended in the first quarter of 1958, 783 million less than in the previous quarter. At the same time, repayments declined only 55 million. The difference between extensions and repayments *added* 465 million dollars to consumer income during the last quarter of 1957 but *subtracted* 263 million in this year's first quarter. A rise in new instalment borrowing usually supplements current income; a decline in credit extensions means some subtraction from income. This is because the volume of repayments changes only slightly over the short term.

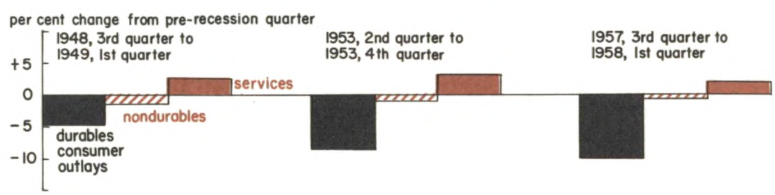
Auto outlays dominate

In the current business downturn, autos and parts expenditures declined an estimated 19 per cent from the third quarter of 1957 through the first quarter of this year, compared with only a 4 per cent drop in household durables and a still smaller decrease in outlays for other consumer hard goods. This

Purchases of consumer durable goods record marked rise in past three decades . . .

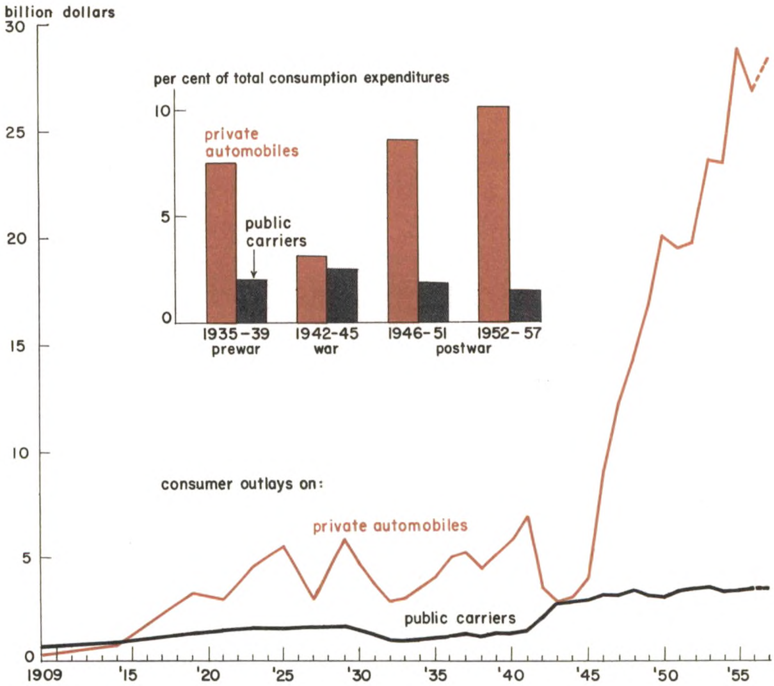


although hard goods spending shows relatively large declines during business downturns



roughly approximates the pattern traced by consumer spending for durables in the 1953-54 recession. In the first postwar downturn (1948-49), though furniture and appliances were hard hit, the automotive industry appeared unaffected by the general business lag because of the huge backlog of demand.

Bigger share of consumer dollar goes to autos in postwar period



Prior to the current decline in auto expenditures, consumers were allocating a substantially greater proportion of their spending for autos than in the Thirties. Total automotive-related outlays, including autos and parts, service, and gas and oil have accounted for over 10 per cent of personal consumption expenditures during the past few years, whereas the 1935-39 average was 7½ per cent (see chart).

All the comforts of home

Most consumer spending for nonautomotive durables is for products used in and around the home—furniture, floor coverings, dinnerware, appliances, lawn mowers and radios-TV. The remainder, approximately 25 per cent by dollar volume, is composed of smaller and more heterogeneous items, which include jewelry, books, durable toys and sports equipment.

Unlike automobiles and allied products, household durables as a group have not been garnering a substantially larger proportion of consumer expenditures than before the war. Nevertheless, there has been a significant change in the kind of household hard goods attracting the most consumer interest. New products have spelled the difference. Both appliances and radio-TV have increased in importance within the durables group since prewar, while furniture and other household items have not gained as rapidly.

