

Business Conditions

1970 September



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THE Trend OF BUSINESS

Inventory growth ahead

Although the downtrend in general business appears to have been reversed, a vigorous revival has not developed. Adjusted for higher prices, the Gross National Product (total spending) began a renewed uptrend in the second quarter of 1970, following declines in each of the two preceding quarters. Industrial production—which measures the physical output of factories, mines, and utilities—was on a plateau from May through September 1970, after a 3 percent decline from the July 1969 peak. Wage and salary employment was unchanged in September, ending a five-month decline, but the unemployment rate rose further.

Consumer income has moved to new highs in recent months, despite reductions in employment. Credit has become more available, and most interest rates have receded from second quarter highs. These factors have set the stage for significant advances in consumer spending, home building, and state and local government spending. On the other hand, further reductions in defense spending are scheduled through the first half of 1971, and business managers remain cautious on new capital spending plans. The picture is clouded, also, by the strike that idled more than half of the nation's motor vehicle workers in September and October. Given these cross-currents, the outlook is more than usually beset with uncertainties. Nevertheless, looking ahead into 1971, most business analysts

expect a gradual uptrend in activity, albeit with no early return to the full employment conditions of 1968 and 1969.

The 1969-70 decline in activity exhibited the typical attributes of a business recession. Among these were declines in employment, construction, and manufacturing; increased unemployment and business failures; slower growth in income and retail trade; lower profit margins; and postponements of plant and equipment projects. The magnitude of change in these measures was greater than in the 1967 "mini-recession," but much less than in the four generally acknowledged business recessions that began in 1948, 1953, 1957, and 1960. If the recent adjustment is to be termed a recession, it must be counted as the mildest of the postwar era. Among the striking differences between the developments of 1969-70 and the four postwar recessions was the performance of total business inventories. In the face of faltering sales and production cutbacks, total business inventories continued to rise in the past year, although at a slower pace. Each of the four acknowledged recessions featured net declines in inventories.

Inventory rise continues

Declines in output larger than declines in shipments from the summer of 1969 to the summer of 1970 resulted in inventory declines in some manufacturing industries. This

occurred in motor vehicles, processed foods, and textiles. At the retail level, inventories were reduced only at stores handling building materials. But for business as a whole, the book value of inventories, amounting to almost \$170 billion in July 1970, was almost 6 percent higher than a year earlier.

Except for a slight dip in January 1970, total business inventories have continued to rise throughout the business adjustment. On a quarter-to-quarter basis, the uptrend in inventories has continued for almost a decade. The last quarterly decline was recorded in the first quarter of 1961.

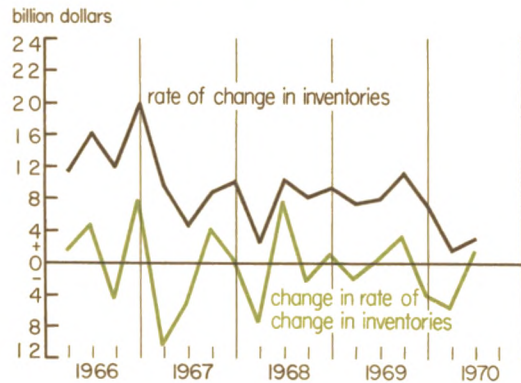
In the first two postwar recessions, total business inventories declined for four successive quarters. In 1957-58, inventories declined for three quarters and in 1960-61, for two quarters.

Although inventories have continued to rise, business slowdowns in the past decade have been accompanied by a significant reduction in the rate of inventory accumulation. In the 1966-67 business adjustment, inventory accumulation reached a peak annual rate of \$20 billion in the fourth quarter of 1966. In the second quarter of 1967, this rate of increase was less than \$5 billion. As a result, inventory investment contributed \$15 billion less to total spending in the latter period.

Last year, inventory accumulation reached a peak rate of \$11.3 billion in the third quarter. In the first quarter of 1970, this rate was only \$1.6 billion. Inventory investment, therefore, contributed almost \$10 billion less to total spending in the latter period.

