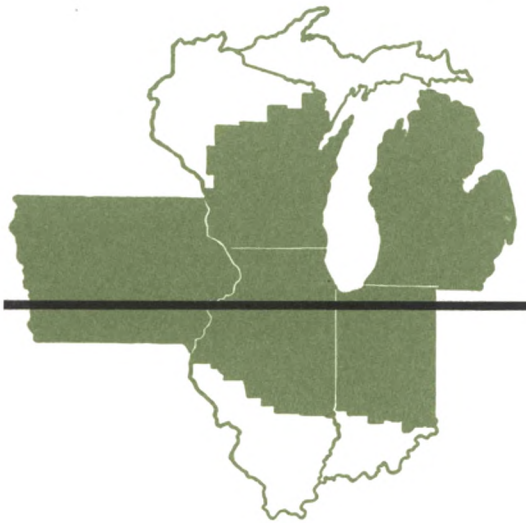
A review by the **Federal Reserve Bank of Chicago**

Business Conditions



1959 October

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THE Trend OF BUSINESS

The nation's economic pulse slowed perceptibly in the third quarter as important work stoppages took their toll of current output. The index of industrial production moved down from its June record high of 155 (1947-49=100) to 153 in July and 149 in August. A further decline was indicated for September.

Steel was the most important industry shut down by strike, but most domestic copper producers also were idle, and, in addition, a number of firms in the meat packing and glass industries were down for varying periods. There were only a few reports of secondary layoffs resulting from shortages of steel up to mid-September. Thereafter, such reports appeared with increasing frequency. Industrial and farm machinery and a variety of other lines have been affected.

Between mid-June and mid-August, wage and salary employment, seasonally adjusted, dropped by 350,000, or 1 per cent. This decline in total employment was less than the drop in steel and the closely allied activities in mining and transportation. Therefore, strike-induced declines in employment were partly offset by continued expansion in the nonindustrial sector; employment in trade, services and state and local government rose to new highs.

Slower expansion?

It was not difficult to spot some signs of slackening growth of output prior to the beginning of the steel strike in mid-July. Three of the sectors which had contributed heavily to the general upswing from the low point in the spring of 1958—construction, Government spending and additions to inventory—appeared to have been making a maximum contribution, temporarily at least, in the second quarter of this year. However, the evidence of a slowing rate of rise has been suppressed by subsequent events. As a result of work stoppages, industrial output declined in the third quarter. While it will take some time for a new pattern to emerge, one immediate consequence of the termination of the strike is likely to be a resurgence of activity in the industries most affected by materials shortages.

Furthermore, a slowing in the rate of growth need not presage an early general letdown in activity. Evidence is accumulating that expenditures on plant and equipment are rising and that the movement may continue for some time. A Government survey released in September indicates that capital spending by business firms will be 9 per cent larger in 1959 than in 1958. At the turn of the year, it was widely anticipated that no appreciable rise in these expenditures would occur.

The percentage increase indicated for manufacturing, both durable and nondurable, is about the same as for the total. The railroads and other transportation lines plan increases of more than one-third. Only the public utilities report that outlays will be smaller in 1959 than in 1958. Other surveys

of business decisions on new projects suggest that the rise in capital spending, which is currently 7 per cent below the 1957 level, will continue in 1960.

Record corn crop

Crops matured rapidly in August and September under relatively favorable weather conditions in most regions. Estimates of yield per acre were increased, with the result that total production of crops is now believed to about equal last year's spectacular output. With livestock production trending upward, over-all output of agricultural commodities is at a record level and the large supply is expected to exert downward pressure on prices.

Production of corn, the major crop grown in the Midwest, was estimated early in September to total 4.4 billion bushels. This would be a record high, 15 per cent above the preceding year and 35 per cent above the average of the ten years—1949-58. Since corn is utilized primarily as a feed for livestock, the large supply will tend to sustain the current expansion in production of cattle and hogs unless very large amounts are moved into Government stocks.

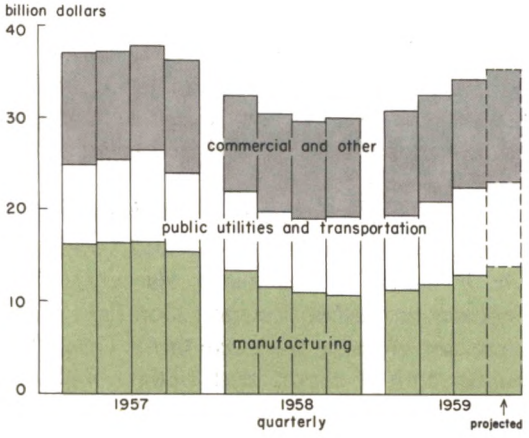
As of mid-September, the top price of hogs at Chicago was $14.00 per hundred pounds, reflecting the decline of one-third from the $21.00 figure a year earlier. A further increase in supply would likely result in still lower prices. Prices of cattle, on the other hand, continued to exceed the year-earlier level. Thus far, the increase in production of cattle has shown up largely as an increase in number on farms and ranches.

Farmers' receipts from marketings of crops and livestock in the first eight months of 1959 totaled about 19 billion dollars, 2 per cent below receipts in the corresponding period last year. Farm production costs have been somewhat higher, also contributing to a decline in net farm income.

