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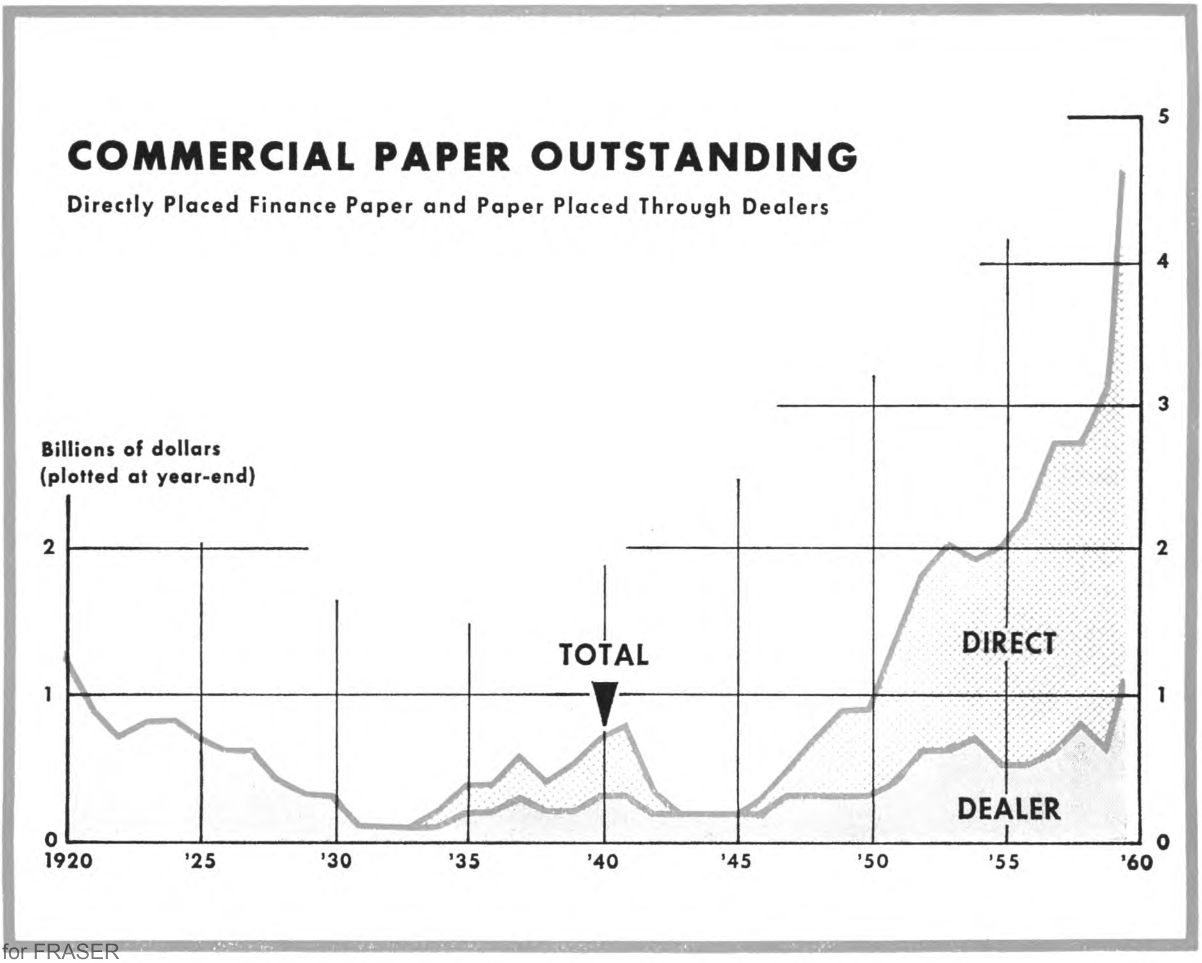
IN THIS ISSUE

Use of Commercial Paper to the Fore....3

Notes on Federal Reserve Publications...9

New Year in Autos..................10



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Use Of Commercial Paper To The Fore

The term commercial paper has been used traditionally to describe the various types of short-term credit instruments issued by business and banking firms to raise funds. In recent years, however, the term has been employed more and more to mean specifically the short-term promissory notes issued by a relatively small group of business firms which borrow funds in the money market.