Despite the greater severity of the recent business decline, as compared with 1966-67, the reduction in the rate of inventory investment was less severe than three years earlier. Most businesses were better prepared in 1969 for declines or slower increases in sales. Prompt reductions in output at the manu-

Changing rate of inventory investment a volatile factor in the economy



Note: Figures are seasonally-adjusted annual rates.

facturing level, combined with cautious ordering by retailers and distributors, prevented many involuntary inventory buildups.

Both in early 1967 and in early 1970, many observers believed that a general business inventory liquidation was underway, perhaps assuming the magnitude and duration of such liquidations prior to 1961. Data now available indicate that such was not the case. Strength in final demand for goods by consumers, business, and government necessitated the maintenance of adequate stocks.

Inventories in the cycle

Changes in the rate of inventory investment have played a major role in each recession, or period of sluggish growth, in the postwar period. Declines in plant and equipment spending by business, or in defense spending by the government, have had substantial impacts on total spending in a number of periods. But spending for inventory is far more unstable than spending on

any major type of final purchases. Inventory investment is the only component of total spending that can become negative. This occurs when inventories are liquidated and part of current needs are supplied “off the shelf” from production in prior periods.

The rate of spending on all goods and services, the Gross National Product (GNP), rose \$35 billion from the first quarter of 1969 to the third quarter of 1969, and the rate of final spending (total spending less inventory investment) rose \$31 billion. In the next two quarters, however, GNP rose only \$17 billion, while final spending increased \$26 billion, almost as much as the first period. The striking difference in this comparison—the much sharper drop in total spending as compared to final spending—reflects changes in business inventory investment. In the first period, net inventory investment rose; in the second period it declined sharply.

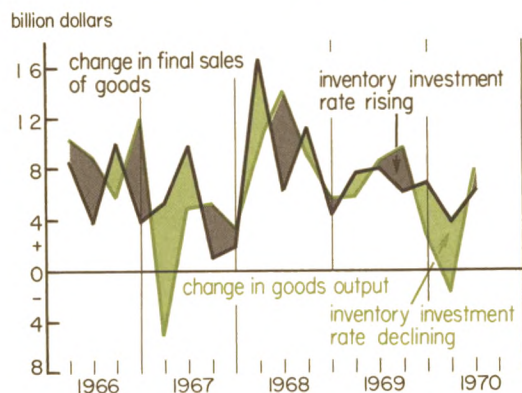
The importance of inventories in the recent business slowdown is even more striking when spending is adjusted for price inflation. In constant dollars (1958 purchasing power),

total spending declined \$7.1 billion from the third quarter of 1969 through the first quarter of 1970. Total final sales rose slightly in this period, by \$1.5 billion, after adjustment for price increases. Taken together, this represents a reduction of \$8.6 billion in the rate of inventory investment, an amount larger than the entire decline in real activity.

Using constant dollar data, the change in inventory investment in 1948-49 substantially exceeded the decline in total spending. In 1953-54 and 1957-58, this sector accounted for half of the decline in total spending. In 1960-61, the reduction in the rate of inventory investment about equaled the decline in spending.

It is an oversimplification to characterize the business declines since World War II as “inventory recessions.” Many factors were at work in each case, and components of total spending other than inventories also declined, or rose, at a slower pace. Decisions to reduce the rate of inventory investment typically are triggered by other developments, including expectations as to the prices and availability of goods, changes in orders, sales and profits, and the cost and availability of funds.

Final sales more stable than total spending on goods



Note: Figures are seasonally-adjusted annual rates.

Are inventories too high?

Inventories can be judged to be excessive, or inadequate, only in relationship to current and prospective levels of sales or production. Therefore, stock-sales ratios are widely used in analysis, whether for total business, particular industries, or individual companies. These ratios are calculated by dividing the book values of inventory at the end of each month by sales (shipments for manufacturers) for that month.

At the end of July, the stock-sales ratio for all business was 1.57. This was higher than in the same month of 1968 or 1969, but about the same as in 1967. The higher overall

stock-sales ratio this year largely reflects the position of the durable goods manufacturers and auto dealers. Within durable goods manufacturing, most industries reported increases in inventories relative to sales. The largest increases in stock-sales ratios were for steel, machinery, household appliances, and television.