In the first three quarters of this year, net farm income was at an annual rate of 11.5 billion dollars, more than 20 per cent below the relatively high level in the corresponding months in 1958. A larger than seasonal rise in marketings in the fourth quarter, reflecting the large crops of corn and cotton, may boost net farm income for the entire year somewhat closer to the 1958 level.

Farmers' capital expenditures have been at a substantially higher level in the current year. These expenditures typically lag somewhat the changes in farm income; hence, the rise reflects in part the sharp increase in farm income in 1958 while the nonfarm economy was experiencing recession. The increase in machinery purchases reflects also the larger acreages of important crops, particularly cotton and corn. If farm income should decline further in 1960, farmers' capital outlays probably would decline, in contrast with a probable rise for most other kinds of business.

Plant and equipment expenditures rise still short of 1957 peak



Banks loaned up?

With the current business upswing only 18 months old and bank loans already substantially above 1957 peaks, the question arises as to how much more loan demand the banks will be able to accommodate. When are banks loaned up? Aside from certain legal limitations on the volume of particular kinds of loans in relation to capital funds, there is no automatic warning device to signal a disproportionate loan position. Nevertheless, most bankers have some notion as to what proportion of their resources they feel comfortable about keeping in loans, as against investing in securities. When monetary policy is restraining growth in the total volume of bank credit, new loans exert intensified pressure on this relationship which banks seek to protect by careful screening of loan applications and higher interest charges.

At midyear, aggregate loans on the books of the nation's 14,000 commercial banks constituted 56 per cent of their total earning assets. Although this is by no means an all-time high (it exceeded 70 per cent in 1929), it is equal to the point reached at the peak of the 1955-57 boom. Judging by experience of the past 30 years, some observers have concluded that the banks are rapidly approaching a loaned-up status.

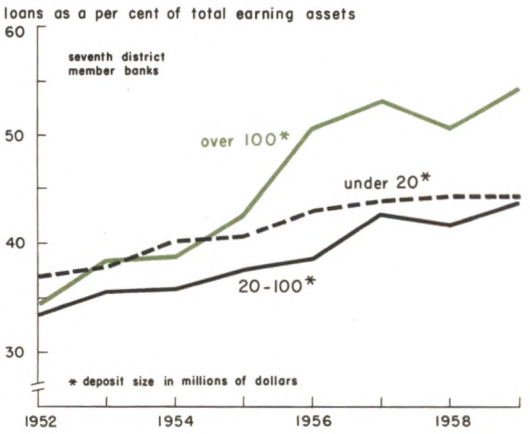
This over-all ratio actually reveals very little about the severity of current pressures. Individual bank ratios vary greatly. And some banks seem to get a "loaned-up feeling" at much lower ratios of loans to total earning assets than do others. This is doubtless due in part to the liquidity of investments or the amount of commercial paper and insured or non-risk items in individual loan portfolios, but it also reflects basic differences in management attitudes and policies. Of course, there is always slack at some banks as evidenced by extremely low loan ratios.

Less room at the top

The accompanying chart shows an upward trend in the average proportion of loans to earning assets for the three major-size groups of Midwest member banks. To some extent, this reflects changes which have tended to reduce the risk element such as the growth of insured or participation loans.

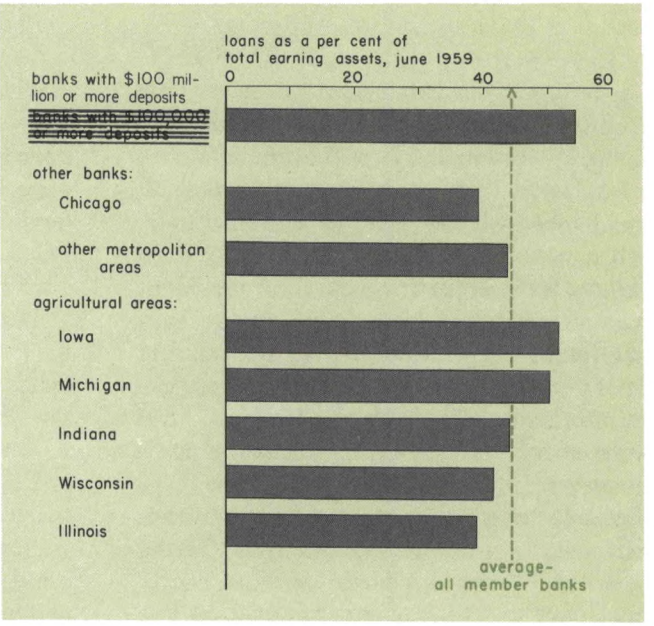
As might be expected, the largest banks—those with deposits of 100 million dollars or more—exhibit the most dynamic changes over time. Loans of all kinds comprised 55 per cent of the portfolio of the average bank

The largest banks have shown the greatest increase in loans in recent years



in this largest-size group in mid-1959—more than half again as important as they were seven years earlier. On the other hand, the average ratio of loans to earning assets in the small banks—those with less than 20 million dollars of deposits—increased much less, though more steadily. The moderately large-size group (20 to 100 million dollars deposits) shows the lowest loan ratio throughout the period. While small banks continued to increase loan positions through last year's recession, the larger banks showed a marked cyclical response, but, by midyear, they had already bounced back above their mid-1957 ratios. Average ratios for both medium and small groups, however, were still under 45 per cent.