As the meaning of the term has tended to narrow, the use of commercial paper to raise funds has increased markedly. Over the entire postwar period, following the wartime episode when the use of commercial paper had been reduced substantially, the amount of commercial paper outstanding has climbed to a level which is nearly four times as great as the prewar record level reached in 1920. Moreover, in 1960 alone the amount of commercial paper outstanding has increased by more than $1.5 billion, reaching a total of $4.6 billion as of the end of July.

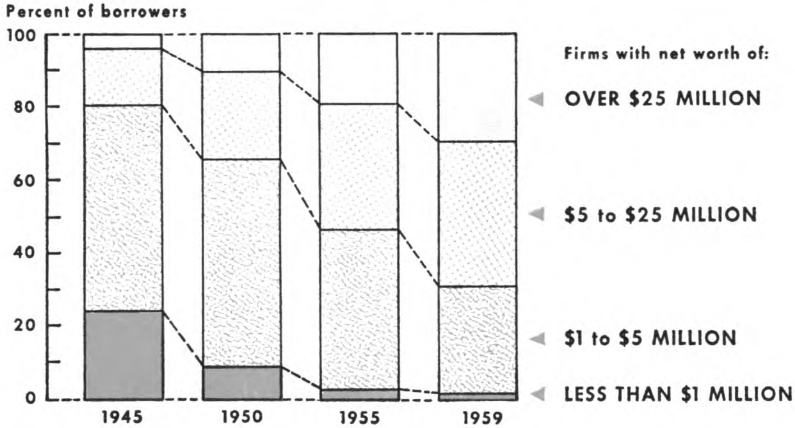
The commercial paper market, as defined above, is the oldest of the various segments of the short-term money market. Although the market can be traced in financial history as far back as the early 1800's, it developed essentially the present form early in the twentieth century. Then, as now, business firms, which are rated highly by the market, obtained short-term funds by issuing unsecured notes on a discount basis through a small number of commercial paper dealers. The maturities of the unsecured notes have usually ranged from four to six months, although, currently, some are as short as five days while others run over nine months. The denominations of the notes vary, but they are for the most part in multiples of $5,000.

One of the more significant developments in the postwar commercial paper market, as compared with the market during the early part of the century, has been the marked growth in the amount of commercial paper placed directly with investors by some of the large sales finance companies. During the 1920's and early 1930's all borrowing and lending by major industrial concerns that was carried on in the commercial paper market was done through commercial paper dealers. The introduction of directly-placed paper took place in the mid-1930's. After making fairly sizable inroads, the amount of directly-placed commercial paper was reduced to virtually nothing during the abnormal credit situation of the war period. Since 1945, however, finance paper placed directly with investors has moved into prominence in the commercial paper market, amounting currently to more than three times the amount of paper placed through dealers.

The rapid postwar growth in the commercial paper market, and especially the more recent expansion, has paralleled the growth in the demand for working capital on the part of business firms. Since the market is not generally considered a source of permanent working capital, borrowers use it mainly to supplement short-term bank loans in meeting peak seasonal and cyclical needs. On the other hand, the sales finance companies that are active in the directly-placed market, in order to satisfy a growing, yet highly flexible, demand for their services, have tended to tap the market more or less continuously.

The extent to which firms have been able to satisfy their working capital demands by selling commercial paper has, of course, depended upon the supply of funds available in the market at any one time. During the 1920's, commercial banks were the major suppliers of funds in this market, holding about 90 percent of the amount outstanding. Country banks and small city banks, in particular, held a large volume of commercial paper as secondary reserves.

NET WORTH OF COMMERCIAL PAPER BORROWERS
(4 selected years)



Source of data: National Credit Office, New York, N. Y.

In the past several years, although banks have continued to acquire commercial paper, there has been a large-scale entry of new types of purchasers. Recent purchasers include such diverse groups as non-financial corporations, pension and trust funds, insurance companies, and college endowment funds. Of these, nonfinancial corporations are estimated to hold over 50 percent of outstanding paper.