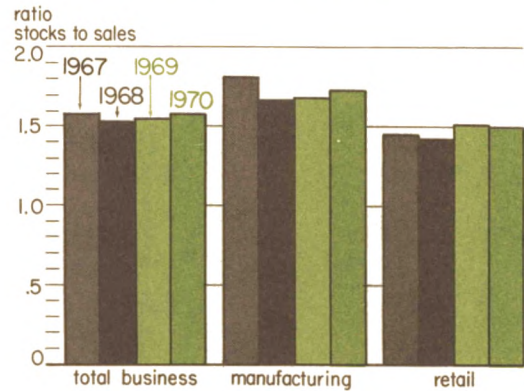
Sharp changes in stock-sales ratios from one month to another usually reflect unexpected or erratic changes in sales rather than changed policies as to the desired level of inventories. In a business upsurge, stock-sales ratios usually decline as sales outpace production. When business activity declines ratios usually rise because production schedules are not reduced rapidly enough.

Stock-sales ratios usually reach a peak near the trough of a business cycle before production has adjusted fully to reduced demand. After starting upward in late 1969, the stock-sales ratio for all business rose to a peak of 1.60 in April 1970.

Production cutbacks began in most manufacturing industries in the summer of 1969. Since April, total manufacturing output has been about in line with final sales with the result that the total stock-sales ratio has been stable. Some industries that had reduced output sharply in late 1969, notably household appliances and TV, reversed this trend in the summer months. In other industries, including building materials, textiles, and paper, output continued to decline.

The importance of a proper mix in inventories underscores one of the limitations of the stock-sales ratio as a measure of the adequacy of inventories. Complaints of unbalanced inventories, sometimes resulting in lost sales, have been reported in the business press in recent months. Auto dealers, for example, have had inadequate stocks of domestic compact cars. Some other models

Inventories higher relative to sales than last year, about the same as in 1967



Note: Data for July.

have been in excess supply.

Another problem in using stock-sales ratios is that, while sales are recorded in current dollars, the book value of inventories depends, in part, on accounting methods. The book value of manufacturing and trade inventories is about \$170 billion. At market prices, the total value of inventories may approximate \$200 billion. Many businesses use conservative accounting practices, valuing inventories at cost or market, whichever is lower. In addition, LIFO accounting (Last In First Out) is used for all or part of the materials consumed by many manufacturers. Manufacturing accounts for almost 60 percent of business inventories. In periods of rising prices, book values of inventories increasingly are understated in LIFO accounting because the current cost of goods and materials is applied to current sales.

No clear long-term trend in the size of inventories relative to the volume of current business has emerged in the postwar period. Since late 1966, sales ratios have approximated those of the early Sixties and the

middle Fifties. These ratios declined fairly steadily from 1961 through early 1965, but this may have reflected the concurrent rapid rise in sales. The higher stock-sales ratios of the late Sixties apparently was associated with the relative growth of defense and equipment industries whose inventories are large relative to shipments.

Controlling inventories

Much has been written about the extent to which improved managerial skills have permitted a reduction in the size of inventories, especially through computerized accounting controls. Such techniques can be especially valuable for businesses that must stock tens of thousands of parts or finished products. "Stock-outs" of parts or finished products may result in undesired downtime in manufacturing or lost sales at retail stores.

Computers can aid management by providing accurate information instantly. This advantage has been offset, in part, by the need to maintain stocks of a larger variety of models, colors, styles, and sizes. Changing trade practices, with shifts in the overall inventory burden between manufacturers, distributors, and retailers, also may override managerial efficiencies in determining actual inventory trends. In any case, machines cannot replace judgment in making decisions as to prospective sales, changes in availability of supplies, and trends in prices.

Business firms estimate that the cost of carrying inventories is about 15 to 25 percent of their value per year. Some managers place these costs even higher, but the average appears to be about 18 percent. Included in carrying costs are interest on borrowed funds, taxes, insurance, storage, handling, record keeping, obsolescence (caused by changes in style or technology), pilferage, deterioration, and overhead.