Loan positions vary among District banks



What, if anything, do these trends imply as to the "loaned-up" position of Midwest banks? At the very least, they suggest that there is no absolute "ceiling" on the proportion of its resources the banking community as a whole is willing to channel into the accommodation of insistent loan demands—albeit at higher interest rates.

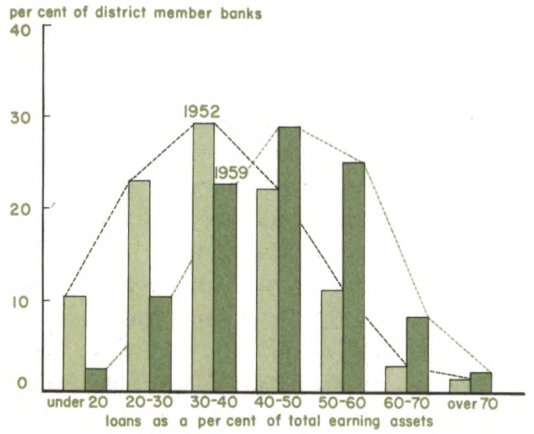
There are, of course, wide variations in loan positions among the medium-size and smaller banks which are related to a combination of size and location factors. Basically, these differences result from the predominate credit needs and competitive relationships within communities of varying economic structure. In general, it appears that in urban centers the largest banks tend to have the most loans in proportion to their total portfolios. As is indicated by the chart, when the very large banks are excluded, loan ratios of Chicago banks are much lower than those of banks of comparable size in other metropolitan areas.

In agricultural areas, on the other hand, the proportion of loans to total earning assets appears to be completely unrelated to size of bank. There are, however, marked differences among banks in predominantly agricultural areas in the five District states. Average ratios for both Michigan and Iowa banks are substantially higher than for the other three states. In fact, they are higher than those of city banks, except those in the very largest-size group. Michigan banks have a high proportion of real estate loans, and, in some cases, are close to their legal limits on credits of this type. In Iowa, on the other hand, farm loans dominate rural bank portfolios. Probably the most important factor contributing to relatively high loan ratios at

Iowa banks is the credit demand associated with the financing of a growing volume of feeder cattle at rising prices in recent years.

While the averages of loan ratios represent the levels characteristic of most of the banks in each group, the range of individual ratios is extremely wide. The proportion of banks with over half of their resources in loans has more than doubled since 1952 and this group now includes more than a third of all District member banks. Half of the banks with deposits over 100 million dollars have loans totaling between 50 and 60 per cent of earning assets, and a quarter of them have pushed into the 60-70 per cent range. Ratios at medium and smaller banks vary much more widely, ranging between extremes of 8 and 92 per cent. Sixty per cent of rural Michigan banks are at levels over 50 per cent. Iowa has the largest proportion of banks in the over-60 per cent range. Illinois has the largest proportion of banks with very low ratios. Twenty-five per cent of the rural banks in Illinois report loans at less than 30 per cent of earning assets.

A much larger proportion of banks has high loan ratios than in 1952



To some extent, these differences reflect the diverse nature of the banking business in various parts of the Midwest. Most of the large banks in big cities have relatively large business loan portfolios. Lending by banks in smaller urban areas, on the other hand, is concentrated largely in real estate and consumer loans. While these types of credit have also risen, the smaller banks have enjoyed a commensurate growth in deposits, enabling them to meet loan demands without greatly changing the loan and investment balance of their assets.

Other things considered

In the final analysis, the loan ratio is only one factor by which a bank's ability and willingness to provide additional loan accommodation can be judged. The data reviewed here reveal that loans in the range of 50 to 60 per cent of earning assets are becoming more or less standard and that ratios upwards of 60 per cent are no longer uncommon. But the number of banks with relatively small amounts of loans would appear to indicate a good deal of room for further loan expansion, particularly among medium-size and smaller banks. This, of course, is less true in the rural areas of Michigan and Iowa than elsewhere in the District.

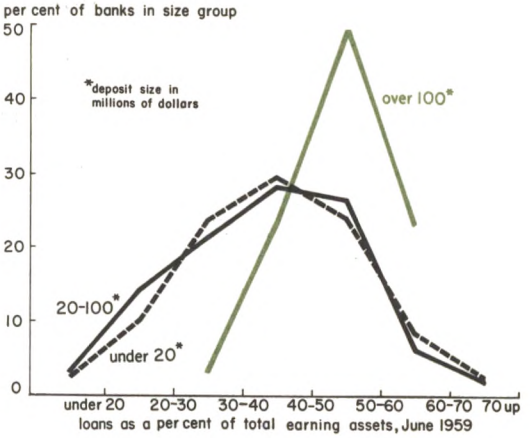
All things considered, however, the potential for loan expansion may be less real than apparent. Each bank's management has its own standards to go by, and banks with relatively low loan portfolios are likely to prefer them that way. Furthermore, the composition of the existing loan portfolio is important. Consideration of a new loan may depend on whether it fits into the banks' objectives with respect to portfolio diversification. As implied earlier, the volume of "insured" loans may account for some of the variation in loan ratios among banks.