The continuous growth in the liquid funds of these groups, which has provided a major portion of the supply of funds to the market, has been an important factor in the postwar growth, as well as in the very recent expansion, of the use of commercial paper.

As a result of the influx of new buyers, one of the striking features of the present commercial paper market is that it is increasingly becoming a market in which various institutions in competition with the banking system are meeting part of the short-term demands of business firms.

Fewer Borrowers in Dealer Market

From a relatively low level, at the end of the war, the amount of paper placed through dealers, which represents now a minority of the commercial paper market, has recovered to the extent that its dollar volume is now approximately at the level of 1920 when all commercial paper was placed through dealers. In striking contrast to the postwar expansion in dealer paper, however, has been the sharp drop in the number of borrowers in the market. In 1959, only 335 qualified firms offered paper through dealers, as compared with nearly 4,400 during the 1920's. Since borrowers have not numbered more than 450 in any year in the postwar period, the greatest portion of the decline in the number of borrowers obviously occurred prior to World War II. It is thus significant that the entire expansion since 1945 in outstanding dealer paper has originated from less than one-tenth of the number of firms selling paper during the 1920's.

During the postwar period, there has been a marked trend toward relatively larger firms using the market as a source of short-term funds. As shown in the accompanying chart, whereas 80.8 percent of the borrowers had a net worth of under $5 million in 1945, only 31.6 percent had a net worth of under $5 million in 1959. The trend cannot be attributed to short-term cyclical influences, since the movement toward the $5-25 million and the over-$25 million classes has taken place steadily throughout the postwar period.

The nature of the dealer commercial paper market is such that only large firms which have impeccable credit ratings and which are well-known to investors can sell commercial paper. At present, ten dealers purchase the unsecured promissory notes of business firms. Since dealers do not endorse the notes when purchased and since holders may wish to dispose of the notes before maturity, the name of the company must largely sell itself. Furthermore, notes are sold with the provision that investors can return them if they are not satisfied with the firm's record. As may be expected, however, losses have been practically negligible.

Although investors in the commercial paper market are located throughout the United States, as well as in some foreign countries, particularly Canada, borrowers in the market have been concentrated near the money market centers of New York and Chicago. Historically, about 80 percent of the borrowers have been located in the eastern half of the United States.

Despite the decline in the number of borrowers in the commercial paper market, a considerable variety of borrowers continues to be represented. As shown in the accompanying chart, the principal classifications of borrowers include manufacturers, finance companies, wholesalers, and retailers. During 1959 manufacturers and finance companies, combined, comprised about three-fourths of the total number of borrowers. The manufacturers group included food and related products, textiles, and metal products; automobile finance companies accounted for the major part of the financial classification.

Although requirements for issuing commercial paper are relatively rigid, the market does provide an important alternative source of funds for seasonal and cyclical needs for qualified firms. In addition, there is a prestige factor which apparently tends to enhance the firm's ability to borrow in the long-term end of the market.

COMMERCIAL PAPER BORROWERS ACCORDING TO INDUSTRIES 1959

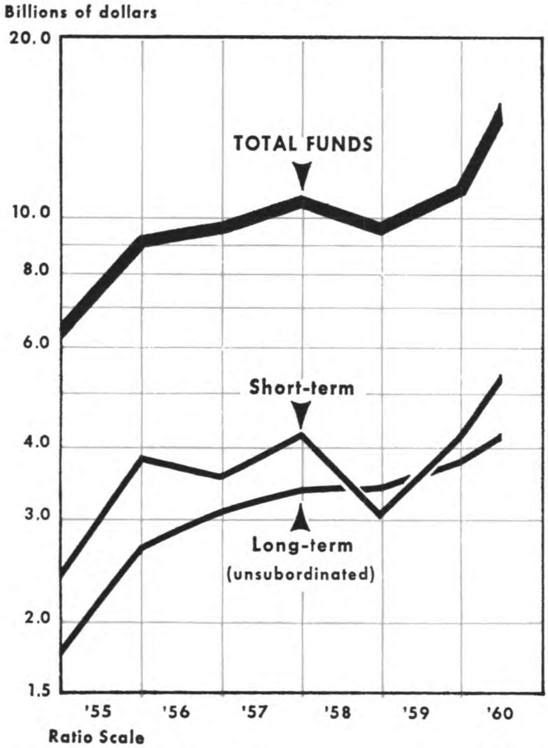
Source of data: National Credit Office, New York, N. Y.