The past decade has witnessed a remarkable surge in the popularity of new products. Television sets in January 1958 were in 86 per cent of the 49 million U.S. homes wired for electric service, according to *Electrical*

Merchandising. Ten years ago fewer than 3 per cent of the 33 million wired homes had TV. Other household durables which have risen from relative obscurity include room air conditioners, gas and electric clothes dryers, dishwashers, food waste disposers and food blenders. It has been estimated that during the past two years, 50 to 60 per cent of manufacturers' sales of household appliances, radios and TV came from products that were almost unknown at the end of World War II. The emergence of these new products has been an important factor behind the relative stability of total spending on durables in the nonautomotive category.

But the more familiar household appliances, too, have served to stimulate consumer hard goods outlays. Refrigerators and automatic clothes washers in particular have recorded marked gains over the past ten years.

Appliance prices "soft"

Consumer durables prices as a group have increased 15 per cent since 1947. This is slightly less than the 18 per cent advance in prices of nondurables and much less than the 38 per cent rise in prices of services. What's more, the durables increase was almost solely the result of a 30 per cent gain in prices of autos and parts. Prices paid for durables other than automobiles as a group have gained only slightly over the past decade. Changes reported by the Bureau of Labor Statistics for selected durables of "comparable quality" are listed below:

	Per cent change from 1947 to 1957
refrigerators	—29
televisions	—22*
vacuum cleaners	—11
washing machines	+ 4
cook stoves	+ 7
furniture	+14

*since 1951

In some instances, although the price for a comparable product declined, consumers upgraded their purchases and actually spent more per unit. This was true, for example, in the case of vacuum cleaners and refrigerators. The average refrigerator sold in 1947 for an estimated $225 at retail, while ten years later the average price paid was $320 for a larger, more deluxe unit.

The stable-to-downward price trend in household durables has been due in part to the reductions typically encountered after a new product gains widespread acceptance. But much of the price softness appears to have stemmed from the intense competition in both the distributing and manufacturing ends of the business. In appliance distribution, a new form of retailer arose to spur competition—the discount house. For many of these distributors, operating expense ratios were reportedly not much more than half as high as for traditional outlets. On the production front, the number of appliance makers in the U. S. rose rapidly until after the Korean conflict, when mergers and failures became fairly widespread. Generally hardest hit were the producers lacking full lines to offer dealers.

Broad repercussions

The basic appeal of these products rests in their capacity to provide comfort, entertainment or convenience and, possibly, obvious evidence of their buyers' affluence. That the stepped-up spending for appliances, television and autos has had a broad impact on the nation's economy, there can be little doubt. Hard goods have changed the life of the American consumer in many ways.

The time-saving features of automatic clothes washers and dryers and other such goods no doubt have played an active role in the movement of women into the labor force.

And it seems clear that the desire to have these "conveniences" has also spurred on many women to augment family income. In the early months of the current year, 33 per cent of the female population 14 years of age and older were employed, compared with 24 per cent in 1940.

The automobile, of course, tends to dominate the consumer durables sector. Growth of consumer outlays for private vehicles has far surpassed the rise in spending for public transportation (see chart). Distances have melted with the continued rise in popularity of the auto, stimulating and abetting the move to the suburbs. Shopping centers catering to homemakers who drive continue to spring up. Drive-in banks, eating places and theaters have become commonplace. Today there are over 56 million passenger cars registered in the U. S. Three-fourths of the nation's families own at least one auto.

Despite the greatly increased use of a wide variety of durables, the significance of "apparent" market saturation ratios is difficult to interpret. A growing population, high and generally rising levels of disposable income and technological changes all serve to bolster consumption expenditures, even where individual appliances are found in nearly all households. In autos and television, for example, the second car or TV set has been rising in popularity. Radios too, though in more than 90 per cent of all wired homes through most of the postwar period, have turned in steady gains in the past few years.

As in the past, new products can be expected to figure importantly in the consumer durables future. A variety of innovations such as picture-frame TV and solar batteries even now are on the horizon. But as long as durables remain durable, their purchase can be postponed when the income outlook is uncertain or when there is an inclination to make the old model do for a while. Consumer spending for these products, in consequence, will probably continue to exhibit sharp short-term variations as well as vigorous growth over the longer pull.

Financing small business—a review

Last spring the Federal Reserve System released the first two-thirds of a broad study of the financial problems of small business. Addressed to four Congressional committees having a special interest in these matters, the published report is available to the public.[1]

[1] *Financing Small Business,* Report to Committees on Banking and Currency and Select Committees on Small Business, U. S. Congress, prepared by the Federal Reserve System, April 11, 1958. Government Printing Office, $1.50.