Liquidity, of course, is a major factor. In a period of bond market weakness—a condition quite typical of business booms—a bank's management may decide to place funds from new deposits or maturing securities in loans but be unwilling to sell securities at losses in order to accommodate additional loan demands. Available data indicate that banks hold relatively small amounts of short-term liquid assets, particularly the smaller banks. From the standpoint of both liquidity and current loan to asset levels, it appears that the medium-size banks in urban areas have the greatest potential for increasing loans.

However, the positions of the largest banks in the major cities are perhaps less restrictive than their high loan-to-asset ratios would imply. These banks have highly flexible asset structures and may have a greater capacity and willingness to absorb security losses than their smaller cousins. Moreover, while rates charged by small banks tend to be inflexible, particularly at the upper fringes, large banks with their many "prime" business borrowers are in a better position to adjust rates in step with publicized changes in the "prime" loan rate.

One further consideration is that the loan positions of large city banks, as measured by the loan to earning asset ratio, may be exaggerated because of the inclusion in their loan totals of reserve-adjustment-type items. The recent widespread practice of disposing of temporarily excess funds through overnight loans to other banks or to Government securities dealers has tended to increase the loan component of city bank assets and also has contributed to its cyclical variability.

The greatest loan pressures are at the largest banks



Matching banks and borrowers

Even if pockets of unused capacity for loan expansion exist in some areas, they tend to be relatively small in total and do not necessarily have significance from the standpoint of relieving loan pressures over the economy as a whole. Loan demands associated with high and rising economic activity are concentrated largely at those banks particularly qualified to provide this type of loan. Small banks cannot accommodate large borrowers, and their loans to small borrowers are limited largely to local firms and individuals. Any additional funds normally move into investments and these may orig-

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inate within or outside the local area. Thus, to the extent additional credit demands reflect the needs of large businesses, the position of large banks is highly important even though available funds in smaller banks may be adequate to meet the legitimate needs of small businesses, consumers and home owners.

Autos in '60

In late summer, the automobile industry reported plans to assemble 1.9 million passenger cars in the fourth quarter of 1959. This total would exceed the similar period of last year by almost 40 per cent and would closely approximate the record fourth quarter of 1955. But these schedules were set when it was anticipated that the steel strike probably would not exceed two months' duration. Continuance of the strike beyond mid-September has required a downward revision of fourth-quarter projections.

Typically, auto firms make generous provision for supplies of parts and raw materials. Production foregone when buyer interest is at a high pitch is far more costly in terms of lost profits than the expense of carrying additional inventory. Nevertheless, there is a limit to the amount of additional inventory which can be provided as a precautionary measure.

The auto industry usually takes about 20 per cent of the steel industry's output. Although other materials can be substituted for fringe amounts of the ton and one-half of steel in the average car, steel remains as the basic structural material. Moreover, although some switching and conversion is possible, steel on hand must be in the right mix. Hot rolled strip cannot be substituted for cold rolled sheet, and plates cannot be replaced by bars. Without steel, auto assembly lines must eventually grind to a halt.

Although the steel strike has required downward adjustments in auto production schedules late in the current year, car producers are confident that 1960 will be the biggest year since 1955, which was by far the largest in history. In that year, 7.2 million new passenger cars were registered, including 60,000 imports. The next highest year was 1950 with 6.3 million. Optimists hope for retail sales of about 7 million cars next year. If they are right, dollar volume of new cars sold would be at a record level by a good margin despite the probable increase in proportion of lower-priced models. Manufacturers' prices have advanced about 15 per cent since 1955.

Predicting auto demand

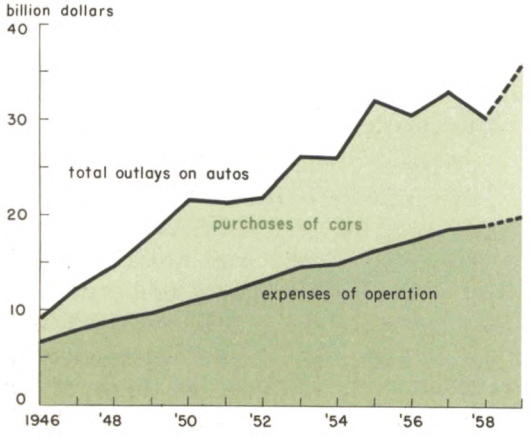
"Experts," both in- and outside the automobile industry, have devoted much time and effort over the years to attempts to predict the number of new cars which the public will buy in the year ahead. Elaborate statistical techniques have been employed to relate such factors as consumer income, the number of households, the price of cars relative to other things, the number and age

of cars in use, the scrappage rate and the availability of credit to the demand for new cars. But the record indicates only modest success has been achieved in forecasting auto sales accurately.

For a given year, individual forecasts often have covered a considerable range. But in two recent years, 1955 and 1958, the actual numbers of cars produced and sold fell outside of the *range* of published forecasts. In 1955, actual sales exceeded the most *optimistic* advance estimates by hundreds of thousands, and, for 1958, the most *pessimistic* projections were hundreds of thousands too high.