Another factor in the use of commercial paper as an alternative source of credit has been the statutory ceiling on bank loans to a single large borrower. Because of the rapid growth in financing needs, many major industrial concerns have found themselves at the legal maximum of commercial banks. Further expansion of loans from commercial banks is thus realizable only through resort to additional banks.

Role of Finance Companies in the Directly Placed Paper Market

During the postwar period, the directly-placed commercial paper market has steadily expanded to become an important source of short-term funds for the large sales finance companies. In addition, an exceptionally rapid expansion in directly-placed paper began early in 1959.

MAJOR SOURCES OF FUNDS OF SALES FINANCE COMPANIES
(end-of-year)



Note: Other, but relatively less important, sources of funds include capital accounts, subordinated term debt, and other liabilities.

Changes in total funds employed by sales finance companies during recent years have largely taken the form of changes in the volume of short-term credit.

With the entrance of one company in June of this year, there are now ten sales finance companies, including the four largest, which place commercial paper directly with investors. The finance companies borrowing short-term funds this way have developed their own staffs and facilities necessary for selling their paper more or less continuously to investors throughout the year.

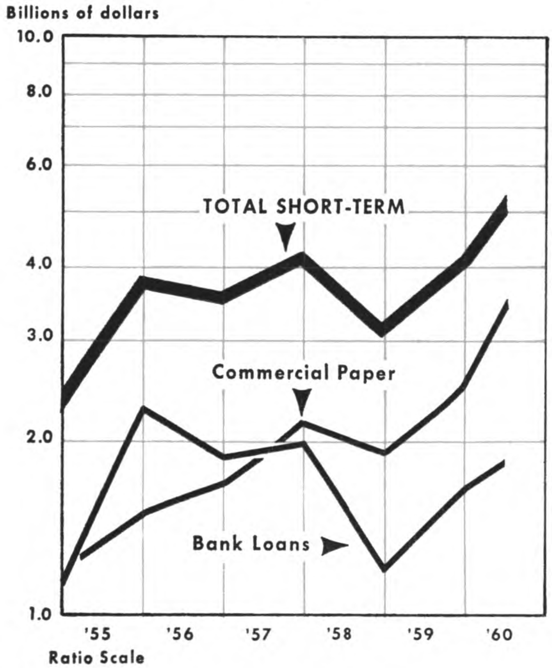
Since the end of the war, sales finance companies have been under constant pressure to meet the very large increase in the demand for their services. In order to meet such demand, which consists primarily of automobile dealer financing, the finance companies have relied heavily upon borrowed funds. The expansion in automobile credit has fluctuated widely from year to year. As a result, sales finance companies, in order to maintain some flexibility, have borrowed largely by means of short-term obligations.

Between the end of 1946 and the end of 1954, the large sales finance companies increased their use of bank lines of credit by nearly the same amount as their outstanding commercial paper. Beginning in 1955, there have been at least two periods when the use of commercial paper has increased markedly relative to the use of bank credit. Specifically, during 1955 and since the beginning of 1959, the relatively large expansions in demands for automobile credit have prompted additional use of commercial paper.

The sources of funds available to the sales finance companies, of course, include both short- and long-term borrowing, as well as capital accounts. However, the use of short-term credit has been the most flexible of the various sources of funds. This is shown in the fact that changes in the volume of short-term borrowing by sales finance companies have closely paralleled the course of the last two cyclical expansions of total employed funds in 1955 and 1959-60. (See chart.)

