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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Economic Stabilization, Automation, and Energy Resources

of the

Joint Economic Committee

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Mr. Chairman and Members of the Subcommittee:

In its continuing assessment of the business situation, the Federal Reserve pays close attention to changes in inventory investment and to the circumstances which give rise to those changes. It is important for all of us to know as much as we can about these matters and I am sure that our analyses will benefit from the valuable background studies which have been prepared for this Committee and from the further impetus that these hearings have given to research in this field.

My own view is that inventory fluctuation is symptomatic of rather than fundamental to the cyclical behavior of the economy. From the evidence, inventory fluctuations would appear to be a major factor in intensifying cyclical swings once they get under way. But whether inventory changes are a major factor in triggering cycles is more questionable. In retrospective analyses of cyclical movements, the association between changes in inventory and in gross national product may seem impressive, yet it may well be that swings in business sales expectations, placements of orders and Federal expenditures exerted a more determinative influence. It is possible, at least in theory, for an economy to have stable investment in both plant and equipment and in inventories and yet to experience cycles in output because of fluctuations in these other factors.

In this connection it is important to recognize that inventory changes result not only from conscious management decisions but also from causes outside management control. And there is no present means of determining the relative importance of the voluntary and involuntary changes. For these reasons, we must go behind the published statistics, indispensable as they are, to assess the underlying inventory and production decisions which help determine the strength of consumption and investment demands. Therefore, further research into the relation of inventories to cyclical fluctuations should be directed not only to improving data on inventory holdings but also toward shedding some light on the decision-making processes themselves.

From your Committee's invitation, I understand my major assignment today to be to comment on the influences of the cost and availability of credit on inventory investment. Necessarily, much of this discussion must be imprecise, for, despite earnest efforts-- which include the studies commissioned by this Committee--relatively little is known about the effects of specific financial conditions on inventory policy.

While the cost and availability of credit is one influence on the level of inventories which businessmen desire to hold, it seems obvious that this is not the predominant influence. Unless the availability of credit is extremely limited, businessmen will give more weight in decision-making to expected sales trends, the volume of incoming orders, backlogs of unfilled orders, the level of production, the presence or absence of materials shortages and expected

price changes. If inventories are insufficient, the result may be expensive interruptions in production and loss of customers. The resulting costs usually would be larger than the cost of funds borrowed to carry larger inventory. Moreover, interest is only a small part of over-all inventory expense. The total cost of carrying inventories has been estimated at between 10 and 25 per cent per year, while interest rates applicable to this type of credit generally fluctuate below 6 per cent.

Businesses ordinarily finance their inventories in a wide variety of ways. Besides bank or other short- or intermediate-term borrowing, they may do so by retaining earnings, issuing securities, incurring greater trade debts to suppliers, and by drawing down cash and other liquid assets. Even the reduction or postponement of plant and equipment outlays or the holding down of accounts receivable may provide inventory finance. In recent years, trade debt has become a prime vehicle with which financially strong businesses help finance the inventories of customers who are unwilling or unable to resort to bank or other market borrowing. In the 12 months ending with March 1962, for example, corporations increased their aggregate trade debt by more than \$7 billion. The growth in corporate short-term indebtedness to banks, however this is measured, was far smaller.

Also, commercial banks usually exert considerable effort to insure that their business customers obtain the credit they need for purposes such as inventory investment. Banks often elect to provide for such needs by reducing portfolios of liquid and even long-term securities and, on occasion, by limiting mortgage, security and

other nonbusiness lending. Business loans are the bread and butter business of many banks, and it is evident to them that a dissatisfied business customer can be lost forever to competing lenders. Additionally, bankers have traditionally regarded inventory needs as one of the most legitimate reasons for borrowing and they consider the meeting of such needs as one of the most appropriate forms of bank lending.

Yet after all these considerations have been taken into account, it seems to me that credit conditions do at times significantly influence inventory policies. Moreover, I think it reasonable to believe that the potential influence of these conditions is greater now than in earlier postwar years, because interest costs are a larger proportion of total inventory costs and because business firms generally have become less liquid and therefore more dependent on credit.