Erratic experience such as this must put the observer on guard against the possibility that individual forecasts or even an average of several forecasts can be far off the actual result. It is not even possible to state with certainty that a rise in total consumer spending will be accompanied by some rise in spending for new autos as well. In both 1956 and 1958, spending for new autos declined while total personal consumption expenditures increased. Moreover, individual firms within the industry can make only limited use of an industry forecast, however accurate. Market shares of particular makes have varied greatly from year to year.

Car-connected expenses show smooth rise as car buying fluctuates



The number one industry

Rankings of the nation's principal industries are often arbitrary because of the difficulty of categorizing various firms and lines of activity. Nevertheless, a characterization of the motor vehicle industry as "tops in manufacturing" is beyond dispute. In recent years, production of motor vehicles has accounted for about 5 per cent of all *manufacturing* employment and 1.5 per cent of *all wage and salary* employment (full-time equivalent basis). It has generated over 2 per cent of the national income and over 7 per cent of the national income originating in manufacturing. These data include trucks, which account for about 15 per cent of the activity in the industry.

An estimated 42 per cent of the auto industry employment, including producers of parts as well as complete vehicles, was accounted for by Michigan in June of this year. This compares with 57 per cent ten years ago. Despite the decline in its relative position, Michigan is still about three and one-half times as important as Ohio which ranks second. Indiana, the third ranking state, has about one-fifth as many auto workers as Michigan this year.

The 306,000 persons employed by the motor vehicle industry in Michigan in June was about one-third of all manufacturing employment in that state. This is not the whole story, however. Many workers in other lines such as primary metals, metal fabricating and machinery are engaged in supplying the auto industry with parts and materials. Altogether, perhaps half of Mich-

igan's manufacturing employment probably stems from the auto industry. In Detroit, Flint and certain other cities, the proportion is much higher. Kenosha and South Bend also have high proportions of employment in motor vehicles. Although this industry accounts directly for only about 2 per cent of economic activity nationally, it is of much greater importance to many Midwest communities in which it constitutes a large part of total employment.

In the past decade, the proportion of consumer expenditures directed to new cars and "net purchases of used cars" (mainly dealer profits derived from the handling of used cars) has ranged from 3.9 per cent in 1958 to 6.2 per cent in 1955. In the "typical" year, the figure has been close to 5 per cent. On this basis, 1959 probably will turn out to be fairly typical.

Fluctuations in expenditures on new cars have been substantial. In 1955, there was a 39 per cent rise from the previous year. In 1958, there was a 21 per cent decline. The current year doubtless will see a rise of approximately 35 to 40 per cent.

But total consumer expenditures on auto transportation have not been so volatile. The amount of money spent on replacement tires and parts, repairs, gas and oil, tolls and auto insurance in the aggregate has risen every year since World War II. In 1958, consumers spent 18.9 billion dollars on these car-connected outlays compared with 11.5 billion dollars on new cars and net purchases of used cars. In other words, car-connected expenditures were 70 per cent greater than purchases of the cars themselves. This ratio has tended to rise during the past decade.

The import boom

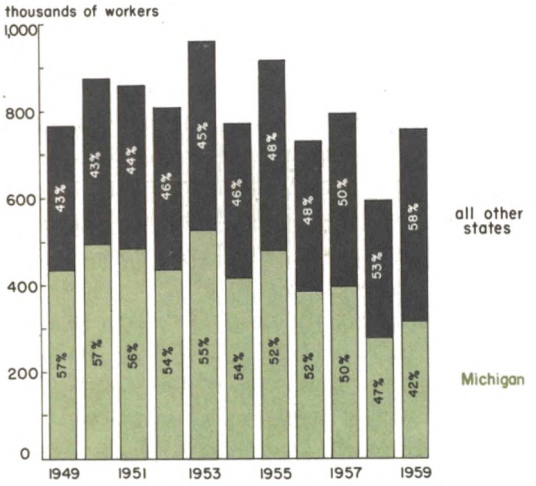
The public has discovered and gradually accepted the varied autos produced in Western Germany, England, France, Sweden, Italy, Czechoslovakia and, perhaps most interestingly, Japan. In 1955, less than 1 per cent of all new cars registered were imported. Last year, this proportion rose to 8 per cent, and, in the current year, it has been running at almost 10 per cent. In mid-1959, well over a million foreign cars were in use in the United States. This was only about 2 per cent of the total, but it was sufficient to make these vehicles common sights on the streets and highways in most areas. In some states, principally those on the coasts, the proportion of foreign cars is much higher.

Throughout the history of the auto industry, a driblet of foreign cars has entered the country. But until recent years, imports consisted almost entirely of "luxury" cars or sports models. The recent import invasion has consisted largely of cars favored for economy and maneuverability.

The rise in imports of foreign cars and the decline of exports of domestically purchased cars have been important factors in the "deterioration" of the United States foreign trade balance during the past few years. In the first half of 1955, 126,000 American cars were exported and 28,000 foreign cars were imported. In the same period of 1959, 60,000 were exported and about 300,000 were imported. Over this period, list prices of American cars have increased more than on foreign cars. But this is related to the fact that each year a more elaborate "package" has been offered here; whereas foreign producers have not altered their products substantially. It was only after 1955, when U.S. cars continued to grow in size, price and complexity, that the import boom took hold.