Direct placement of commercial paper has displayed a more consistent and less volatile rate of growth since 1954 than short-term bank loans. During the 1955 upswing in total employed funds, short-term bank loans grew more rapidly than commercial paper. (See chart on page 7.) However, in the more recent cyclical expansion, beginning in 1959, the rate of rise in the outstanding commercial paper of the sales finance companies equaled that of short-term bank loans, and at midyear in 1960 commercial paper outstanding was growing more rapidly. Moreover, the level of short-term bank lines in use during the recent expansion of auto credit has been somewhat less than at the end of 1955. Consequently, the directly-placed commercial paper of sales finance companies in June of this year was nearly twice as large

SHORT-TERM FUNDS OF SALES FINANCE COMPANIES
(end-of-year)



Of the two sources of short-term credit, commercial paper has shown a more consistent rate of expansion than short-term bank loans.

as short-term obligations with commercial banks.

Rates on Commercial Paper

The open market rates on commercial paper are relatively sensitive indicators of changes in the supply and demand for short-term funds. The open market rate is announced by major dealers on the paper of their prime borrowers. The rate has usually been from one-fourth to one-half percent above the Treasury bill yield, resulting in yield differentials which make commercial paper attractive to investors.

The prime commercial paper rate has usually been at least one percent below the prime rate charged by major commercial banks to their top-quality borrowers. The differential in this case offers interest cost savings to borrowers in the commercial paper market. However, the spread between the commercial paper rate and prime bank rate tends to understate somewhat the actual difference in cost of borrowing. Since commercial banks have set minimum balance provisions which require some proportion of the borrowed funds to be kept on deposit with the bank, the actual cost of bank funds available for use may be greater than the stated rate.

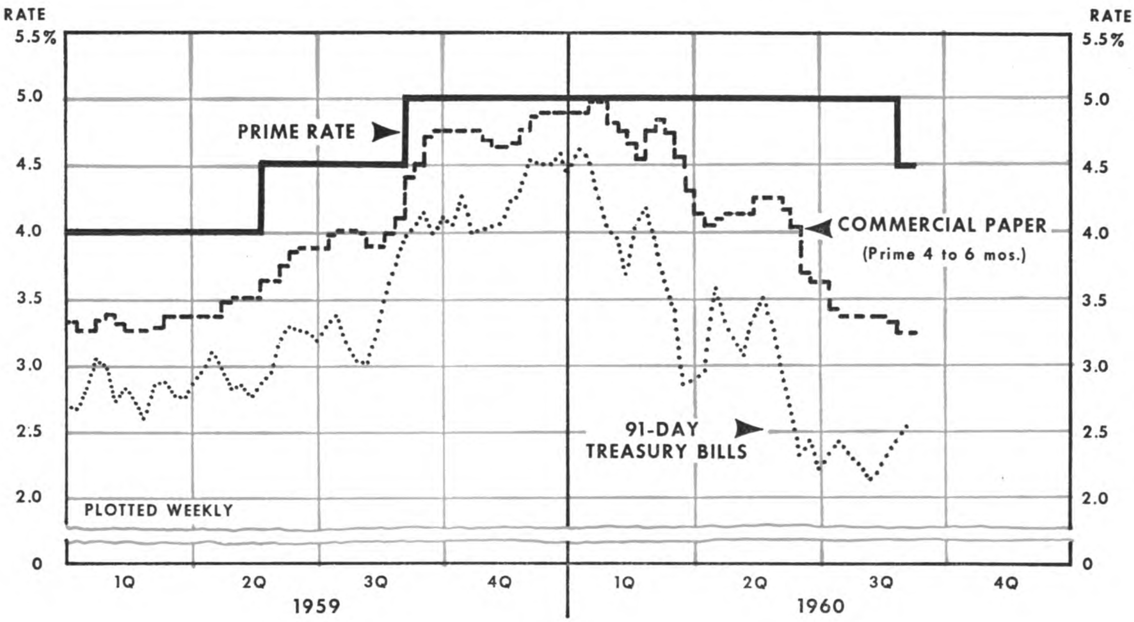
At the same time, however, the spread between the bank rate and the rate on commercial paper placed through dealers overstates the differential between the two rates in that dealers charge a commission, usually amounting, on an annual rate basis, to about one-fourth percent of the unsecured notes.