But there also are costs in *not* carrying adequate stocks. Among these are the potential loss of sales to competitors, risks of price increases (still far more numerous than decreases), and unforeseen interruptions in the flow of purchased materials and supplies. Delivery times have been reduced in many industries in recent months. But this trend could change quickly because of either a rise in sales and output, or labor disputes in manufacturing or transportation.

Polls of business managers usually reveal that a substantial portion think their inventories can and should be reduced. But competitive pressures often prevent such plans from being fulfilled. According to a Department of Commerce survey, 31 percent of all manufacturers considered their inventories to be too high in June 1967, compared to 2 percent that thought inventories were too low. Nevertheless, the rise in inventories accelerated in the second half of 1967. In June of this year, 24 percent of the manufacturers believed their inventories were too high as compared with 1 percent who thought their holdings were too low. Economization on inventory is a highly desirable objective, but not at the expense of sales and profits.

Future inventory trends

Final sales of goods in the second quarter of 1970 were at an annual rate of more than \$470 billion, up \$6 billion from the first quarter rate, and \$23 billion from a year earlier. Final sales of goods have increased each quarter, with one exception, since the first quarter of 1961. A continued rise in inventories has been required to support the rising volume of final business sales.

During the past ten years, increases in total business inventories have averaged 36 percent of the rise in final sales of goods. In the decade, this ratio ranged from 24 percent to

48 percent. Last year it was 30 percent.

Inventory developments in the fourth quarter of 1970 may be altered temporarily by major strikes in the motor vehicle, farm, and construction equipment industries. Looking ahead to 1971, most business forecasters expect an increase in final sales of goods of about 7 percent over 1970—more than \$30 billion. To keep pace with sales, assuming the average relationship, inventories would

have to rise by more than \$10 billion in 1971.

One of the major factors depressing business activity in the past year has been the reduced rate of inventory accumulation. This trend appears to have been halted in recent months. A faster rate of inventory accumulation probably will be one of the major factors, along with consumer spending and residential construction, that will contribute to the revival of general business activity in 1971.

U. S. trade—pressures for restriction

World trade more than doubled during the Sixties. In 1969 alone the increase was 14 percent. This year a further rise of 8 to 10 percent is anticipated.

Growth in international trade has been encouraged by a gradual relaxation of international trade barriers. In recent years, however, demands of some industry and labor groups for protection against foreign competition have increased both in the United States and in other economically developed countries. Pressure for more protection endangers future growth in world trade.

In the mid-1930s, the United States first began negotiating a series of reciprocal trade agreements that facilitated tariff reductions on an item-by-item basis. The trend toward freer world trade continued through the broad range tariff reductions of the “Kennedy round” of negotiations which culminated in 1967. Throughout this period, the United States provided the leadership required to achieve a freeing of trade restrictions. As tariff rates declined, however, nontariff barriers to trade among nations became more significant. These nontariff barriers include

import quotas, licensing requirements, and restrictions on capital imports.

Restrictions on foreign trade by other nations along with increasing imports has led to a growing interest in the United States in the rebuilding of protective barriers. Restrictions by the Japanese government on the importation of goods have been particularly severe while the increase in Japanese exports to the U. S. market has been large. Restrictions on agricultural products by the European Common Market (EEC) have increasingly concerned American farmers (see **Business Conditions**, February 1970).

A bill currently before the U. S. Congress would provide for the imposition of import quotas on a potentially wide range of goods. If enacted, it could reverse the gradual easing of formal trade restrictions. Furthermore, there is the possibility of other countries reacting to United States imposed quotas with additional trade restrictions of their own.

Tariffs and quotas

Tariffs, the most common trade restrictions, are import taxes levied on the value of

the imports (ad valorem), or on physical units (specific). Variations of these basic forms are numerous. Ad valorem rates, for example, may be related to the selling price of domestically produced counterparts (“American selling price”) rather than the import price, as is the case with benzenoid chemicals imported into the United States. Or, if the import price is less than the domestic price, as is frequently the case, the tariff may be equivalent to the amount of the difference between the import and the domestic price (the EEC does this with some agricultural imports). Whatever the form, a tariff interferes in the free pricing system. But, even with the tariff imposed, supply and demand continue to function to determine the price and the quantity of the product taken. Because of the tariff, the price will be at an artificially high level, and the quantity imported will be less.