In part, the demand for the smaller, more economical car has been met by American Motors and Studebaker, whose major as-

Michigan's share of automotive employment continues to fall



sembly plants are located in Wisconsin and Indiana, respectively. In 1957, these producers accounted for only 3 per cent of total domestic output. However, in the first eight months of 1959, they accounted for 9 per cent of domestic production. This was the largest share provided by producers other than the "Big Three" since 1952, when a number of additional manufacturers were still in production. American Motors and Studebaker have sold almost as many compact cars thus far in 1959 as have been imported. It is apparent, therefore, that American producers can compete in the compact car market despite higher labor and material prices. Now the "Big Three" have entered the field, each with a domestically produced compact auto.

Many marketing experts are still convinced that the American public regards the automobile as its major "status symbol." They hold that the emphasis on an economical auto—for "transportation"—is a passing fancy or, at least, will not gain a permanent hold on a large sector of the car market. Those who believe in the pervasive and permanent nature of the demand for smaller cars point to the appeal of maneuverability under conditions of growing congestion on the highways and in parking areas, and the interest of many families in possessing two cars, one of which can be quite small. The economy aspect, they maintain, is also related to the stiffer competition for the consumers' dollar which has been created by other wants associated with the higher proportion of home ownership with its attendant expenditures, the growing cost of financing higher education and other factors.

In any case, trends in the automobile market are offering material for conversation unequaled in many years. The introduction of the first Chrysler in 1924, the Model A Ford in 1928, the V-8 engine in 1933 and the automatic transmission in 1939 provided focal points of interest. But the current development calls into question much of the accepted thought concerning the place of the motor car in the United States economy.

What about competition?

The rise in imports and the decline in exports of automobiles are particularly noteworthy because the auto industry has more than held its own with foreign competition during most of its history. In fact, automobiles best exemplified the potential of mass production as applied to even a complicated and expensive commodity. In the latter half of the decade of the 1920's, more than 9 per cent of United States' passenger car production was exported. In the late Thirties, exports averaged over 7 per cent, a proportion which was reachieved in the

early postwar years. Since 1953, however, exports have accounted for only 3 per cent of production, and, in 1959, the proportion is running below 2 per cent. In part, this reduction has resulted from import restrictions imposed by various foreign governments in an attempt to conserve dollar exchange and encourage their own auto industries. But that is not the whole story.

Exports of trucks in recent years have been maintained at close to 20 per cent of domestic production. This is less than the 30 per cent of the late 1920's, but it is apparent that our trucks have maintained their popularity abroad more successfully than have our passenger cars.

It is conceivable that the compact cars might help revive export markets for American cars. These autos are larger and more powerful than the typical "foreign" cars; hence could fill a gap between the foreign makes and the conventional American models.

Reasons for optimism

The current year has been a good one from the standpoint of auto sales, but the consensus in the industry is that 1960 will be even better. As suggested above, specific forecasts have not been highly accurate in years past but this does not dampen the current optimistic expectations.

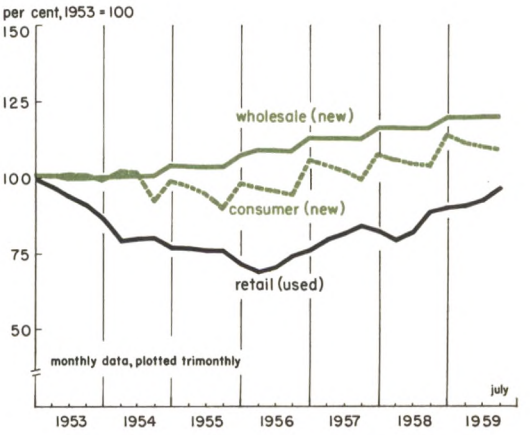
The main reason given for optimism concerning prospective car sales is simply that income and over-all activity were rising prior to the steel strike and that growth is expected to resume once steel is flowing again. Furthermore, many people are convinced that the wide choice of cars available to the public, including the compact cars of the "Big Three," will attract buyers.

In addition, the total volume of sales in the past *two* years is interpreted by many analysts as indicating that the public will increase purchases in 1960. While the 1959 recovery from 1958 has been almost as great as the 1955 rise from 1954, car sales in 1959 have not been unusually high.

In the earlier period—1954 and 1955—12.7 million cars were sold; in 1958 and 1959, sales apparently will total only about 11 million. As a result, there are fewer late model cars in use at the present time than was the case at the start of the 1956 season. The year 1956 was the second full year of recovery from a recession, but it witnessed a sharp decline in car sales. For a number of reasons, the 1955 level of car sales was clearly not sustainable. While a similar development could occur in 1960, industry spokesmen believe it is highly unlikely.

The initial price lists issued by U.S. producers indicate an attempt "to hold the line" on 1960 models, although it has been suggested that higher steel prices may require some upward adjustments later on. In 1959, manufacturers' prices had risen for the sixth straight year.

Used car prices have risen more rapidly than new cars since early 1958



Investment in 1958: a profile

Last year, American consumers, businesses and governments invested over 125 billion dollars in long-lived physical assets—housing, business and government structures, and durable goods and equipment. This was about 7 billion dollars less than in 1957, which was a record year for investment outlays. But even in a recession year marked by sizable declines in business plant and equipment outlays and consumer durable goods spending, close to 30 per cent of the nation's output of goods and services was of items which will be used over a period of years. In dollar terms, 1958 investment outlays were exceeded only during the capital expenditure boom of 1956 and 1957.