While much of the financing of inventory positions normally comes from internal and nonbank sources, the bank component can be strategic at some times and for some borrowers. Inventories have several characteristics that make them more susceptible to changing credit conditions than are plant and equipment outlays. The possible range of inventory mix and level is wide, while fixed capital investment often requires all-or-nothing decisions; some portion of inventories can be liquidated in case of need, while fixed capital requires long pay-off periods; inventory levels can be raised or lowered rather quickly, while fixed capital installations can require up to two or three years of lead-time and are not halted easily once begun. Thus, the initial impact of a change in credit

policy on business investment outlays may fall on inventories even though inventory financing requires only a small share of all funds raised.

The potential impact of monetary policy has probably been strengthened by the decline of internal corporate liquidity since the early and mid-1950's and by the currently spreading belief that price increases of the earlier postwar character are not apt to recur in the near future. By whatever yardstick corporate liquidity is measured--liquid assets taken as percentages of current liabilities, total liabilities, or transactions--the ratios are now significantly lower than in comparable stages of other postwar business recoveries. For example, liquid assets of manufacturing corporations were 58 per cent of their current liabilities in March 1959 but only 45 per cent of their current liabilities in March this year. Thus, manufacturing liquidity fell by 23 per cent between about the same stages of the 1958-59 and the current business recovery. Furthermore, the abatement of inflationary expectations among businessmen means that the interest cost of borrowing is no longer offset by the anticipation of higher prices.

Monetary policy also has indirect effects on business demand for inventories, as can be illustrated briefly. Through its effect on plant and equipment outlays, monetary policy may indirectly influence new orders for producers equipment and building materials and hence inventory investment in the industries producing these goods. Similar influences spread out from changes in the availability of loanable funds for the financing of houses, autos and other consumer durable goods.

To sum up, demand and supply effects in credit markets undoubtedly influence inventory investment contra-cyclically. On balance, the magnitude of these effects would seem to be significant and pervasive although moderate. The gradual narrowing of the spread between profits and interest rates, the fall in corporate liquidity and the higher level of interest rates in recent years suggest that in future periods of credit restraint, monetary policy may exert somewhat more restraint on inventory accumulation than during most of the postwar period.

My invitation to appear today specifically requested comments regarding the feasibility of introducing some form of direct control over bank lending for inventory purposes. On the basis of the Board's experience with selective controls in the security, mortgage and consumer credit areas, I am very skeptical of the desirability or practicality of credit controls directed specifically towards inventory investment. One characteristic of credit--even of the most specialized type--stands out from our experience: that is, it is impossible to trace, except by the business decision maker. Who is to say whether borrowing to finance plant and equipment "really" finances that or a concomitant rise in inventories?

Aside from these general defects, a specific problem in any effort to exercise direct control over inventory lending would arise out of loans secured by or financing expansion of the borrowers' accounts receivable. Since the accounts receivable of a firm often finance the inventories of its customers, much inventory financing actually appears in balance sheets as accounts payable and accounts

receivable. Accounts receivable of nonfinancial corporations now stand at a higher level than inventories themselves, in terms of book value. Thus, financially strong businesses could obtain large amounts of new bank credit secured by their existing receivables, which then could be used to expand their receivables and thus to finance inventory expansion by their customers. And to the extent that other borrowers are denied bank credit by selective controls on inventory credit, the ultimate effect might well be to force additional financing along the accounts receivable route. Such a development does not seem desirable from the standpoint of maintaining and extending the competitiveness of the economy and curbing market power of dominant suppliers.

In short, there would be serious, and probably insurmountable problems in any attempt to ration one specific use of credit by business. It would also be very difficult to avoid discrimination against those growing businesses which must rely on bank credit to a greater extent than established firms.

I realize that this discussion of direct, selective controls on inventory credit has not included any suggestions on how the difficulties mentioned might be overcome. But I seriously doubt that there is anything constructive to offer with respect to administrative controls of this type. The problem remains, of course, of inventory fluctuations and their effects on the business cycle. Effective use of available tools of monetary policy can assist in

moderating these swings, as can appropriate fiscal and Federal procurement policies. Also helpful is the continuing development of accurate, detailed and prompt statistics on inventories and related factors. These will enable individual businessmen to assess more accurately the output and inventory investment decisions of their customers and suppliers and hence help diminish destabilizing movements in their own output and inventories. The effort of your associated subcommittee on economic statistics has contributed importantly to this objective.

But by far the most important influence on inventory investment is the character of the economy and business expectations regarding the future course of events. Basically, our attention should be focused on means for shaping that character and these expectations in ways that encourage vigorous, stable and sustainable patterns of economic growth. Continuing progress toward this objective should do much to moderate cyclical swings in anticipations and hence in inventory investment.