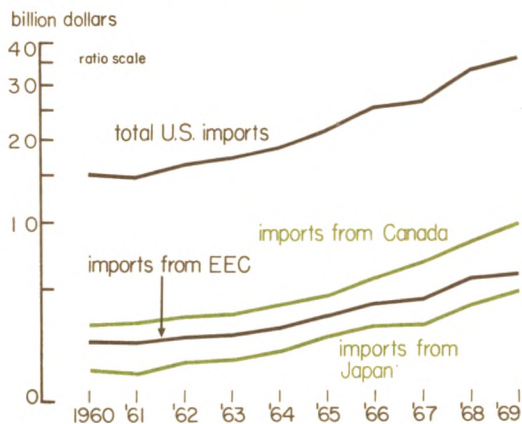
Within the United States interested groups are pressing for import quotas, “voluntary” or mandatory, rather than increased tariffs to protect domestic producers.

If the supply of imports is not sensitive to a change in price, imposition of a tariff will not result in an increase in the import price. Rather, the tariff will be absorbed by the exporter with the result that there will be little or no reduction in the quantity imported. Unlike tariffs, quotas impose predetermined limits on the importation of specified products regardless of price.

Arguments for protection

Among the most common arguments offered in favor of trade restrictions are: (1) the encouragement of new industries; (2) the protection of domestic wage standards against low cost foreign labor; and (3) the maintenance of industries essential to national security. The first two are basically

Total U. S. imports more than doubled during the Sixties



economic arguments and the pros and cons underlying each can be set forth in economic terms. The third is more political than economic.

There is a long history of protection for new industries that are not initially competitive with similar industries in foreign countries. Under such circumstances a potentially efficient new industry may develop successfully when it otherwise would not have survived foreign competition. Too often, unfortunately, the result is that the new industry grows but cannot face foreign competition effectively if the protection is removed. The new industry argument was put forth in the United States prior to World War I.

Far more common today is a plea for protection against the competition of “cheap” foreign labor. Current interest in quotas on textiles, apparel, and footwear imports is based on the belief that sales of domestically produced goods are being lost to imported goods that utilize cheap foreign labor.

In practice, the cheap labor argument may support a position that results in the inefficient use of domestic labor and capital re-

sources. Economically, a more desirable long-term response to cheap foreign labor is to encourage a recombination of resources within the industry in order to increase efficiency; or to encourage a movement of resources out of the industry and into more productive uses. More efficient utilization of resources, coupled with free entry of less expensive imports, can result in a higher level of economic welfare for the entire nation.

International trade is based on the principle of comparative advantage. Every nation has comparative cost advantages or relative efficiencies in the production of certain goods and services. Ideally, a nation should concentrate on the production and export of those goods and services which it can produce most efficiently, and import goods and services for which it is a relatively inefficient producer. Each nation can, then, produce goods of relatively higher value, as compared to the resources used, and exchange them for goods of equal value, but which would require the utilization of more resources if domestically produced.

Political considerations often prevent the theoretical economic ideal from being realized. A government may restrict trade and accept inefficiencies in the use of resources. Governments do in fact impose numerous restrictions on the international flow of goods and services. But due to the interdependence among nations it may not be politically acceptable or economically sound for one country to suddenly discard all trade restrictions. Economic dislocations resulting from such unilateral action may result in domestic production and employment problems, and international payments deficits which cannot be corrected because of the trade restrictions of other countries. Nevertheless, multilateral movements toward the elimination of trade restrictions remain a desirable long-term goal.

The realities of world politics provide the basis for the national security argument for trade protection. In spite of substantial cost disadvantages it may be desirable to maintain certain domestic industries in a viable condition, through protection from foreign competition, because the foreign source may be cut off. The national security argument has been used as the rationale for restricting the importation of such products as steel, watches, and crude oil.

Current pressure for quotas

Some countries have aggressively expanded sales efforts in foreign markets to provide an outlet for the production of their industries. From 1960 to 1969, Japanese exports almost quadrupled to \$16 billion. In the same period exports of the EEC nations increased two and a half times to \$76 billion. Increasingly, U. S. industries have felt the pressure of this foreign competition. This trend was aided by the more rapid rise in U. S. domestic prices starting in 1965.