Too often, energy expended on the small business question has, as the phrase goes, "produced more heat than light." The new work, *Financing Small Business,* therefore, attempts in the course of 549 pages to illuminate a subject which, unfortunately, is extremely difficult to delineate in a clear-cut, unequivocal fashion.

The published volume condenses the findings of two parts of a study begun by the Federal Reserve System about a year ago.

A third part is tentatively scheduled for publication in 1959.

Part I consists of 16 "Background Studies" by associates of private research organizations as well as members of the research staffs of the Board of Governors of the Federal Reserve System and the 12 Reserve Banks. These articles contain much original thinking but are based largely upon previously published data and materials.

Part II contains the results of the special "Surveys of Credit and Capital Sources" which were undertaken and analyzed by the Federal Reserve economists. New data were developed for all major classes of lenders, and much valuable information was obtained on lending practices and the judgments of experienced lenders and investors.

Part III of the study, still in the exploratory stage, will present results of a survey of the "borrowers" who obtain funds or goods on credit from the "lenders" discussed in Part II. The Bureau of the Census is cooperating in the careful preliminary soundings which are necessary if this difficult project is to achieve its fullest utility.

Even without Part III, *Financing Small Business* stands as the only comprehensive work on small business to appear in the last decade. It represents, moreover, the broadest cooperative attack on the problem ever published.

Why study small business?

It is widely accepted as axiomatic that a private enterprise economic system must be constantly invigorated by the creation and growth of new firms. The small business financial "problem," therefore, can be stated as follows: Are credit and capital sufficiently available to permit new entrants and smaller existing firms to make their maximum contribution to economic progress?

The question of the adequacy of the financial resources available to small business is not new nor is it confined to the United States.[2] The controversy of the postwar period continues the argument of the 1920's and 1930's. The recent resurgence of interest, of course, is related to the "tight money" period of 1955-57 when the nation was faced with a situation in which aggregate demand outran supply. During these years, public policy-makers relied primarily upon restriction of credit expansion to retard the rise in prices. It has been suggested that the stricter rationing of credit required under these circumstances impinged more severely upon small businesses than upon their larger competitors.

The primary interest of Congress in requesting the study is in the consideration of legislation to "fill gaps" in the credit structure, if such are believed to exist. In the current session of Congress, a number of bills have been introduced providing for the chartering and financing of "capital banks" which would be part of an organized system for supplying small firms with long-term loans and equity capital. In late June, one of these bills had passed the Senate and had been approved by the House Banking and Currency Committee.

Definitional difficulties

How large is a small business? What is "adequate" access to funds? What is "equitable" treatment? What is a "legitimate need" for funds? Attempts of the contributors to the study to give these terms precise meaning met with only partial success.

Some of these concepts are so elusive that the discussions recall the Socratic dialogues which grapple with the meaning of "truth,"

[2] Same, p. 109.

"justice" and "virtue." But the first question, "What is small business?" must be answered in some fashion if facts and ideas are to be collected, tabulated and analyzed intelligently.

There are about 4.3 million business enterprises in the nation and most of them are small by any criteria. Size of business, of course, is a relative matter, depending upon the industry. A "large" tool and die shop is much smaller than a "small" steel firm. Electric utilities are by nature "large" in comparison with most retailers or establishments providing personal services.

Most studies of small business utilize the size breakdowns available in existing published data. As a result, the Part I background studies employ various size definitions, depending upon the particular statistical series used by the author.

After weighing the relevant factors, the Federal Reserve staff evolved size categories for the major industrial groups for the special studies of Part II.[3] In the case of retail trade, for example, organizations with less than 50 thousand dollars of assets are designated "small," while those with over 1 million of assets are "large." For miscellaneous manufacturing, the comparable limits are 250 thousand dollars and 25 million; for sales finance companies they are 5 million dollars and 100 million. In most industries, the "small" group includes at least 90 per cent of the business population.

Small business in the postwar period

Much recent discussion of the small business situation implies that hardly anybody starts a small business any more or that those who do are soon snuffed out. This approach, of course, badly distorts the true picture. There is ample evidence that the postwar period was a particularly favorable time for the formation and growth of new firms.

In 1957 there were 400,000 or 10 per cent more businesses than in 1948, when in turn there were many more than prewar. Average net growth, therefore, was 50,000 per year. The gross number of new entrants was as large as 380,000 in a single year. Withdrawals also ran over 300,000. Virtually all of these new firms were very small at their inception.