The 1957-58 recession was an inventory and investment recession. Last year, investment and inventory spending was nearly 13 billion dollars less than in 1957, but outlays for currently consumed goods and services rose over 10 billion dollars. In the recovery phase, however, investment and inventory spending has led the way. In the first half of 1959, investment outlays of all types were at an annual rate of more than 11 per cent above the 1958 level, while other outlays were up only 7 per cent. Spending on public and private housing, plant and durable goods reached a new all-time peak in the first six months of this year.

Investors and consumers

Consumers are the most important class of investors in long-lived goods. Last year, expenditures for new housing and consumer durables (plus plant and equipment outlays by nonprofit organizations) amounted to over 45 per cent of total investment expenditures so defined. This was somewhat less than in 1957, as increased expenditures for new housing failed to offset the decline in purchases of consumer durables, especially automobiles. The peak year for consumers as investors was 1955, when new housing outlays set a record (which no doubt will be exceeded this year), and auto expenditures also set a record.

In 1956 and 1957, which were record years for business plant and equipment expenditures, *nonfarm businesses* accounted for about one-third of total investment spending in the economy. In 1958, however, business investment declined by nearly 15 per cent. Outlays for producers' durable goods bore the brunt of this decline. Farm investment expenditures, on the other hand, rose by about 10 per cent in 1958.

Federal, state and local *public agencies* spent around 30 billion dollars for new construction and durable goods last year. Public construction activity continued its uninterrupted postwar climb in 1958, exceeding the 15 billion dollar mark for the first time. Military items account for the great bulk of government hard goods purchases. Expenditures for military equipment at present are, of course, a good deal lower than in the peak year of the Korean War. Government equipment purchases for civilian programs are small in amount but have been rising rapidly.

Gross and net capital formation

The 125 billion dollars spent in 1958 for investment purposes is not a net addition to

the nation's stock of durable assets. Much the largest share of investment expenditures does no more than offset the continual process of aging of existing assets. The useful lives of many types of equipment are short indeed, and substantial sums must be invested each year merely to maintain a stock of equipment no more aged or obsolescent than it was a year earlier. Some types of industrial equipment, for example, become obsolete through model changes within one or two years. Much of the investment in military hard goods, particularly the most complex and expensive items, must be written off soon after it is made, as military technology changes. And consumer durables depreciate very rapidly in the first year or two of their lives. Last year, for instance, consumer durable goods outlays were nearly 37 billion dollars, but estimated net capital formation in the form of consumer durables was only about 2 billion dollars.

Because of high investment outlays in the recent past, business capital consumption allowances — including depreciation charges, capital outlays charged to current expenses and accidental damage to fixed business capital —continued to climb in 1958, despite the drop in gross investment spending. Thus, net capital formation by business was less than half as great as in 1957.

Figures on capital consumption allowances and net capital formation have to be interpreted with some caution. Ordinarily, the funds spent for new plant and equipment buy assets which are much improved over those purchased some years earlier. New plant or equipment which does no more than offset depreciation is apt to be a good deal more productive than the aging assets which are replaced. There is no real way to measure these quality differences which are especially marked in industrial equipment. However, taking productivity into account, net capital formation in 1958 undoubtedly amounted to considerably more than the one-fourth of gross investment indicated in the chart.

The funds for investment

All types of investors provide part of the funds they need to finance their investment outlays from the excess of their receipts over their spending for currently consumed goods and services and accumulation of inventory. For the remaining funds, investors resort to the capital and credit markets, where the

Data on capital formation

Many of the figures used in the article cannot be found in the U. S. National Income accounts, but have been estimated from a variety of sources in order to present a broad perspective on gross and net capital formation. The National Income accounts do not count as gross investment either consumer durable goods expenditures or public expenditures for construction and equipment. Moreover, the official estimates of capital consumption allowances are applicable only to private construction and producers' durable goods. Thus the data in this article for expenditures by governments on durable goods and for depreciation on government investment and consumer durables are rough estimates. The estimates for public outlays for equipment are based upon the concepts used by the Census Bureau in its reporting on governmental finances.

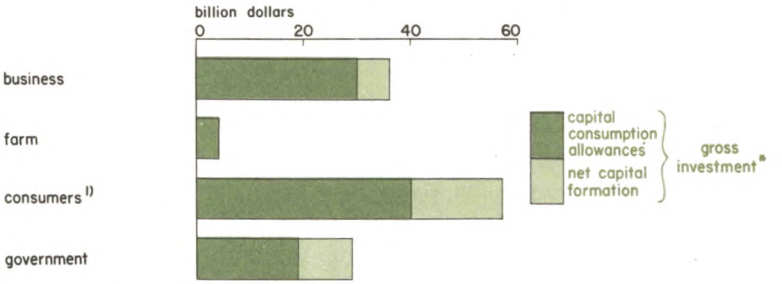
savings of individuals and organizations are mobilized and shifted from those with a surplus of savings to those in a deficit position.

In most years, businesses as a class are in a deficit position. That is, businesses invest more funds than they can provide from capital consumption allowances and retained earnings. The past year, however, was exceptional: Capital consumption allowances, retained earnings (although much reduced from the previous year) and substantial inventory liquidation provided about 5 billion dollars more than the business gross investment total of 36 billion dollars.