Foreign products gained acceptance in the U. S. market because they compared favorably with domestically produced goods in quality and price. Moreover, some imports, such as subcompact automobiles and wool-silk textile blends, were of a type not produced in the United States. Stronger competition from abroad, combined with frustrations associated with limited accessibility to foreign markets touched off domestic demands to rebuild U. S. trade barriers.

For many years the United States has used quotas to restrict certain imports. Some agricultural products have been protected by import quotas since the 1930s. Sugar and dairy product quotas are of major importance. Beef quotas also have been imposed at times. "Voluntary" cotton textile quotas were first initiated on a bilateral basis with

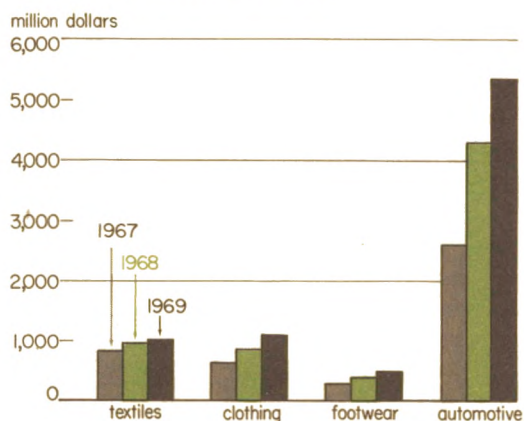
Japan in 1956 and were expanded in an international agreement in 1962. Oil import quotas, imposed on a “voluntary” basis in 1958, were made mandatory in 1962. A three-year “voluntary” quota on total steel tonnage, agreed to by exporters of steel to the United States in 1968, went into effect in 1969.

During 1969 and early 1970, U. S. negotiators made unsuccessful attempts to persuade the Japanese to impose “voluntary” restrictions on exports of synthetic and synthetic blend textiles and apparel to the United States. Partly because these negotiations were unproductive, the bill now being considered by Congress (H.R. 18970, introduced on August 13, 1970) would impose import quotas on specific textiles, apparel, footwear, and furs. Supporters of quotas initially suggested that this legislation could be made applicable to textiles and apparel only. The history of trade legislation indicates, however, that this may not be possible. Proponents of any such bill, in striving for political support, frequently agree to support the demands of others as well. Such appears to be the case with the current trade bill.

The trade bill of 1970

The current version of the trade bill of 1970 includes protection for many goods other than provisions to restrict textiles, apparel, and footwear imports. Certain provisions could expand quota coverage—depending upon the level of market penetration—to autos, consumer electronics, flat glass, ceramic tile, and bicycles to name only a few products. These products, and others may come under quota or other restrictive provisions of the bill if imports of the particular product: (1) make up more than 15 percent of U. S. consumption; (2) account for a rapidly increasing share of the domestic market; and/or (3) are injurious to domestic

Clothing, footwear, and automotive imports increase dramatically



production and employment in the opinion of a majority of the Tariff Commission.

The trade bill in its present form would limit the 1971 importation of specified textile, apparel, and footwear articles from each foreign country to the average level during the years 1967, 1968, and 1969. After 1971, affected imports would be limited to a maximum growth of 5 percent per year for each category of goods for each country shipping these goods to the United States. The bill would also allow particular textile, apparel, or footwear articles to be exempted by the President if unrestricted importation would not disrupt the U. S. market situation. In addition, all goods covered by the bill from a specific country may be exempted if the President determines such action to be “in the national interest.”

There are, in addition, other provisions in the bill which would affect trade. Among the most important are: (1) a provision for establishing Domestic International Sales Corporations (DISC) which would provide

certain tax advantages for exporters, and (2) a provision empowering the President to eliminate the American selling price method of tariff valuation on imported chemicals. These provisions are expected to encourage expansion of trade.

Trend toward restriction

Quotas for textile, apparel, and footwear imports are supported, in part, because of charges that plant closings and unemployment result from low-wage foreign competition. It is claimed that low foreign wages make imports inexpensive, and are responsible for rapidly increasing imports of textiles, apparel, and footwear.