There was one business firm for every 40 inhabitants in the U. S. in 1957. This was almost exactly the same ratio as in 1929. The proportion was much lower at the end of World War II, but the upsurge in net business formations was rapid in the years that followed, suggesting a suitable environment.

Millions of new firms were created since World War II and a substantial proportion has survived. Some have been very successful. Although comparisons present many pitfalls, the best test of success of business enterprise of any size or age is profitability. Available data suggest that the earnings of small corporations on net worth compare favorably with those reported by larger enterprises.[4] Moreover, owner-managers of the smaller corporations are able to vary the amounts paid in executive compensation, more or less at will, and thus influence reported corporate earnings.

As might be expected in a profit and loss system, many small firms do not "make the grade." Last September, the failure rate, as tabulated by Dun and Bradstreet, was almost 60 per 10,000 firms annually. This was a postwar peak, but it compares favorably with a rate of 70 in 1939 and 99 in the 1920-29

[3] Same, p. 161.

[4] Same, p. 126.

decade.[5] "Discontinuances," the number of firms winding up operations, run about 30 times the number of "failures" which result in loss to creditors. The great bulk of both failures and discontinuances involve firms which are both small and new.

All in all, one writer observes, "The data suggest that incomes of small businessmen have risen fairly steadily during recent years and probably at a faster rate than that of the whole population."[6] Moreover, these businessmen were sufficiently well-financed that they had less than one-half of their assets invested in their businesses, and their personal and mortgage debt was relatively lower than the rest of the population.

Small inherent disadvantages

Virtually all lenders and students of small business report that the principal problem is not financial but managerial.[7] A small firm usually lacks executive depth. It may be utterly dependent upon the abilities of one man who may die or retire, leaving the enterprise without a competent helmsman. One man may supervise production, sales, finance and purchasing. Perhaps he is qualified to do only one of these jobs adequately. In any case, his time and energy are not inexhaustible.

Small firms usually lack diversification and cannot balance out adverse developments or mistakes as easily as large firms. They may sell to only a few customers or in a restricted region. A small manufacturer may be a subcontractor who supplies an integrated producer only with the portion of its total supply of a component that it cannot handle in a period of strong sales. A reduction in final sales may mean that the subcontractor is not needed at all. Needless to say, a limited market may result in very large and sharp fluctuations in sales and profits which the capital cushion may be too scant to absorb. In short, the small firm more often is vulnerable to dips in the economy or shifts in demand.

Other disadvantages of the small firm relate to costs. It may have to ship in less-than-carload lots with freight charges up to 50 per cent higher than the bulk rates paid by larger competitors. It may be unable to buy goods in large enough quantities to get maximum discounts. Often it is not able to spread such costs as advertising and research over a large enough volume of business.

Borrowed money costs small firms more. They are usually less "credit worthy" than large firms by the usual standards. Also, the administrative costs involved in granting and policing loans are proportionately higher on smaller loans. As a result, borrowing costs usually are considerably higher than those borne by large firms.

Against this formidable array of "economies of scale" possessed by the large competitor, the small firm can oppose flexibility of decision making. It can react more rapidly to unexpected developments and is not usually burdened with large overhead expense. That these advantages are sufficient in millions of cases is indicated by the large number of small firms which have been born and which have prospered in the postwar period.

Competing for funds

Broadly speaking, the sources of funds tapped by small firms are similar to those utilized by large firms. These sources can be grouped under the two general headings—equity and debt.

In virtually all cases some ownership capital must be provided before a firm can begin operations. Additional amounts can be

[5] Same, p. 132.
[6] Same, p. 127.
[7] Same, p. 322.

added by the original owners or by others who find the opportunity attractive. One of the characteristics of small firms is that they cannot sell securities to the general public through investment bankers except at prohibitive cost. But, once a firm is established, the bulk of equity capital invested in most businesses, large or small, comes through the route of retained earnings. Thus, profitability permits an increase in equity, and a larger equity cushion provides additional borrowing power—"nothing succeeds like success."

Borrowing can be long-term—over one year—or short-term. In whatever form funds are borrowed, loans to small firms are more likely to be secured than is the case with those granted to large business. This is understandable because the longevity and future success of a small firm are less assured. The longer the maturity of the loan and the larger it is relative to equity and debt previously acquired, the greater the likelihood that security will be necessary.