Consumers are characteristically in surplus, as a group. Disposable personal income ordinarily exceeds outlays for nondurables and services by more than the amounts expended on purchases of housing and consumer durables. For the group as a whole, the surplus is

In 1958,

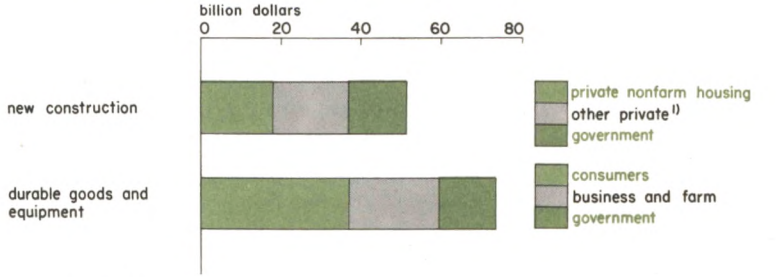
consumers were the most important class of investor, in both gross and net terms.



1) including nonprofit organizations

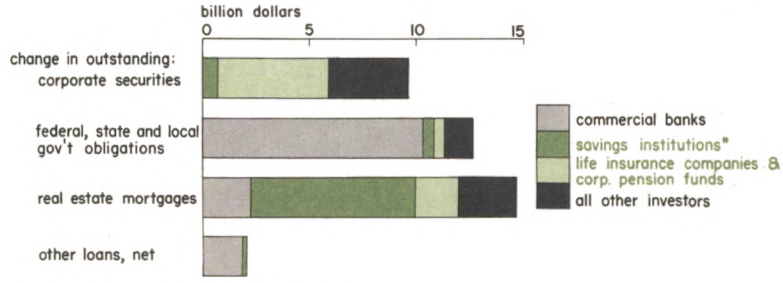
*excluding inventory changes and net foreign investment

Equipment outlays, although sharply less in 1957, were still larger than new construction expenditures . . .



1) includes business, farm and nonprofit organizations

and commercial banks were the most important suppliers of external funds for investment.



*savings and loan associations and mutual savings banks

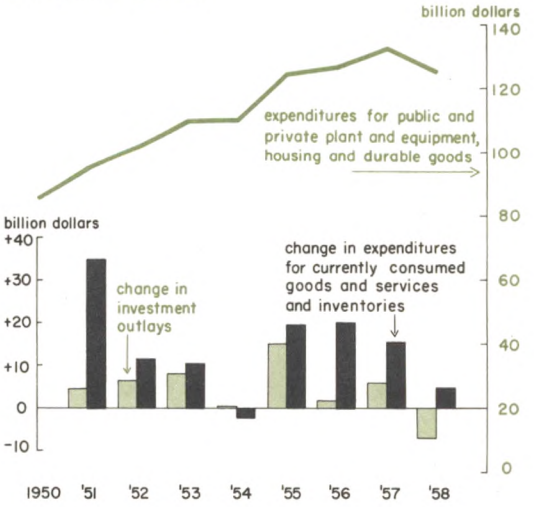
usually, as in 1958, a small one. But there is large-scale external financing among consumers, effected through financial institutions, since consumers, both individually and as a group, simultaneously increase their financial savings and use credit to buy long-lived physical assets.

State and local governments in recent years have been spending more on plant and equipment than they have available from revenues after meeting current expenses and have therefore been continually in the capital markets for funds on a large scale. The Federal Government's large swings between cash surpluses and deficits, however, have made the over-all government sector at times a net supplier and at times a net user of external funds. In 1957, for example, the public sector of the economy had a small surplus; in 1958, there was a very substantial deficit, for public investment expenditures were more than 10 billion dollars greater than the surplus on current account.

In 1958, net external financing—that is, the net change in outstanding corporate securities and financial obligations of other sectors—was nearly 39 billion dollars, almost 7 billion dollars more than in the previous year. The Federal Government's deficit was responsible for the rise. Mortgage debt rose more than in 1957, as did state and local government debt, but outstanding corporate obligations increased less in 1958 than in 1957, and consumer borrowing to purchase durables actually declined in 1958.

Nearly 40 per cent of the external financing was absorbed by the increase in real estate debt, nearly one-third by the increase in governmental obligations and about one-fourth by the increase in corporate securities outstanding. Commercial banks, which had ample funds to invest during 1958, were much the largest suppliers of external funds,

Investment spending
a volatile sector



in contrast to their experience during the 1955-57 boom. Banks absorbed more than 80 per cent of the increase in governmental debt and about 15 per cent of the increase in mortgage debt.

The major types of savings intermediaries in combination provided nearly 45 per cent of external funds in both 1957 and 1958. Savings and loan associations and mutual savings banks provided more than half of the net mortgage financing, an even larger share than in the recent past. Life insurance companies and corporate pension funds, as in 1957, absorbed about half the increase in corporate securities and about one-seventh of the net mortgage financing. Other investors—individuals, nonfinancial corporations and nonprofit organizations—were important suppliers of external funds to corporations and state-local governments, and to a lesser extent to the mortgage market, but reduced their holdings of U. S. Government and Federal agency securities.