Although imports of textiles and apparel have increased rapidly in recent years the quantities have remained small relative to U. S. production. From 1967 to 1969, household textiles and personal apparel imports increased nearly 57 percent. The largest gains were in apparel goods made of synthetic and synthetic blend materials. Japan, Hong Kong, South Korea, and Taiwan, along with other Asian sources, contributed the largest in-

crease in U. S. imports of synthetic apparel, rising from \$213 million in 1967 to \$415 million in 1969. The increase in imports of these items from the EEC was considerably less, expanding from \$28 million in 1967 to \$59 million in 1969. Nevertheless, the 1969 dollar volume of both textile and apparel imports combined accounted for less than 5 percent of the U. S. market. For certain types of goods, such as shirts, imports made up a considerably larger share of the U. S. market.

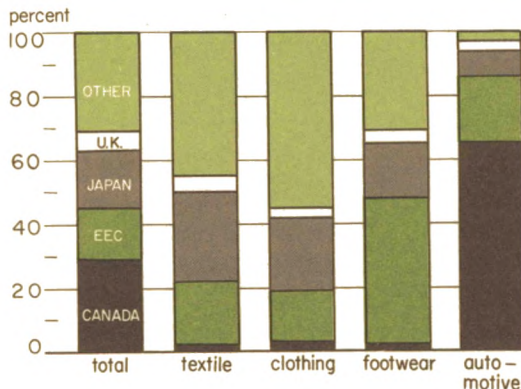
Domestic employment in textiles, apparel, and footwear, which grew substantially through most of the 1960s, leveled off and then began declining during 1969 and so far in 1970. A number of less efficient plants closed. The problems associated with plant closings and layoffs are intensified in areas where production is concentrated, where skills of the labor force are not easily transferable, and where alternative job opportunities are limited.

The recent downturn in employment and production activity in textiles, apparel, and footwear is not the result of increased imports alone. The slowdown in these industries also reflects a more general slowdown in the economy, and is also related to declining military requirements.

When quotas or tariffs are imposed, protected industries gain a buffer against foreign competition. But resources are less efficiently utilized as a result. The industry involved, if it actually requires protection, is consuming capital, labor, and time resources which could theoretically be used to produce more goods, services, and income if the resources were efficiently employed elsewhere. But there are domestic social hardships and economic costs in making an adjustment toward freer trade which must be considered.

Adjustment problems associated with reductions in trade restrictions have influenced

Canada, the EEC, Japan, and the United Kingdom provide most U. S. imports



the administration of such programs in the past. This is reflected in the limited magnitude and gradual implementation of the reductions. Furthermore, there is increasing political acceptance and support for providing adjustment assistance to persons and firms adversely affected by increased imports.

Ill-will and retaliation

Among the indirect consequences of new quotas or tariffs is the possibility of retaliation by those countries directly affected by U. S. restriction. Both the EEC and Japan have publicly suggested that they may increase trade restrictions if the trade bill currently before Congress is passed. The EEC has indicated that it would restrict imports of U. S. soybeans. Japan, with a highly protected domestic market, could discontinue their progress toward trade liberalization or increase restrictions on U. S. agricultural commodities. The EEC and Japan are second and third only to Canada as markets for U. S. goods.

Midwestern agriculture would be hurt severely by such action. Two-thirds of U. S. soybean production is from the Midwest and nearly 60 percent of U. S. soybean exports,

the largest agricultural export, go to the EEC and Japan. Restrictions against U. S. industrial goods are also possible. The seriousness of initial retaliatory actions is magnified by the potential for continuing "rounds" of trade restriction—a continuing attempt by the countries involved to place themselves in the most advantageous trading position.

Freer trade?

Since the 1930s the United States has been a leader in promoting world trade, and in reducing artificial restrictions to international trade. In the past decade, imported goods have assumed a growing role in the U. S. economy. Imports provide price and quality competition with domestically produced goods, help hold down production costs and permit higher levels of living for consumers.

Any short-term benefits, which might be derived for special groups through trade restrictions, must be weighed against the disadvantages of restricted trade to the entire nation. Moreover, the United States, because it is the leading trading nation, must take into account the probable economic and political impact of its actions on other trading nations.

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