The reason that discussions of small business financial problems often center around equity is that there is no way to "secure" ownership investment. The equity investor shares in the profit or loss which results from operations after all expenses are paid. Moreover, most small businessmen do not wish to share profits or control with outsiders.[8]

Despite the special place of equity capital, there is a similarity between ownership investment and long-term debt. Usually it is difficult and sometimes it is impossible to liquidate either of these types of investment in a small firm. Once the commitment is made, short-term credit may continually be renewed and, in a sense, represents a semipermanent addition to a firm's resources. But the short-term creditor is able to review the loan at each maturity and determine whether it would be desirable to withdraw further support. Funds made available on a short-term basis are not so likely to become "frozen" as are longer-term commitments. Hence, relatively little complaint has been heard over the years about the availability of short-term loans.

The crux of the small business problem is found in the fact that many firms would like to borrow money on a long-term basis and avoid continuous negotiations with lenders if loans could be be had unsecured and at relatively modest rates of interest. Lenders, for obvious reasons, are reluctant to make such loans without a bevy of restrictive covenants which break down the differentiation between long- and short-term credits by accelerating maturity dates on the occurrence of a variety of contingencies.

Equity for the growing enterprise

Discussions of the small business problem, therefore, tend to concentrate on the more romantic manufacturing sector, which accounts for only 8 per cent of the small business population. Of this group, only a small fraction are growing rapidly or exploiting new or improved products. It is this dynamic type of enterprise which is supposed to face a dearth of "venture" or equity capital.

But large quantities of equity money are regularly being invested in small firms and particularly in those which offer the prospect of rapid growth. In the 1946-56 period, it has been calculated, the net increase in the number of firms involved an initial investment of at least 6 billion dollars in equity form. This sum is approximately equal to all the external equity funds obtained by established corporations in comparable industries.[9] Of course, only a small proportion of this total involved sales of stock through

[8] Same, p. 13.

investment bankers. Rather, equity investment was provided directly by the owners themselves, their friends and relatives and by "angels" suggested by bankers or others.

There are large quantities of funds in liquid form available for investment in business firms at any time. Over 2 million spending units have $10,000 or more in liquid assets. The average new firm involves an equity investment of only about $12,000, and personal contacts often can supply this necessary nucleus.

Much has been written about the way the tax system discourages risk-taking. But investment in small business often permits the investor to take his profits as capital gains taxed at only 25 per cent, thereby avoiding the higher rates of the personal income tax.

Term loans and mortgages

It is readily apparent why lenders are reluctant to grant loans maturing several years hence to firms which have been in existence only a few years. Even an established firm which is expanding rapidly or otherwise changing in character may have difficulty in arranging long-term credits because past performance is not always a reliable guide to future ability to cover interest and amortization payments.

Nevertheless, between 1948 and 1957—or broadly through the postwar period—loans over one year to maturity owed by small manufacturing corporations increased by over 250 per cent—more rapidly than for all other manufacturers. Such credits increased from 9 to 18 per cent of equity, compared with a gain of 14 to 18 per cent for all manufacturing enterprises.[10]

Of course, much of longer-term credit owed by small business consists of real estate mortgages or debts owed on equipment purchased in time-sales contracts. Insurance companies and banks are the principal suppliers of real estate mortgage funds. In recent years, time-sales financing has become extremely competitive, with independent and manufacturer-owned finance companies and banks actively seeking these loans.

Credit from suppliers

One of the most important sources of funds used by small firms is trade credit, a fact not widely appreciated. For the most part, these credits are offered by suppliers through open book accounts. But in some cases suppliers also provide cash loans or the loan of facilities. There are also examples of "downstream" loans from large customers who wish to assure their sources of supply.[11]

Indirectly, trade credit gives small firms access to the national capital and money markets through their larger associates. In a real sense, the most important "bankers" supplying working capital to small firms, particularly retailers and wholesalers, are the manufacturers who supply them with goods. This was especially important in the "tight money" period 1955-57. Trade credit analysis suggests the extent to which small and large firms complement rather than supplement one another.

Trade creditors have many advantages over banks or other financial institutions. Often they know the product, the practices of the trade and, perhaps, the borrower better than the loaning officer. Moreover, they have at risk only the time and materials directly invested in the goods which may be considerably less than the full sales price. If necessary, they can liquidate the goods

[9] Same, p. 144.
[10] Same, p. 140.
[11] Same, p. 482.

with minimum loss. The disadvantage of trade credit to the customer is that it often involves heavy cost on a per annum basis if cash discounts are not realized.

All firms utilize trade credit more or less. But in the 1946-55 period, only 4 per cent of the funds obtained by 300 large corporations was represented by an increase in payables, whereas, for all other corporations, the proportion was 13 per cent. For "small" firms, the proportion of total financing obtained in this manner was much higher.

