BUSINESS LIQUIDITY IN TODAYS ENVIRONMENT

Remarks by Mr. Robert P. Mayo, President of the
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R. W. Pressprich and Co. Seminar on Money Markets
September 23, 1970

I welcome the opportunity to talk to you tonight about business liquidity--that modern day "heffalump." If you, or your children or grandchildren are Winnie the Pooh fans, you may know that a heffalump was a thing that everybody knew all about and thought everyone else knew all about. The only hitch was that nobody had ever seen one and nobody knew how to define one.

Attempts to define "business liquidity" have had the same type of indifferent success. There are as many definitions as there are analysts--a problem that economists also have since if they were placed end to end they would never reach a conclusion either.

Viewed broadly, liquidity is a state of mind, a feeling or attitude. But even when defined conventionally, as the ratio of quick assets to current liabilities, we are not certain what it means. Uneasiness arises each time the over-all ratio reaches a new low but yet it continues to reach new lows year after year and corporations have apparently been able to continuously accommodate themselves to the reduced level of liquidity.

But I do not intend to make light of the concern with liquidity nor of its substantial decline in recent years. Indeed, if liquidity could be looked at in isolation, I could argue for a course of economic policy that would quickly restore liquidity in all sectors of the economy. But, as is so frequently the case in matters of importance, there are other objectives to be served as well

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by economic policy. And since last year this has been the battle against inflation. Moreover, it has been inflation that has contributed so significantly to the erosion of corporate liquidity.

But before going further with this line of argument, let's take a closer look at some of the trends in liquidity. The ratio of cash and governments divided by current liabilities as calculated from SEC data, has declined almost every year since World War II. At the end of 1945 this ratio was 93 percent; ten years ago, 39 percent and at the end of March 1970, 18 percent, a postwar low. Liquid assets increased in most years but not as fast as the rise in current liabilities.

While this continued decline in the ratio is a matter of concern, it is impossible to say what specific level implies a critically illiquid position for a significant number of individual corporations. As I noted earlier, uneasiness arises each time the measure reaches a new low but so far corporations have been able to survive.

The persistent decline in corporate liquidity is, in part, a reflection of the continued expansion in the volume of open-book credit extended to business customers. The decline also reflects the more efficient management of cash assets. Sluggish payments by customers have caused liquidity problems for some firms. This is documented, both by the increase in the number of days sales outstanding and the proportion of receivables reported as past due. The great bulk of these accounts are "good" in the long run, but many business firms have improved their cash positions, or have avoided cash borrowings, by delaying payment of bills.

In the last year a further strong contributing factor in the narrowing in liquidity positions has been the heavy reliance by corporations on relatively short-term borrowings to finance fixed investment. Some of these borrowings

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may continue to be rolled-over, but many corporations are undoubtedly under pressure to replace them with more permanent funds.

While a particular type of financing is not matched to a particular type of outlay, certain general relationships have developed over the years. It is not startling to suggest that corporations, in general, would prefer to finance long-term outlays with long-term funds--relying in sequence on internally generated funds, long-term capital market borrowing, and lastly on short-term funds raised in the money market. Similarly, they would prefer to use short-term funds to finance short-term uses, such as inventories and the extension of trade credit. But these relationships were distorted last year.

In 1968, outlays on plant and equipment exceeded internally generated funds by about $5 billion. By 1969, the gap had widened to $14.5 billion and in the first quarter of this year, rose further to 19.5 billion at a seasonally adjusted annual rate. At the same time, short-term borrowings were unusually large relative to outlays for inventories, net trade credit and other short-term uses.

It would appear that in 1969 some $10 billion of demand for net new funds was shifted from long-term markets to the banking system and the commercial paper market. Even if this amount had been obtained in long- rather than short-term markets, the decline in over-all corporate liquidity would still be the sharpest for any year of the 1960's.

The delay in long-term financing in a period of monetary restraint and the waiting for a return of more hospitable capital markets were expected. We were all aware of the large demands for liquidity that had built up over a period of excess demand and a dangerous degree of inflationary pressure. With the advent of economic policies designed to slow the pace of total spending and eliminate excess demand pressures on business firms did mount. The money and capital markets did experience unusual strains.

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The tensions that developed earlier this year came from a number of places--heavy corporate demands for long-term credit, expectations of large Treasury borrowing in the latter part of this year, disappointment with the seemingly slow progress in getting inflation under control and concern that some prominent firms might be financially over-extended.

Anxieties such as these could have led to a scramble for liquidity that would have endangered prospects for recovery. But fortunately, efforts by business firms to strengthen their liquidity positions have remained orderly for the most part. Nevertheless, in the unlikely event that such a scramble had developed, the Federal Reserve would have used all its authority to ensure that unusual demands for liquidity were satisfied.

Both open market operations and the discount window were used constructively this year to accommodate credit demands on the banking system. In addition, once it became apparent that some firms were having difficulty in refinancing commercial paper, the Board suspended Regulation Q ceilings on large denomination CDs with maturities of less than 90 days. This enabled banks to obtain funds that investors were hesitant to place in other markets and to rechannel these funds to borrowers previously dependent on commercial paper. Further, it was made clear that the discount window would be available to assist banks in meeting the needs of businesses unable to roll over commercial paper.

Thus, it should be obvious that the Federal Reserve System is willing and able to cure any incipient liquidity crises. But the powers of the central bank as the ultimate source of liquidity can, and obviously should be reserved for extraordinary circumstances. Our financial institutions have demonstrated that they are sufficiently strong and flexible to handle credit worthy needs--even when exceptionally large.

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Having weathered the financial stresses earlier this year so well has renewed confidence in the resiliency of our financial system. Further, circumstances in the markets began to change in response to a moderate change in monetary policy and a more tranquil atmosphere is now apparent in our financial markets.

As you undoubtedly noticed in the press yesterday, the record of the FOMC policy actions taken at the June 23, 1970 meeting have been released. The Committee concluded that uncertainties and strains in financial markets remained sufficiently great to warrant giving continued priority in open market operations to the objective of moderating pressures in those markets. The members also decided that to the extent compatible with that course, operations should be directed at fostering moderate growth in money and bank credit over the longer run.

This is, in my view, a moderate and cautious course but an appropriate one. It would be unfortunate to have an excessively rapid expansion in deposits and bank credit that would under cut the effort to restore price stability.

Remember too, that we have been creating an economic environment in which modest improvements in business liquidity are increasingly likely. The rapid expansion of time deposits in recent months has placed many commercial banks in a favorable position to accommodate business loan demands. The tone of the commercial paper markets also has improved in recent months. Interest rates have receded from their peaks in recent months, even though the capital markets have absorbed a high volume of securities. (In the first three quarters, corporations will have sold $27 billion of new securities, up from $20 billion in the same period of 1969.)

I am not unaware of the accumulated pressures on liquidity in the major sectors of the economy. But I am convinced that the efforts we have taken to bring the economy back on course and our continued attention to the financial markets will provide the base for a well balanced structure of output and sustainable economic growth in the future.

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