The directly-placed commercial paper rate of the sales finance companies has generally been slightly below the rate of borrowers in the dealer market. Although the sales finance companies in the directly-placed market publish their rates separately, changes in the rates of one company are usually closely followed by changes in the rates of the other companies. The offered rates are listed according to the maturity of the notes, and have usually a differential of 1.25 percent between the notes of five to twenty-nine days and those over nine months.

As shown in the chart on the next page, throughout 1959 the rate on commercial paper placed through dealers moved steadily toward the bank rate for prime borrowers. The average differential between the bank rate and the commercial paper rate moved from .69 percent in the first quarter of 1959 down to .23 percent in the fourth quarter, before lengthening to an average differential of .73 percent in the first seven months of 1960. Since the spread has customarily been about one percent, the cost of commercial paper relative to bank credit has been rather large throughout most of the period from early 1959 through July 1960.

Despite the increased cost of commercial paper relative to bank credit, the amount of outstanding paper grew rapidly during 1959

SELECTED SHORT-TERM MONEY RATES



and especially during the first seven months of 1960. During 1959, however, the increase in outstanding paper was due wholly to the directly-placed market of the sales finance companies. It was not until the beginning of 1960, when the demand for credit became more widespread, that the amount of outstanding paper placed through dealers expanded rapidly.

Commercial and industrial loans at member banks in leading cities rose about 2 percent, from $30.5 billion to $30.9 billion, during the first seven months of 1960. Contrasted with this is the rise in commercial paper outstanding placed through dealers, which amounted to about 80 percent (from $627 million to $1,116 million) during the January-July period of 1960.

One factor in the ability of major corporations to obtain funds in the commercial paper market has been the level of the rate on commercial paper relative to Treasury issues with comparable maturity. The average spread between the dealer paper rate and the Treasury bill rate during 1959 was .57 percent, but it averaged .97 percent during the first seven months of 1960, in contrast to the customary spread of one-fourth to one-half percent.

Seasonal Patterns in Data

One feature common to the firms which place their paper through dealers is the seasonal nature of their operations. For these firms, commercial paper serves as a source of funds to finance seasonally large inventories or a particularly large volume of accounts receivable. For example, large retailers, such as department stores, sell commercial paper to finance heavy inventories during the fall and Christmas seasons. Also, textile mills and food processing firms, such as flour mills, tap the market during harvest seasons to accommodate the large purchases of cotton and grain.

As evidenced by the monthly data on commercial paper placed through dealers, the amount outstanding increases at the end of the summer, rising to a seasonal maximum during November. Outstandings increase again during February, reaching a peak in

March, before declining through the summer months.

Since the large sales finance companies in the directly-placed market sell paper more or less continuously throughout the year, a relatively small amount of monthly fluctuation of paper outstanding might be expected. In fact, during the early part of the past decade, this was largely the case, since the amount outstanding rose consistently throughout the year and contracted sharply only during the month of December.

In the past few years, however, swings in the monthly magnitudes have become sharper. Downswings have occurred not only in December, but also during the months of April, June, and September. The timing of such seasonal downswings corresponds to the tax payment months of corporations. During these months, when corporations are less liquid, the finance companies increase their use of lines of bank credit, so as to satisfy continuing needs for relatively large amounts of short-term credit.

NOTES ON FEDERAL RESERVE PUBLICATIONS

Among the articles recently published in the monthly business reviews of other Federal Reserve banks are:

"The Outlook for U. S. Foreign Trade", Federal Reserve Bank of Chicago, September 1960.

"The Seaway and Iron Ore", Federal Reserve Bank of Minneapolis, August 1960.

"The Emerging Common Markets in Latin America", Federal Reserve Bank of New York, September 1960.

(Copies may be obtained without charge by writing to the Federal Reserve Bank named in each case.)