Large firms also ease the financial problems of customers by leasing equipment, by carrying inventory at widely dispersed warehouses for ready delivery and through providing financial advice. Sometimes, too, they will endorse notes or help the customer to establish a banking connection.

Commercial banks surveyed

Frequently the small business firm can turn to such specialized lending institutions as commercial finance companies, the U. S. Small Business Administration, various state development corporations and "venture capital" companies. All of these organizations operate directly in the area of "marginal credits."

As a group, the commercial banks are the most generalized of all lending institutions, although, individually, they often specialize in certain of the types of loans mentioned earlier. In late 1957, there were close to 2 million business loans outstanding to almost as many individual borrowers.

A broad sample of member banks was contacted last fall to permit the tabulation of loan asset data which could be compared with the results of a 1955 survey.[12] During the intervening period the largest borrowers obtained a large share of the growth in total loans.

Business loans in the aggregate grew by 32 per cent between 1955 and 1957. For borrowers with assets of 25 million dollars or more, the rise was 61 per cent; for firms under this group, it was only 21 per cent.

There are a number of reasons which can be put forth for the more rapid growth in loans to the large firms. One factor was purely statistical. During a period of rapid growth and price inflation, business firms tend to "graduate" from one category to another. The top group, of course, has no ceiling. Just to hold their position in a given industry, it was necessary for some firms to grow by 20 per cent or more between 1955 and 1957.

Another important consideration is that the most pronounced contrast in bank loan growth between large and small firms in the period under review was in manufacturing. The tendency was much less evident in nonmanufacturing lines.

The central feature of the 1955-57 business upsurge was the boom in capital expenditures. The bulk of these outlays was in industries characterized by large-scale operations. The "tight money" period also witnessed rapid growth in working capital needs of most business firms. Inventories and receivables of large firms expanded twice as fast as those of small firms. In many cases, they assumed, perhaps for competitive reasons, a portion of the working capital burden of their customers.

Because of this great increase in need for funds, large firms ran down their extensive holdings of liquid assets to low levels. They also obtained record sums through the issuance of securities. Firms which were not able or did not choose to obtain all of the money they wanted internally or through the capital markets turned to the commercial

[12] Same, p. 371.

banks. Most of them possessed top-notch credit ratings, and many had unused lines of credit at large banks. Often they were actually free of debt before the squeeze on their cash position occurred. The expansion in bank credit to large business during the boom was built upon a small base relative to total resources of these firms.

In the first half of 1958, with investment needs off sharply and easier money conditions prevailing, large firms, particularly utilities, are taking the opportunity to sell a heavy volume of bonds and are reducing bank debt as they move to restore their deteriorated liquidity positions. In fact, it is probable that a greater than proportional share of the reduction in bank loans since last fall is accounted for by large firms.

Doubtless, many small firms were unable to pass the more stringent standards of creditworthiness during the 1955-57 period. But there is evidence that their demand for funds was less avid than that of the large firms.

Lending limits, usually 10 per cent of capital and surplus, require small banks to deal exclusively with small business. During the 1955-57 period, the business loans of banks with less than 10 million dollars in deposits expanded by only 12 per cent, while at banks with deposits of 1 billion dollars or more, these loans rose by 42 per cent. Very large banks, of course, are typically the bankers for the giant firms. In order to satisfy the credit demands placed upon them, large banks were forced to liquidate holdings of securities and borrow from the Federal Reserve Banks in order to accommodate their customers.

Solving the "problem"

The Federal Reserve study remains incomplete. Tentative conclusions drawn from these materials will be tempered by the results of the "borrowers survey" and other information which will become available with the passage of time. Nevertheless, much material has been provided for guidance of policy-makers and students of business finance.

Thus far the study has been most useful in illuminating the variety of sources of direct or indirect financing for small business. It covers the financial institution environment in which small business operates: the scope of lending to small business by types of financial institutions, the credit instruments specifically tailored to the needs and limitations of small business, the complementary role of the large business suppliers in extending trade credit or its equivalent. Too often, such background understanding is ignored and there is a tendency to approach the small business problem with one of two simple preconceptions; either that it does not have adequate access to financing or that it does. To these could be added the logical possibility, evidenced, perhaps, by an excessive rate of small business mortality, that not just enough but too much financing may be available. Testing these, and other more complicated but more realistic possibilities, is the process by which the solution to the small business financing problem will eventually be found.

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