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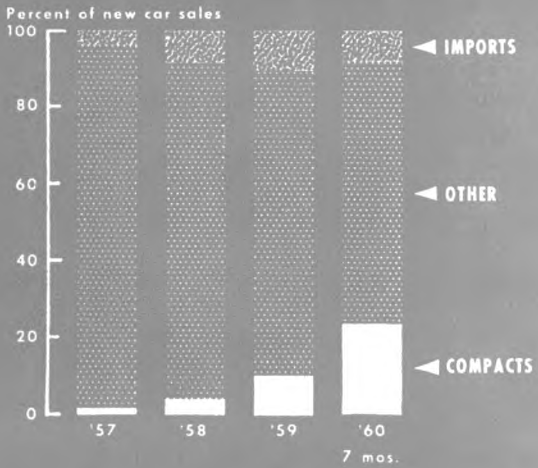
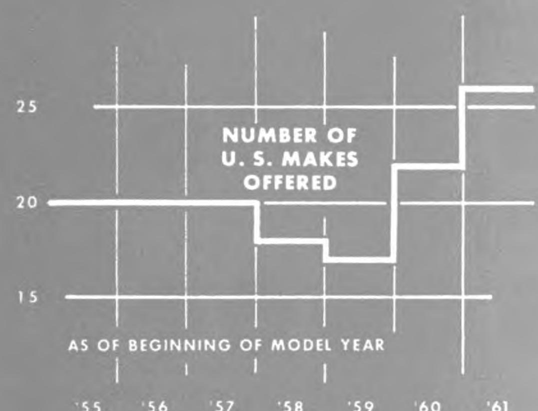
"The Seasonal Squeeze" is the title of a detailed special study of seasonal banking patterns in the Third Federal Reserve District. *Copies of the booklet are available without charge from the publisher, the Federal Reserve Bank of Philadelphia, Philadelphia, Pennsylvania.*

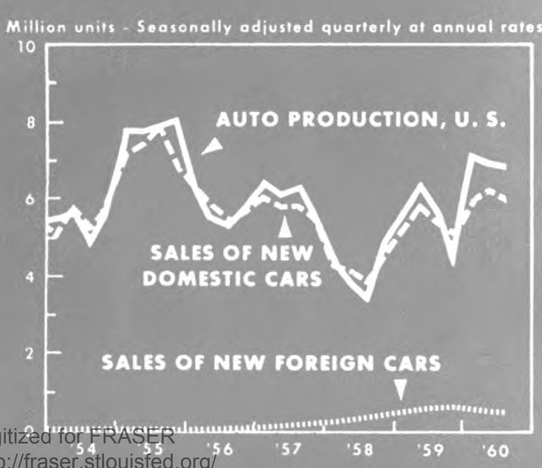
The changing pattern of consumer demand is reflected in the growing market shares of foreign makes and domestic compacts . . .



. . . as well as in the number of new domestic makes offered . . .



. . . stimulating interest in new cars which, so far this year, are selling at a rate second only to the 1955 high.



New Yea

THIS MONTH marks the opening of a new model year for the auto industry. Looking back, auto makers can view a fairly successful 1960 model run, but one that was characterized by shifting consumer preferences. As it embarks upon the 1961 model year, the industry is still in a period of transition.

One measure of the change in the pattern of auto demand is the number of individual makes offered. In the model year just beginning, 26 different nameplates will be featured as compared with only 17 makes at the beginning of the 1959 model run. The recent increase reverses the long-term decline in the number of makes offered, which reached a low just about two years ago.

The growing popularity of the compact car was largely instrumental in enlarging the number of makes available. Ten makes of compacts are among the 1961 domestic offerings as compared with only one compact in the 1958 model year. The rapid acceptance of these smaller vehicles is demonstrated by the fact that they accounted for one-fourth of the 1960 model production, when only six makes of compacts were produced. Also, sales of compacts through the first seven months of this year more than tripled from the same 1959 months.

Consumer acceptance of domestic compacts seems to have halted the rise in the popularity of foreign-made automobiles. Sales of imports have begun to slide, trailing the record year-ago level by 7 percent at mid-year, thereby ending the rapid growth in sales of imported cars which began about 1956. U. S. compacts also seem to have proven

n Autos

popular in world markets and have helped to reverse the declining trend in new car exports.

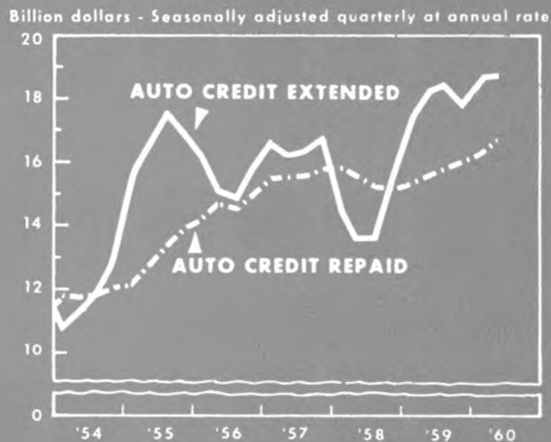
Total new car sales during the first half of 1960 were running at an annual rate of about 6.7 million units, with domestic makes selling at around the 6.2 million rate. During this same period, domestic output approximated a 7.0 million annual rate, tending slightly downward as the year progressed and as dealer inventories of new domestic makes reached record levels slightly in excess of 1.0 million units. It should be noted that new record levels in dealer inventories of the 1961 models might be expected, if sales hold near recent levels, since four additional compacts will be included among the new models.

The rapid rise in the compact's popularity has had several important economic ramifications. They require less materials per unit to produce, for example, which has caused some concern among the industry's suppliers. Also, they are somewhat less expensive to operate, traveling farther on each gallon of gasoline than many of the larger models. Of particular interest to bankers is the considerable impact that the compacts have had upon the price structure in the auto market and, consequently, upon the amount of credit needed to support a given level of unit sales.

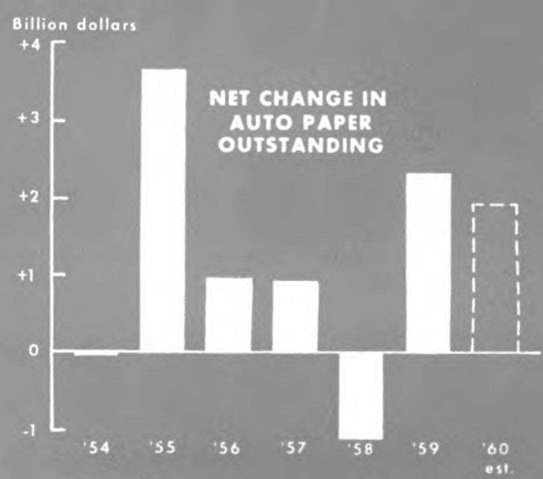
Official measures of factory list prices, which include only standard models and do not yet reflect the new compacts, decreased fractionally with the introduction of the 1960 models. Making allowance for the lower prices of the popular compacts would reduce the average factory delivered price by more than 5 percent. Also, coincident with the

Leveling of new car prices and a decline in used car prices, together with impact of lower-priced compacts (not shown in price chart) . . .

. . . help explain why new auto credit extended this year has failed to rise markedly, altho' repayments are up sharply . . .



. . . thus resulting in a much smaller net expansion of auto credit than last year, despite higher unit sales.



introduction of the '60 compacts last year, used car prices reversed a protracted uptrend, declining by more than 10 percent by mid-1960. Thus, average prices of both new and used cars have declined in the past year as production and sales rose to rather high levels.

There is evidence that the lower price structure has had some effect upon the amount of credit needed to finance automobile purchases. On new cars, for example, the proportion of the total number of cars which has been sold on credit so far this year does not differ significantly from the proportion for the similar 1959 period. Yet, the amount of credit extended to support a higher level of sales is about the same as last year.

The somewhat lower price structure, then, helps to explain why new credit extended to passenger car purchasers has not risen much above 1959 highs while sales have risen substantially. Repayments on outstanding instalment debt on automobiles have continued to rise through this period, however, along with the growth in auto paper outstanding.

The leveling tendency of credit extensions, taken together with the rise in repayments, is reflected in the decrease of nearly 20 percent in the net flow of new money into auto financing during the first seven months of 1960. (For comparative purposes, this percentage change is translated into an annual estimate in the final chart.) Thus, consumer demand for automobiles is not resulting in as much credit expansion as last year even though consumer purchases of cars are greater. While the change in consumer preferences is not the only factor involved, the auto buyers' acceptance of the new compacts certainly played a part in the lessened demand for credit.